Twin Peaks Regulatory Reform: Making the financial sector safer and better for customers

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Twin Peaks reform process to date

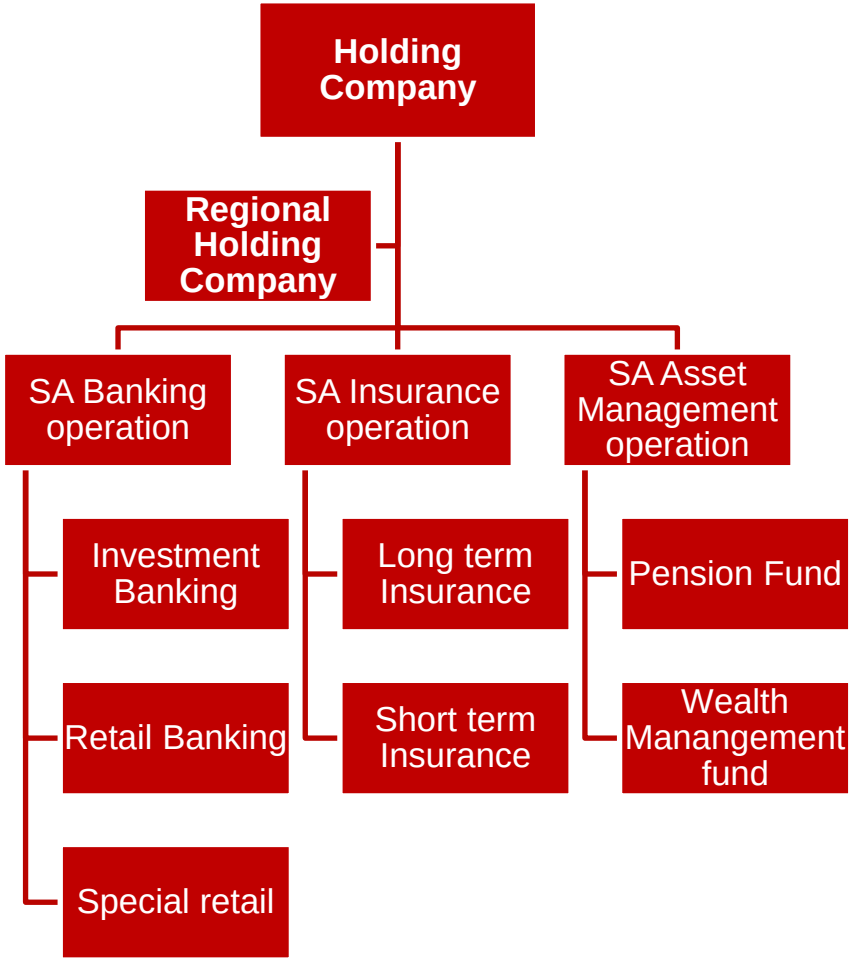
- **2011:** '*A safer financial sector to serve South Africa better*', approved by Cabinet
- **February 2013:** Roadmap – '*Implementing a twin peaks model of financial regulation in South Africa*'
- **December 2013:** **First** draft of the FSR Bill published
- **December 2014:** **Second** draft of the FSR Bill (with response doc & draft MCPF)
- **January – April 2015:** Consultation and comments processing
- **Next steps:**

Phase 1: Who regulates	Phase 2: How do they regulate
• Tabling revised FSR Bill in Parliament (target **June 2015**) • Establish new regulatory authorities (target **1 April 2016**)	• Conduct framework – draft legislation in **1Q 2016**

Regulatory challenges within SA

- Within SA, there are **too many regulators** involved with the financial sector
- Most financial firms are regulated by a number of financial regulators
  - Major banks in SA are regulated by SARB, FSB, FIC, NCR
  - This is because most banking groups do banking, credit, insurance, asset management etc
  - But each "activity" like deposit taking, lending, insurance, investment management regulated separately, each with own law → fragmentation means unlevel playing field, gaps, regulatory coordination compromised
- **Need for regulators to co-ordinate** and ensure that they do not contradict or work against each other
- How do we **prevent regulatory (forum) shopping?**
- Internationally this is even a harder problem – most of our banks operate in more than one country, so need regulatory co-operation between the different country regulators as well
- Concept of home-host regulators means SA is not the home regulator for two of our major banks and insurers

Complex and interconnected financial institutions



- Financial institutions increasingly involved in range of financial activities
- Multiple regulators involved (e.g. FSB, SARB, JSE, CIPC)
- Globally and domestically significant
- Systemically Important Financial Institutions – failure could trigger instability in wider financial system (domestically and globally)

Why do we need the twin peaks system?

Financial Stability / Prudential	Market conduct	Access to financial services	Combating financial crime
Need to strengthen **financial stability** • Reserve Bank to lead on macro-prudential (systemic stability) and micro-prudential (safety and soundness of institutions)	Need to improve **market conduct** • Much wider regulatory net, higher standards applied consistently across sector • Focus on outcomes incl. Treating Customers Fairly	Need to widen access to **financial services** • Treasury to lead • Financial sector code • Co-operative and dedicated banks, and Postbank • Introduce a microinsurance framework	Need to combat **financial crime** • Enforcement agencies to lead • Investigating and prosecuting abuses • Continued work with international partners

It is vital to ensure coordination and information sharing between regulators particularly in the face of an event that threatens systemic stability

"A safer financial sector to serve South Africa better" policy document is available at www.treasury.gov.za/twinpeaks

What are the 'peaks'?

Prudential Authority

- Promote & enhance the safety and soundness of financial institutions
- Assist in maintaining financial stability

Financial Sector Conduct Authority

- To protect financial customers by–
  (a) ensuring that financial institutions treat financial customers fairly
  (b) enhancing the efficiency and integrity of the financial system
  (c) promoting financial literacy and financial capability

Financial Services Tribunal and Enforcement

- Clear internal policies & procedures for administrative actions, including enforcement
- Enhanced transparency & accountability
- Tribunal will hear and decide appeals

Financial Stability

- Powers to SARB – stability standards, SIFIs, managing systemic risk/events
- FSOC - Inter-agency co-ordination of financial stability issues

What is the difference between PRUDENTIAL and MARKET CONDUCT regulation?

- **Prudential regulation** looks at the financial health and soundness of a financial institution
  - Focus is on financial institutions directly, to the indirect benefit of customers
  - Prudential regulators ensure financial institution can meet its commitments now and in the future
- **Market conduct regulation** prioritises the customers of a financial institutions and evaluates how financial institutions interact with customers and each other
  - Market conduct regulators must ensure that financial institutions are not abusing their customers
  - Regulators need to be PRO-ACTIVE and have to PREVENT the crime rather than only punish AFTER the crime
- Market conduct is more than consumer protection, as we expect higher standards from the financial sector

Prioritising BOTH Prudential and Conduct regulation

- Focus of financial regulators in SA has been on prudential objectives, too little emphasis on market conduct objectives
- Even current market conduct regulators do not focus on customers, but on others like intermediaries/debt counsellors from an access/service perspective
- Poor prudential AND conduct practices compromise customer and economic outcomes, hurting confidence and trust, and limiting the potential for sustainable growth
- Sources of conduct risk can differ to that of prudential risk, although poor conduct can affect prudence, and vice versa
- An integrated approach to regulation often results in one objective being prioritised to detriment of other
- KEY TWIN PEAK REFORM IS TO SET UP TWO SEPARATE REGULATORS, EACH DEDICATED TO ONE OBJECTIVE ONLY

The regulatory architecture - our universe today

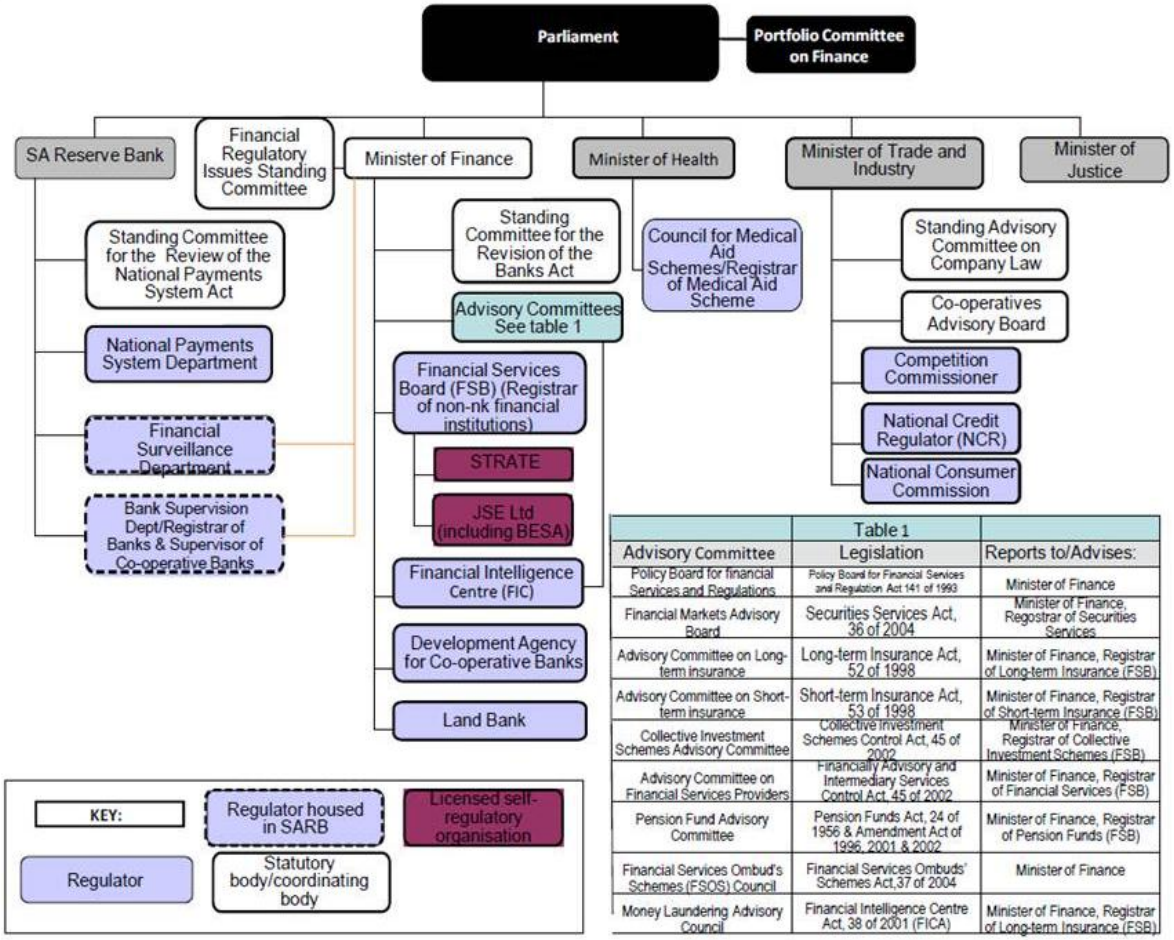
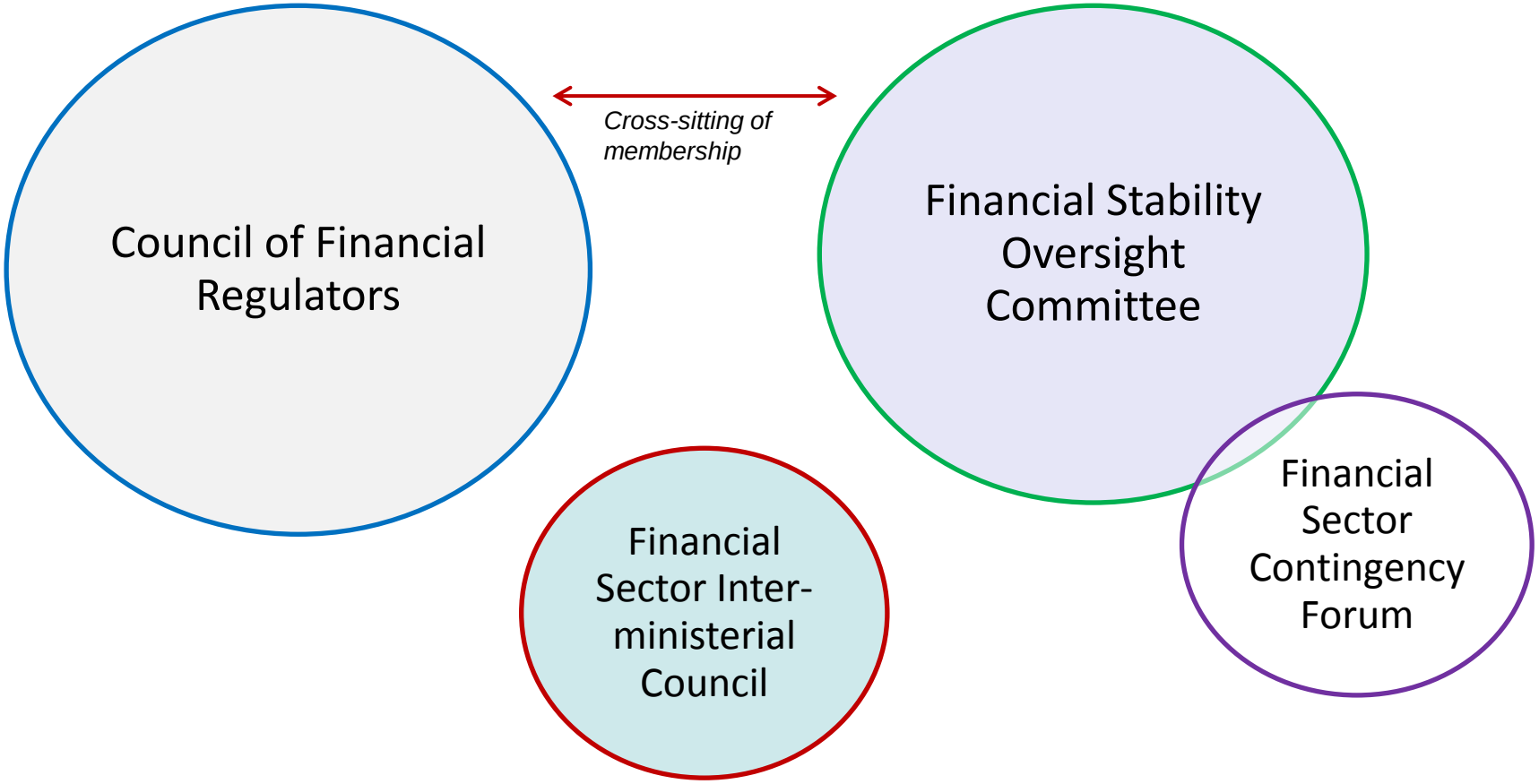


Table 1

Advisory Committee	Legislation	Reports to/Advises:
Policy Board for financial Services and Regulations	Policy Board for Financial Services and Regulation Act 141 of 1993	Minister of Finance
Financial Markets Advisory Board	Securities Services Act, 36 of 2004	Minister of Finance, Regostrar of Securities Services
Advisory Committee on Long-term insurance	Long-term Insurance Act, 52 of 1998	Minister of Finance, Registrar of Long-term Insurance (FSB)
Advisory Committee on Short-term insurance	Short-term Insurance Act, 53 of 1998	Minister of Finance, Registrar of Short-term Insurance (FSB)
Collective Investment Schemes Advisory Committee	Collective Investment Schemes Control Act, 45 of 2002	Minister of Finance, Registrar of Collective Investment Schemes (FSB)
Advisory Committee on Financial Services Providers	Financially Advisory and Intermediary Services Control Act, 45 of 2002	Minister of Finance, Registrar of Financial Services (FSB)
Pension Fund Advisory Committee	Pension Funds Act, 24 of 1956 & Amendment Act of 1996, 2001 & 2002	Minister of Finance, Registrar of Pension Funds (FSB)
Financial Services Ombud's Schemes (FSOS) Council	Financial Services Ombuds' Schemes Act,37 of 2004	Minister of Finance
Money Laundering Advisory Council	Financial Intelligence Centre Act, 38 of 2001 (FICA)	Minister of Finance, Registrar of Long-term Insurance (FSB)

Better co-operation and co-ordination between financial sector regulators



Twin Peaks and improved financial sector regulation

- **Increased regulatory coverage**, minimising potential for regulatory gaps
- Regulatory laws that are **complete, harmonised, integrated, proportionate**
- **Dedicated and equal emphasis** on monitoring stability, prudential and conduct risks in financial sector
- Enhanced oversight of **micro-prudential regulation** for banks, insurers, financial markets, special focus on conglomerates
- **Increased focus on outcomes**, especially fair customer treatment
- **More efficient use of supervisory capacity,** strengthen risk-based approach
- **Strong and swift action** for contraventions

Twin Peaks and improved financial sector regulation

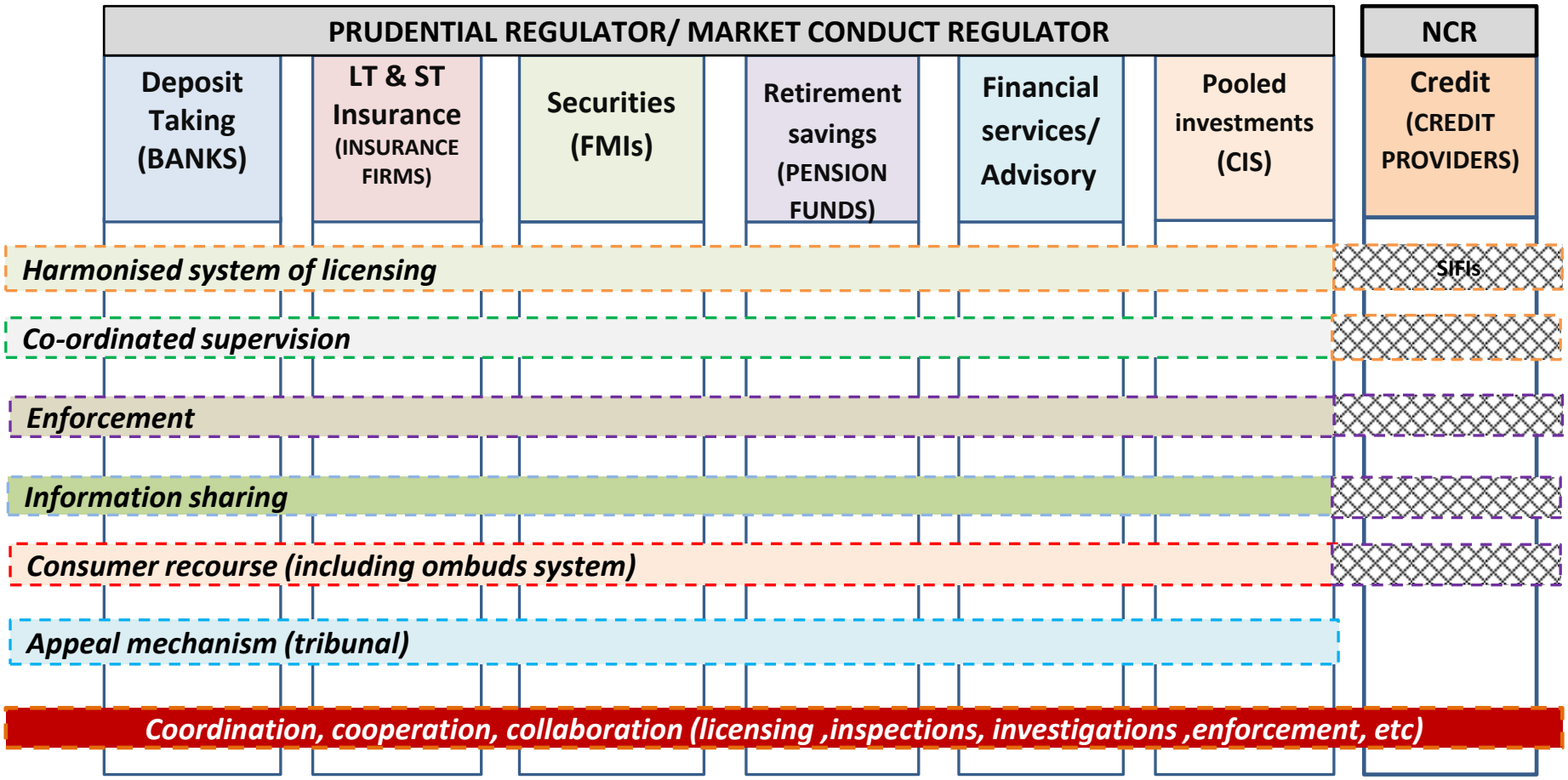
- **Better financial sector regulators**
  - Focused areas of supervision, minimised opportunities for regulatory arbitrage
  - Proactive, pre-emptive regulators who prevent problems rather than respond to them
  - Intensive, intrusive, risk-based approach to supervision; visible enforcement
  - Better cooperation and coordination among regulators

- **Better financial institutions**
  - Financially sound institutions regulated in line with international standards
  - Institutions operate on a level playing field ito regulation
  - Institutions entrench a culture of achieving positive economic and customer outcomes

- **Improved customer experiences**
  - Financial customers are treated fairly at all stages of interaction with financial institutions, from marketing to sale and post-sale treatment

A harmonised system of regulation

- Twin Peaks is a comprehensive and coherent system going beyond the setting up of the "twins"



MARKET CONDUCT FRAMEWORK

Goals of improved market conduct

- Level playing field, where regulatory requirements are **based on the financial activity** performed

- Shift culture of regulator and industry to **proactively and intensively focus on outcomes** and the **spirit of the law** rather than mere compliance – institutions should see fair customer outcomes as inherent to business operations; regulator FORWARD looking

- Law should **use principles** and rules, with **structural intervention where necessary** eg. RDR

- **Strong and swift enforcement** for contraventions, **increased emphasis on remedial action** including **consumer redress i.e. not just fines** – poor customer treatment should expose management/shareholders

- Strong, easily accessible **dispute resolution channels** with consistent approaches to resolving customer disputes

Chapter 1 – the problem statement

- *Market conduct considers how persons involved in the financial sector* ***conduct themselves and their businesses*** *in relation to* ***clients, customers, and each other****, with a* ***focus on fairness and integrity*** *(p. 10)*

- History of bad service: Competition Commission Jali Enquiry, poor pension fund administration ('bulking'), crippling early termination penalties (Statement of Intent)

- Current conduct challenges (Table 1.1) highlights:
  - Insufficient focus on customer needs
  - Many conduct challenges common across the sub-sectors, while others are unique
  - In some instances deep structural problems
  - Abusive practices exist where there is regulatory coverage

- Regulatory siloes impede reform (Figure 1.1 p. 15)

- Financial customers not sufficiently empowered (Figure 1.2)

High costs in retirement industry – Lerato's story

- Lerato invested in a retirement annuity 25 years ago, and decides to review its performance as she approaches her retirement age. The RA seems to have been a poor performing investment, and Lerato wants to compare its performance against other investments
- Lerato asks the insurer for a breakdown of all costs incurred on her investment. Instead, she receives a general response and marketing material from the insurer. She isn't sure that the information disclosed explained the poor performance of her RA. However, when she asks for more information, the insurer invites her to meet with their actuaries for a proper explanation, and says that she would need a sound knowledge of actuarial science too
- An actuarial friend shows Lerato that the real fee "killing" her investment was not the administrative fees charged by the insurance company, or even the commission paid to the broker, but the fee charged by the manager of the fund investing the balance of her annual premium after costs.
- When Lerato tries to move the poor performing policy to a more competitive provider, she discovers that doing so would incur even more financial loss, due to the early termination penalties

RETIREMENT SAVINGS: Questions to consider

- What information was disclosed to Lerato when she bought the RA? Did she understand how different charges might affect the growth of the investment? Why did she not receive sufficient ongoing information during the life of the investment to enable her to judge sooner whether it would deliver on her expectations?
- When she requests information, is the insurer understanding and responding to Lerato's needs?
- Is it fair that ordinary consumers need to be actuaries to be able to evaluate their policies?
- How can financial customers hold institutions accountable for poor treatment?
- How can disclosure better support policyholder capability? Should disclosure of charges be standardised?
- Can increased portability support increased competition and drive better value retirement products?

Chapter 2 – what is market conduct regulation, how does it protect better protect customers?

- *A financial sector that **conducts itself with integrity**, in the **interests of real customer needs** rather than just those of management or shareholders, **promotes confidence in the sector by delivering better outcomes for customers and the economy**.*

- **Generic consumer protection laws not sufficient** to protect financial customers.

- Complicated, complex products may take a long time to complete (e.g. pension products), sector **concentrated and interconnected** (Box 2.1, p. 20)

- **Much higher standards of business conduct and customer protection must apply**

- From a customer perspective consider:
  - Are **bank accounts** meeting customer needs?
  - Are households being **discouraged from saving** by an inefficient, customer-unfriendly retirement industry?
  - Why are households **burdened with high levels of debt**?
  - Is the **insurance industry doing enough** to help the average South African manage day-to-day risk?
  - Are customers sufficiently **empowered to hold financial institutions to account**?

A spiral into overindebtedness – Edward's story

- Edward takes out a loan backed by his pension fund to construct rooms on his house. However he uses the money as a deposit for a car instead, with a loan that has with a balloon payment and 7 year repayment plan
- He and his wife Thabina spend a large part of their income servicing this loan, and their retail store cards. Thabina also has a credit card which she uses to the limit and makes minimum payments on every month
- The couple is scrapping by on their income. Then, Edward gets retrenched, and the value of his pension is insufficient to cover his pension-backed loan. They can no longer afford to make repayments on the car and their other accounts. Thabina takes out a pay day loan, but this only puts them deeper into debt
- They avoid their debtors, and get deeper into arrears. Thabina resigns from her job to access her pension to pay school fees and try and repay some of the loans. The couple doesn't know about any credit insurance on their loans that may cover them in event of retrenchment. As they avoid the problem, their debt burden grows…

CREDIT: Questions to consider

- Should there be mechanisms to ensure pension-backed loans are spent on houses and home improvements?
- Balloon payments and longer terms reduce the instalment amount but increase the overall cost of the credit to the consumer. Should this be better regulated? Should the relationship between car dealers and banks be regulated to ensure fair competition and treatment of financial customers?
- Do retailers properly assess the credit worthiness of customers before issuing store cards?
- What “triggers” could be developed to help financial institutions better monitor their customers’ financial well-being?
- Where will the over-indebted consumer get advice? Is there a need for a government-sponsored financial wellness centre to assist consumers with generic advice?
- Should emolument attachment orders be allowed for credit agreements?
- Should credit providers provide well-known and less hostile mechanisms for customers to approach them and make arrangements to settle their debt? Why are so many consumers unaware of their credit insurance cover?

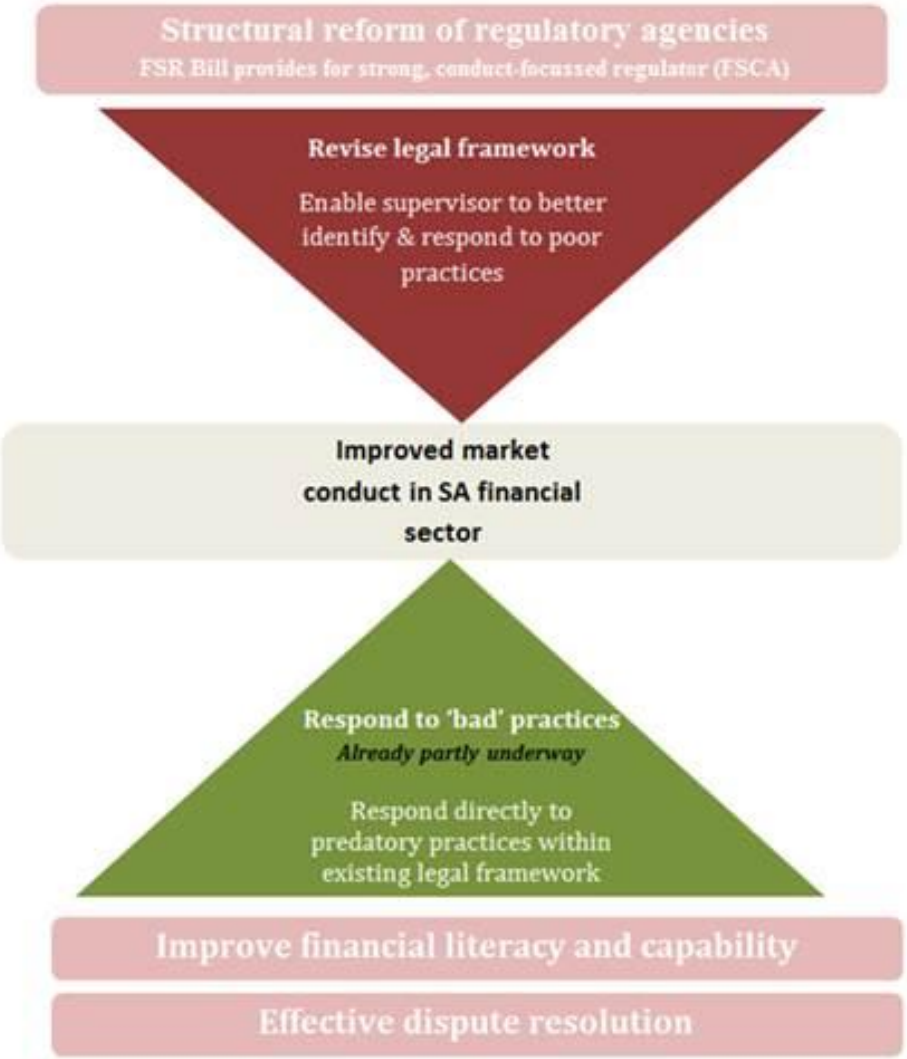
Twin peaks and the new breed conduct regulator

- Twin peaks the foundation for **better conduct, better outcomes**

- **New breed of conduct regulator** - governing principles (Figure 2.3 page 29):
  - Transparent
  - Comprehensive and consistent
  - Outcomes based
  - Risk-based and proportional
  - Pre-emptive and proactive
  - Credible deterrent to misconduct
  - Aligned with applicable international standards

- Consider motor car insurance example p. 30-31

Chapter 3 – strategy underpinned by consolidated and harmonised market conduct law



Simplified legal framework

- Transitioning to the new framework – Figure 3.2

- **Proposed legal framework** to include:
  - Clear definition of the regulatory perimeter
  - Licensing and authorisation of all persons providing financial products and services
  - Outcomes focused approach
  - Flexible and broad subordinate regulatory powers
  - Powers for gathering regulatory information that support pre-emptive outcomes-driven supervision
  - Strong and flexible administrative action and enforcement powers

- Complexities of regulating the **wholesale market**

Chapter 4: Accelerated, intensified industry interventions now

1. **Saving:** Targeting poor conduct practices that compromise savings, especially saving over the long term for retirement. Action plan will work toward:
   - Better governance of retirement funds – investment decisions should be made in the interests of members!
   - Enhanced comparability and value of investment products across the sector e.g. product standards (ban early termination charges), KIDs, FULL cost disclosure
   - Distribution models that better serve the interests of consumers (RDR)

2. **Borrowing:** Confronting unscrupulous lenders, relieving over-indebted households. Action plan:
   - Short term: investigate Emolument Attachment Orders (EAOs), provide financial wellness training, voluntary debt mediation
   - Medium term: clear affordability criteria, standards for EAOs
   - Longer term: strengthen debt collection law, payment system standards, price caps, investigate insolvency arrangements, ensure credit suitable and affordable

Chapter 4: Accelerated, intensified industry interventions now

3. Transacting: Introducing conduct regulation of retail banking (including payment system effects). Action plan:

- Product simplification! Disclose account fees and charges in a way that can compare!
- Improve contestability
- Conduct standards to apply the TCF principles to retail banks, with a particular focus on debit order practices
- Monitor banks' delivery against financial literacy, capability and inclusion targets in the Financial Sector Code.

4. **Managing risk:** A strategy towards insurance risk products that better protect policyholders. Action plan will focus on:

- Product standards, common terminology – what is "comprehensive" cover??
- Disclose right information at the right time in a digestible way – lower premiums generally mean less cover (ie more exclusions!) and/or bigger excess, customers "bullied" through disclosure
- RDR
- Outsourcing does NOT relieve insurer of client responsibility
- NO underwriting at claims stage

Chapter 5: Implementing TCF across the financial system

- **TCF**
  - Governance – customer culture the responsibility of executives, not compliance officers
  - Harmonised **disclosure** framework should give customers the right information at the right time to compare value and suitability
  - The **Retail Distribution Review – structural interventions required?**
    - Triangular relationship between product provider, intermediaries and customer creates inherent conflicts of interest; who does intermediary represent?
  - Improving **internal complaints mechanisms – LEARN from customer experience**
  - Revised **competency framework** for intermediaries

Insurers not putting customers first – Thandi's story

- Thandi buys her first car and contacts an insurer, wanting a simple insurance policy to cover her for theft, accidents and damage. She is the first person in her family to take out motor insurance
- She receives the policy contract from the insurer only after agreeing to the cover. The contract is full of legal terms that are difficult to understand, and doesn't seem to correspond to her interaction with the telesales agent.
- Although Thandi's policy is described as comprehensive, when she tries to claim for hail damage, she finds out that this is not covered by her policy. Then, when someone reverses into her car, her entire claim for repairs is rejected because she had scratched her car 6 months ago and didn't know even minor damages had to be reported. Thandi doesn't know who to complain to about the rejected claim
- Thandi's insurance premium isn't lowered even though her car's value has depreciated. The insurer lowers the premium only after she threatens to switch to another insurer.

INSURANCE: Questions to consider

- Can TCF promote a more customer-centric approach, especially in product design and claims practices?
- Would more simple and standardised disclosure documents, with standardised policy wording (e.g. what is defined as comprehensive), assist in making comparisons with other products easier?
- Should insurers better verify information upfront during the sales process to determine the customer's risk profile, rather than making a quick sale and only assessing risk at claims stage?
- Will a new complaints framework support a more customer-friendly and fair mechanism?
- Will TCF motivate insurers to focus on how to proactively offer better value over the life of a policy?
- Will stricter requirements around pricing, product design and disclosure of product features and claims ratios support CCI products that better serve borrowers?

Chapter 6: An integrated ombuds system

- Foundations of an ombud system based on:
  - Independence
  - Impartiality
  - Confidentiality
  - Openness and transparency
  - Accountability
  - Integrity
  - Clarity of purpose
  - Effectiveness
- Problems which have been identified with the operation of the ombuds schemes include (Fig 1.2 p 17):
  - A general lack of knowledge by consumers about ombud schemes
  - Inadequate transparency and accountability of ombuds
  - Jurisdictional boundaries of the various ombuds and customer confusion
  - The need for greater coordination and consistency between ombuds.

Empowering financial customers, market integrity

- **Chapter 7: Strengthening financial literacy and capability**
  - FSCA will have mandate to drive **financial education**. Will continue work of the National Consumer Financial Education committee

- **Chapter 8: Enhancing the efficiency and integrity of the financial markets**
  - Two options being considered for integrating financial market oversight into conduct framework: incorporating FMA and CRS or retaining as separate

Questions