A safer financial sector to serve South Africa better

Summary presentation

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A Safer Financial Sector to Serve SA Better

- Released on Budget Day 23 February 2011, available on www.treasury.gov.za under 2011 Budget docs
- Aims at making the financial sector safer, by tightening prudential regulations
  - Shift towards twin peak model for regulating the financial sector
  - System-wide macroprudential supervision in addition to strenghthening prudential and market conduct regulators
- Aims at improving market conduct and protect the consumer better
- Aims at broadening access to the financial sector
- Aims at protecting the integrity of the financial sector
- Related publications included new Regulation 28 gazette to regulate investment framework for pension funds
- Related discussion docs on prudential regulation of foreign exposure and framework for cross-border direct investment – public comments by 30 April
- Related tax policy changes as they affect tax deductions towards pensions and retirement annuities, expanding list of living annuity providers, provident funds

Overall purpose of the document is to outline financial reforms over the next few years

International commitments or discussions

- G20 and Financial Stability Board recommendations
- Implementation of Basel III and Solvency Assessment and Management (SAM)

South African issues

- Making the financial sector safer
- Uncompetitive, opaque and fee-dependent financial services
- Need to broaden access and ensure Charter is appropriate
- Coordinated approach to tackling financial crime

The document outlines proposals along four priority areas

Financial Stability	Consumer protection	Access to financial services	Combating financial crime
• Reserve Bank to lead • Establish a Financial Stability Oversight Committee	• Financial Services Board and National Credit Regulator to lead • New market conduct regulator for banking services in the Financial Services Board	• Treasury to lead • Further support to co-operative and dedicated banks, including Postbank • Treasury to introduce a microinsurance framework	• Enforcement agencies to lead • Investigating and prosecuting abuses • Continued work with international partners

Council of Financial Regulators

Ensures coordination where necessary

Chapter 2 sets out the lessons from the crisis and how we plan to strengthen stability

- Key lesson from the crisis → take a *macroprudential* or *system-wide* approach to financial sector regulation
- **Analyse** the impact of economic imbalances, asset price bubbles, rapid credit growth and procyclical regulations on the financial sector
- **Respond** by using a mix of traditional macroeconomic and financial sector tools: e.g. interest rates, capital reserve requirements, asset risk-weights
- Focus is on supporting financial stability and countercyclical economic policy
- Stronger prudential requirements in banking and insurance

Chapter 3: Strengthening the regulatory framework

A set of principles guide the approach

- All financial service providers must be appropriately licensed or regulated;
- Regulation and supervision must be transparent and sufficiently intense, intrusive and effective
- Regulators must operate objectively with integrity and be operationally independent, but must also be accountable for their actions and performance
- Regulations should be of universal applicability and comprehensive in scope in order to reduce regulatory arbitrage
- The regulatory framework must include responsibility for macro-prudential supervision
- Market conduct oversight must be sufficiently strong to complement prudential regulation, particularly in the banking sector
- Financial regulators require emergency type powers to deal with a systemic financial crisis requiring strong and overriding legislative powers

Proposals to strengthen the financial regulatory system (1)

1) **Move towards a "twin-peak" model of financial regulation**
   - Joint NT, SARB and FSB task team to examine and propose how best to move towards twin peaks
2) **Strengthen the operational independence, integrity and accountability of all regulators**
   - Heads of regulators should be appointed for a fixed term of five years
   - Heads of regulators must be protected from undue pressure and interference.
   - Regulators should be funded appropriately
   - Regulators must be appropriately accountable for their performance
   - Governance structures to be reviewed so that boards perform only governance functions
3) **Expand the regulatory system to include macroprudential supervision, and establish an interagency Financial Stability Oversight Committee**
   - SARB best placed to be macroprudential supervisor
   - FSOC responsible for coordinating on financial stability issues, mitigating the risk of any crisis and resolution in the event of such a crisis.

Proposals to strengthen the financial regulatory system (2)

4) **Strengthen market conduct supervision and the ombuds system**
   - Expand scope of FSB to cover market conduct in retail banking

5) **Clarify roles and responsibilities**
   - Legislation to be revised to reflect specific roles and functions (i.e. who is responsible for policy, legislation, regulation and supervision)

6) **Promote greater coordination and information-sharing between all financial regulators**
   - Council of Financial Regulators to be established to ensure a flow of information and coordination of regulation in areas such as enforcement, market conduct and legislation

7) **Increase the scope of regulation**
   - Many financial services are not regulated, self regulated or too lightly regulated, including money markets, private pools of capital, credit ratings agencies, stock exchanges, payments systems and disclosure and accounting standards

Proposals to strengthen the financial regulatory system (3)

8) **Public entities and funds operating in the financial system should not be exempted from legislation and regulatory standards that apply to the private sector**
   - Where there are exemptions they should be transparent, and subject to review on a regular basis.

9) **Improve enforcement capacity**

10) **Rationalise advisory and technical committees and enhance consultation processes with the industry and key stakeholders.**
   - Currently more than ten separate advisory bodies, standing committees and boards operating at the expense of the taxpayer.

"Twin peak" aims to give equal weight to prudential and market conduct regulation

Prudential Peak	Market Conduct peak

• Reserve Bank leads on macroprudential, microprudential and financial stability issues
• Responsible for:
  • Prudential regulation of banking, insurance
  • Assessing and responding to financial stability risks
  • Crisis planning
	• Financial Services Board leads on market conduct for financial services working closely with National Credit Regulator
	• Market conduct regulation of all aspects of financial services, including banking, insurance, advisory services etc.

Interagency review process will flesh out timelines, and decide how the prudential and market conduct aspects of certain activities will change (e.g. securities regulation)

As part of its comprehensive review, Treasury considered a number of alternative approaches

- **Institutional approach (China, Mexico, Hong Kong)**
  - The firm's legal status determines i) the regulator tasked with overseeing its activities and ii) the scope of its permissible activities
  - Drawback: Regulators often expand the scope of permissible activities - entities with different legal status end up engaged in similar activities but subject to different regulatory requirements
- **Functional approach (France, Italy, Spain)**
  - Supervisory oversight determined by the type of business being transacted
  - Drawback: It may be difficult to determine under which regulator a particular activity falls, giving rise to disparities in regulatory positions on similar activities
- **Single regulator/integrated approach (Germany, and until recently UK)**
  - A single universal regulator conducts both prudential and business conduct regulation.
  - Drawback: Likely to be conflict between prudential and market conduct regulation
- **Twin peaks approach (Australia, Canada and Netherlands)**
  - Separate regulators for prudential supervision and business conduct regulation
  - Designed to garner the benefits of the single regulator approach (regulatory consistency, jurisdictional clarity and informational efficiency) yet also address the inherent conflicts between prudential regulation and consumer protection.

See box 3.1 on page 29

Chapter 4 sets out proposals to protect consumers from market conduct abuses

Financial services industry is unique

Financial services industry should be held to a higher standard of market conduct than other industries for the following reasons:

- Loss of deposits or savings imposes immediate costs on consumers
- The underperformance or even failure of financial products such as retirement annuities may impose considerable hardship on consumers
- Quality or appropriateness of financial products such as life, property and income-protection insurance is only established some time after purchase or when a disaster occurs
- Many long-term financial contracts impose heavy penalties for cancellation and switching.

A gap in the existing approach is that banking market conduct is unregulated

- Twin peaks system of financial regulation with FSB as the market conduct regulator of financial services industry including banks
- Market conduct activities of FSB to include:
  - Developing principles on how banks should set their fees, how these fees should be reported and what constitutes fair and unfair
  - Implementing Treating Customers Fairly proposal with provision for intrusive supervision and specific interventions
  - Monitoring and addressing abuses in early termination penalties and commission paid upfront on investment products
  - Assessing whether consumer credit insurance protection is delivering on its objectives
  - Protecting consumers using funeral insurance and burial societies against unscrupulous operators

Additional components of the review

- Implement recommendations of ombuds system review including
  - Addressing the role of the Financial Services Ombudsman Scheme Council
  - Increasing awareness among consumers about ombuds and their role
- Improve consumer financial education
- Support activist consumer bodies and the setting up of online price comparison tools

Chapter 5 sets out proposals to safeguard pensioners and support savings

- **Mandatory preservation** - preservation is seen as critical and urgent to maximising savings and retirement income. To be accompanied by restricted withdrawals across all retirement funds and products.
- **Provident funds** - immediate step to dealing with post-retirement leakage is to treat provident funds similar to any other retirement fund.
- **Portability** - ability to keep accumulated pension benefits with former employer or to transfer to new employer will entrench preservation.
- **Enhanced disclosure and transparency** – to enable comparison of products, consider making it a statutory requirement that pension funds provide statements to members on a regular basis, with certain minimum disclosures. Guidelines on relevant information to be disclosed still under consideration.

Safeguarding pensioners and supporting savings

- **Trustee education and governance** – make it a statutory requirement that trustees be "fit and proper" with certain minimum qualifications, and potentially introduce a Code of Ethics for the retirement industry.
- **Consolidation of pension funds** (both public and private sector funds) - consolidation of pension funds critical to improved supervision and consumer protection.
- **RAs** - plagued by perceived high costs and lack of transparency.
  - annuity market to be reviewed with the objective of facilitating competition, reducing costs and improving transparency.
- **Living annuities** - expand the eligibility of living annuity provision to other intermediaries (e.g. Government Retail Bond Scheme and CIS).

As noted in Chapter 6, financial inclusion is a vital part of our efforts of inclusive economic growth

- How can the financial sector serve the poor better?
- Trade-off between inclusion, safety and financial integrity
- Ensure greater access to poorer South Africans, including availability of better and more viable products, cheaper banking, remittances, micro-insurance, credit.
  - Mzansi accounts
  - Small business finance, housing finance
- Implementing tighter access and transformation objectives of the Financial Sector Charter –some progress in resolving breakdown.
- Other current initiatives
  - Develop the co-operative and dedicated banks sector, Postbank
  - Formalise a micro-insurance sector
  - Develop, report, monitor national fin inclusion indicators and targets

A number of current initiatives will be taken forward

- Promote entry into the banking sector
- Introduce deposit insurance
- Develop the co-operative banks sector
- Strengthening and improving the governance arrangements of Postbank
- Formalise a micro-insurance sector that encourages entry of mutuals, cooperatives and other community-based organisations into the insurance sector
- Take forward Financial Sector Charter with increased focus on access targets
- Continue work with G20 Global Partnership for Financial Inclusion
- Develop, report and monitor national financial inclusion indicators and targets

Finally, combating financial crime requires a comprehensive solution

- Improve transparency in the financial system by requiring financial institutions to conduct due diligence on their customers/clients
- Increase the scope of regulation and improve enforcement capacity to respond to compliance failures
- To promote cooperation and information sharing locally and internationally
- Enhancing the integrity of primary information sources of identity information, and making these accessible to the financial and other institutions
- Curb abuses and laundering of proceeds of financial products to finance terrorism
- To enhance financial inclusion through low risk mechanisms requiring less-stringent customer due diligence measures
- KEY CHALLENGE – is our system sufficiently able to deal with those who abuse our system?
  - Accused stretch the legal system to get away with their crimes
  - How can we improve our current systems to deal with those with criminal intent?

Implementing twin-peaks model of financial regulation
Joint National Treasury, SARB and FSB task team

Financial Regulatory Reform Steering Committee

- promote, coordinate and drive initiatives for the implementation of the twin peaks regulatory framework
- formulate and implement financial stability measures to limit the cost of system-wide distress in the financial system

Working Group 1	Working Group 2	Working Group 3	Working Group 4	Working Group 5
Prudential regulatory supervision and resolution policy	Market conduct regulation	Economics of regulation	Legislative framework	Institutional framework and organisa-tional design

Conclusion

- Cabinet has approved shift to twin peaks and principles, and broad road map
- Public comments received on discussion papers on foreign exposure and cross-border investments
- Specific proposals and legislation will have normal consultative proposals (eg Financial Markets Bill, Credit Ratings Agency Bill, Financial Services General Amendment Bill, Banks Amendment Bill)
- Challenge of enforcement mechanisms – additional workgroup for consideration
- We have to act as we improve our system
  - SARB monitoring financial stability in the meanwhile

Thank you