Twin Peaks - Is it all uphill from here?

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The Financial Sector Regulation Bill

The Financial Sector Regulation Bill (the Bill), currently before parliament, is the first phase in implementing the Twin Peaks Retail Distribution Review (RDR) model, which essentially amounts to a regulatory overhaul of the entire South African financial services sector.

The Twin Peaks approach is aimed at anticipating and preventing financial crises while also protecting consumer rights by enforcing fair market conduct. The financial services sector will see a shift from fragmented regulation determined by industry type to consistent and universal regulation of all financial service providers, thus eliminating ambiguity and uncertainty particularly in niche or multi-disciplinary industries. However, during its sitting on 3 February 2017, the National Council of Provinces raised several concerns that need to be addressed before the enactment of the Bill.

One such concern is the fact that the Bill empowers each of the new regulatory bodies to establish and implement "regulatory instruments" with the effect of subordinate legislation. Following concerns raised by the National Assembly in 2016 about the extent of the powers granted to these regulators, the Bill has since been updated to stipulate that parliament must be consulted before regulatory instruments may be made. Section 102(1) of the Bill reads as follows:

"In deciding whether to make a regulatory instrument, the maker must *take into account* all submissions received by the expiry of the period referred to in section 98(2) or 100(2) and any deliberations of parliament."

Arguably, despite the above, the Bill may still have the effect of blurring the lines between the executive and legislative authorities. While makers of regulatory instruments are now obliged to consult with parliament prior to making any new regulatory instruments, it is unclear to what extent, if any, they will be bound by parliamentary submissions.

Concerns were also raised about the continued existence of the National Credit Regulator (NCR) as a separate regulatory authority tasked with the supervision and enforcement of the National Credit Act, thereby adding a third peak to the Twin Peaks model. Both the Financial Sector Conduct Authority and the NCR will be responsible for regulating the market conduct of financial service providers. This means that certain financial service providers will be subject to regulation by both authorities to varying and possibly overlapping extents based on the products they provide, which may result in the very regulatory arbitrage that the Bill aims to avoid.

While the first phase of the implementation of Twin Peaks is largely aimed at establishing the new regulators that will initially operate within the existing industry-specific regulatory framework, it also lays the groundwork for the second phase, which will comprise large scale legislative reform in order to establish a new regulatory framework across the financial services sector. The second phase will commence with the enactment of the Conduct of Financial Institutions Bill (CoFI) followed by various new pieces of industry specific legislation, including the new Insurance Bill, aimed at aligning these industries with the objectives of the Twin Peaks RDR model and Treating Customers Fairly (TCF) initiatives.

The new Insurance Bill

The adoption of the new Insurance Bill will further subject insurers, not only to more strenuous market conduct regulations, but also to solvency assessment and management (SAM) measures, modelled after European Solvency II regulations, aimed at protecting policy holders by ensuring that insurers are able to meet their financial obligations. Notably, SAM regulations also outline guidelines for assessing Solvency Capital Requirements (SCR) in the context of bancassurance structures that are becoming increasingly prevalent in South Africa.

The Insurance Bill makes provision for the Prudential Regulator to designate certain companies as part of "insurance groups" by virtue of belonging to the same group of companies as an insurer. The group solvency requirement of these companies is then, as a general rule, determined by applying the deduction and aggregation (D&A) method, which combines the individual capital requirements of each entity in the group and allows for certain adjustments and deductions in case of intra-group transactions.

The D&A method therefore effectively prevents the entities that make up insurance groups from double gearing or overstating their shared group capital to indemnify against risk and thus satisfy their individual solvency capital requirements on that basis. Once these measures are fully in place, certain financial service providers may come to find that the benefits of diversification no longer exceed the risks.

The Insurance Bill further aims to make insurance products more accessible to low income groups by regulating fee and commission structures, thus requiring insurers to strike a delicate balance between the cost of implementing an array of new measures and practices while keeping consumer costs at a minimum. Globally insurance companies have started to implement technologies like GPS, fleet management software, drones and smartphone apps with the aim of simplifying their processes and reducing costs in order to remain profitable and prosper despite their increased regulatory burdens.

However, implementation of similar regulatory measures in the United Kingdom in response to the 2008 global financial crisis still saw a drastic decrease in active financial advisors, whether as a result of regulatory teething problems, unsustainable fee structures or increased solvency and liquidity requirements to name but a few. Either way, the lesson to be learnt by South African financial service providers seems to be adapt or die.

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