INFORMATION FLOWS REGULATION SUPERVISION FINANCIAL
SECURITY COHESION GDP ECONOMIC GROWTH MACRO PRUDENTIAL
GLOBAL FINANCIAL CRISIS JOB CREATION POVERTY ALLEVIATION
FINANCIAL INTELLIGENCE 11 SEPTEMBER 2001 FINANCIAL INCLUSION
HIGHEST INTERNATIONAL STANDARDS ENHANCE OUR PARTICIPATION DEVELOPMENT
FINANCIAL CONTROLS MICROPRUDENTIAL PRUDENTIAL REGULATION REGULATION
REGULATORY ARBITRAGE REGULATORY CAPTURE REGULATORY FAILURE
REGULATORY RISK RESIDUAL RISK BALANCE OF PAYMENTS BANK
BASEL II AND III G-SIFIS BONDS BOUNDED RATIONALITY BRAND
BRETTON WOODS COMPETITIVE ADVANTAGE PROTECTIONISM EXCHANGE
CONTROLS MOBILITY GLOBALISATION HOT MONEY INVESTMENT
LIQUIDITY VOLATILE CAPITAL FLOWS DIVERSIFICATION ASSET PRICE BUBBLES
ADVANCED ECONOMIES INFLATION COST-EFFECTIVE LIBERALISATION
CONSUMER PROTECTION FINANCIAL SERVICES BOARD MARKET CONDUCT
NEW GROWTH PATH ROSC G-20 CAPITAL ADEQUACY FSB SYSTEMIC
RISKS FOREIGN CURRENCY FINANCIAL FREEDOM GOOD DEBT GOOD
INVESTMENT RESERVE BANK ROSC G-20 CAPITAL ADEQUACY
BONDS COMPOUND GROWTH BANK SOLVENCY II GREAT
DEPRESSION(1930)

A SAFER FINANCIAL SECTOR TO SERVE SOUTH AFRICA BETTER

FSB
EURO-ZONE RAND G-20
SUBPRIME MORTGAGES SECURITISATION SOVEREIGN FINANCES ECONOMIC
RECOVERY DEFLATION RISK-MANAGEMENT FOUR-PILLAR POLICY MONETARY
POLICY IMF WORLD BANK CREDIT DERIVATIVE HEDGE MARKET
FORCES MICRO PRUDENTIAL PRUDENTIAL REGULATION REGULATION
REGULATORY ARBITRAGE REGULATORY CAPTURE REGULATORY FAILURE
REGULATORY RISK BALANCE OF PAYMENTS BANK BASEL II AND III

national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

A safer financial sector to serve South Africa better

2011

National Treasury Policy Document

Republic of South Africa

23 February 2011

To obtain additional copies of this document, please contact:

Communications Directorate

National Treasury
Private Bag X115
Pretoria
0001
South Africa

Tel: +27 12 315 5698
Fax: +27 12 315 5126

The online version of the document corrects minor typographical errors in the printed version.

Foreword

The financial sector plays a central role to support the real economy. Yet, it also introduces risks, particularly when it recklessly chases short-term “artificial” profits, as was proved during the global financial crisis. As a result, internationally, much has been done to improve the regulation of the financial sector. Much more still needs to be done.

While the recession is over, the crisis and the results of the crisis still linger as financial stability is not yet secured internationally. In South Africa, our financial sector successfully weathered the crisis, but a million people still lost their jobs. Recognising the need for coordinated international efforts to secure global financial and economic stability, we have committed to important obligations to try and prevent a similar crisis in the future. These commitments are also informed by our own domestic situation.

Financial stability however is not the only objective. The financial sector needs to do more to support the real economy. The sector has a vital role to play in the ongoing transformation of our society, and our desire to bring a better life to all of our people. For this reason, this document outlines a number of changes in the area of market conduct, consumer protection and financial inclusion, including a new approach to dealing with high and opaque bank charges as well as for insurance and savings charges.

This is the beginning of an important conversation with society including all other stakeholders. We look forward to engaging with each of you on the issues we raise, and together building a safer financial sector to serve South Africa better.

Pravin J Gordhan

Minister of Finance

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Overview

- The financial services sector touches the life of each and every South African. It enables economic growth, job creation, the building of vital infrastructure and sustainable development for South Africa and her people. It is, therefore, crucial that the sector is well-regulated and stable. However, stability is not the only policy objective for the financial sector. The sector is characterised by high and opaque fees, and needs to be more transparent, competitive and cost-effective. Moreover, many South Africans do not have access to financial services. Not only does this inhibit economic growth, it also keeps people trapped in poverty.
- With the worst of the financial crisis behind us, government will have a renewed focus on maintaining financial stability, strengthening consumer protection and ensuring that financial services are appropriate, accessible and affordable.
- To achieve this, the Reserve Bank will be given lead responsibility for prudential regulation and .the Financial Services Board for consumer protection. As part of this, the mandate of the Financial Services Board will be expanded to include the market conduct of retail banking services. Finally, National Treasury will encourage greater access to financial services through a range of initiatives.

The role of the financial sector

The financial services sector is at the heart of the South African economy and touches the life of each and every citizen. Financial services allow people to make daily economic transactions, save and preserve wealth to meet future aspirations and retirement needs, and insure against personal disaster.

"We are pleased with the performance of our financial sector. It has proven to be remarkably resilient in the face of the recent financial crisis and the global economic meltdown"
\- President Jacob Zuma, State of the Nation Address, 10 February 2011

At the level of the macroeconomy, the financial sector enables economic growth, job creation, the building of vital infrastructure and sustainable development for South Africa and her people. However, the global financial crisis highlighted the immense costs of a poorly regulated financial services sector. Although South Africa's financial institutions were resilient in the face of the crisis, the indirect impact through job losses was devastating. In short, we cannot be complacent.

National Treasury launched a formal review of the financial regulatory system in 2007. The scope of this review was expanded in 2008 after the financial crisis. This work has now been completed, culminating in this document, which sets out a number of proposals.

This document provides a comprehensive review of the key challenges facing the financial sector, and proposes a roadmap to deal with the challenges. It presents government's vision of how to reshape the sector in order to address these challenges, and sets out the policy priorities of government over the next few years.

The approach to financial sector reform takes into account not only the direct lessons of the crisis, but also the broader policy objectives of maintaining financial sector stability, protecting consumers and ensuring that efficient, effective and inexpensive financial services are more accessible.

Box 1.1 A safer financial sector to serve South Africa better

To promote sustained economic growth and development, South Africa needs a stable financial services sector that is accessible to all. This policy document sets out government's proposals, emphasising financial stability, consumer protection and financial inclusion. The main proposal is to separate prudential and market conduct regulation. In addition, it addresses:

- **Stability.** The Reserve Bank's mandate for financial stability will be underpinned by a new Financial Stability Oversight Committee, co-chaired by the Reserve Bank Governor and the Minister of Finance.
- **Consumer protection.** Government will enhance consumer protection. The structure of the Financial Services Board (FSB) will be broadened to include a banking services market conduct regulator.
- **Access to financial services.** Financial access will be broadened. The Financial Sector Charter will be reviewed and reforms undertaken to encourage "micro insurance".
- **Coordination.** Regulatory coordination will be enhanced, and regulators strengthened as required. The Council of Financial Regulators will be formalised.
- **Comprehensiveness.** All businesses in the financial sector should be licensed or registered. Institutions providing similar services should be regulated by the same agency.

New legislation will be required to implement the proposals. Several bills dealing with banking, financial markets, credit rating agencies and the regulatory powers of financial supervisors will be tabled in Parliament during 2011. The policy document will be available on www.treasury.gov.za.

The global financial crisis and the domestic financial sector

Though the worst of the financial crisis has passed, the world economy continues to face many challenges. The January 2011 update to the *World Economic Outlook*[1] notes that while economic conditions are improving globally, the return to growth is uneven, taking the form of a two-speed recovery. There is subdued economic growth and high unemployment in advanced economies such as the United States, United Kingdom, France and Japan, in contrast to buoyant economic

[1]Released by the International Monetary Fund in Johannesburg on 25 January. Available online at http://www.imf.org

growth in emerging economies such as China, India and Brazil, with the risk of overheating and rising inflation.

Similarly, the January 2011 update to the *Global Financial Stability Report*[2]notes that "global financial stability has yet to be secured" and highlights the risks of increasingly unsustainable public debt positions and high, volatile capital flows.

Table 1.1 Snapshot of the financial services sector in South Africa

	June 2000	June 2010	Relative size 2010
			Share of GDP
Size*	R68.6bn	R203.8bn	10.5 %
Assets	R 1 890bn	R 6040bn	252%
Of which:			
Banks	R 730bn	R 3040bn	127%
Long term insurers**	R 630bn	R 1440bn	60%
Short term insurers	R 50bn	R 90bn	4%
Pension funds (public and private)	R 470bn	R 1480bn	62%
			Share of formal employment
Employment* **	286000	356 353	3.9 %
			Share of corporate taxes
Tax contribution[+]	n/a	R21 bn	15.3%

Source: SARB, Stats SA, SARS; Tax contribution is for the 2009/10 tax year.

** Size is gross value added in nominal rand of the financial intermediation and insurance component of the finance, real estate and business services sector. Estimate based on projected growth.*

*** The long-term insurer assets figure includes assets of pension funds managed by an insurance company*

**** Financial intermediation, insurance, pension funding and auxiliary services.*

[+] Estimate as detailed disaggregated data is not available. The total financial services, business services and real estate and business services sector contributes R39.6bn or 29% of corporate tax. Excludes VAT and other taxes.

The financial sector in South Africa comprises over R6 trillion in assets, contributing 10.5 per cent of the gross domestic product of the economy annually, employing 3.9 per cent of the employed, and contributing at least 15 per cent of corporate income tax. It has survived the crisis relatively unscathed, and continued its strong performance of the last decade. Since 2000, the sector has grown at an annual rate of 9.1 per cent[3], compared to broader economic growth of 3.6 per cent. Growth in employment has also been very strong: over the same period, the number of people employed in the sub-sector increased by 24.5 per cent and the financial sector has become one of the fastest-growing employers in South Africa. The total assets of the sector have also grown significantly, registering nominal compound average growth of 12.3 per cent between 2000 and 2010. Financial sector assets now stand at 252 per cent of gross domestic product (GDP)[4]. However, as with most financial sectors, South Africa's has become more globally

[2]Released by the International Monetary Fund in Johannesburg on 25 January. Available online athttp://www.imf.org

[3]As measured by gross value added.

[4]More data on the financial sector is available in the appendix to this document

connected and concentrated, potentially exposing the country to significant risks.

Given the need for higher economic growth and job creation, it is imperative to ensure that the South African financial system remains competitive and that it is made safer through regulation that follows global best practice, but bearing in mind the specific circumstances of our own economy.

While South Africa was spared the direct effects of the global financial crisis, the resultant recession has led to substantial job losses

Although South Africa has sound macroeconomic fundamentals and a robust financial regulatory framework, we suffered more proportionately from the financial crisis compared to other G-20 countries, with job losses of close to 1 million jobs. Growth has finally recovered, though at a significantly lower level than in 2007. The New Growth Path[5] developed by government aims to increase the rate of growth to above 6 per cent and create 5 million jobs by 2020.In the G-20, President Jacob Zuma committed South Africa to a global financial regulatory reform agenda aimed at strengthening financial stability. These commitments are in four areas:

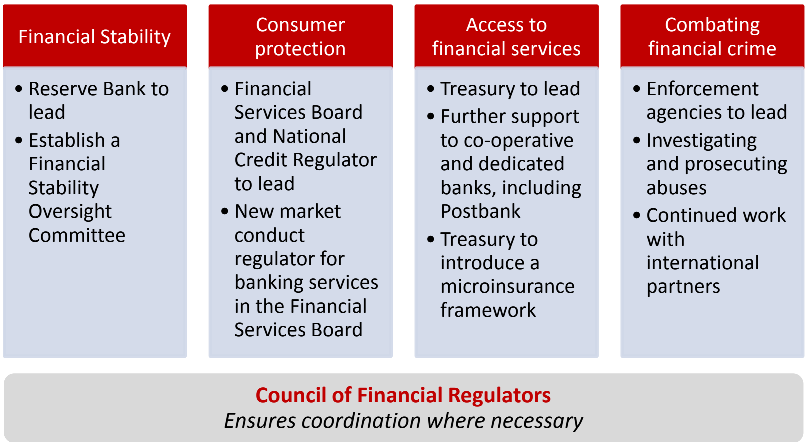
1. A stronger regulatory framework – developing appropriate principles for weak areas of the global system of financial regulation.
2. Effective supervision – strengthening the effectiveness, governance and domestic and international coordination of our regulators.
3. Crisis resolution and addressing systemic institutions – ensuring that the costs of a financial institution's failure are as small as possible, and that such a failure does not affect the broader financial system.
4. International assessment and peer review – undertaking regular assessments of the regulatory system and benchmarking our principles and practices against the international norms.

Against this background, this policy document sets out a new framework for South Africa. It is structured into four policy objectives:

1. Financial stability
2. Consumer protection and market conduct
3. Expanding access through financial inclusion
4. Combating financial crime

[5] Available online at www.info.gov.za/view/DownloadFileAction?id=135748

Figure 1.1: The new framework will take a holistic approach



In order to achieve these objectives, as detailed in chapter 3, the major policy shift is to move towards a modified "twin-peaks" model, where different agencies are given the lead responsibility for key policy objectives.

Policy priority 1: Financial stability

Increased global interconnectedness requires enhanced supervision

The South African financial services industry operates in a globalised environment where a crisis in one economy can easily spread to another, with devastating speed and impact. Increased international trade, vital to ensuring that South Africa creates jobs and continues to grow, will require the financial sector to be integrated further with the global economy. This, however, may introduce increased financial stability risks and the need for enhanced supervision of the financial sector.

The crisis has also highlighted the need for financial regulation to be better coordinated with monetary, fiscal and other economic policies and to take into account systemic risks. As detailed in Box 2.2, this "macroprudential approach" will form the basis of our financial system regulation and broader financial sector policy reforms in the years ahead.

South Africa supports G-20 initiatives to strengthen global financial stability

Against this background, a number of initiatives were announced in 2010, and will be taken forward this year:

- *Financial Stability Oversight Committee*: A new financial stability oversight committee will be established, comprising the South African Reserve Bank, Financial Services Board and National Treasury. It will be jointly chaired by the Governor and the Minister of Finance.
- *Council of Financial Regulators*: The Council of Financial Regulators will provide interagency coordination between regulators on issues of legislation, enforcement and market conduct. It will also include relevant standard-setters such as the Independent Regulatory Board for Auditors. This Council will not be involved in the day-to-

day operations and activities of the regulators. It will meet at least once or twice a year.

- *Improved banking and financial crisis resolution frameworks*: Substantial progress on strengthening South Africa's resolution and crisis management framework has taken place over the past year, mainly focused on improving interagency coordination. National Treasury and the Reserve Bank have are also finalising a comprehensive joint review of the crisis contingency framework.
- *International peer review*: G-20 countries, through the Financial Stability Board, have committed themselves to international peer reviews of their financial sector. During 2010, the International Monetary Fund and the World Bank jointly assessed South Africa's compliance to international regulatory best practice in banking, insurance and securities regulation. The assessment indicated that the quality of South Africa regulation and supervision is generally very good.

Policy priority 2: Consumer protection and market conduct

The South African sector is characterised by high and opaque fees

The South African financial sector is characterised by high and opaque fees, and, in some cases, the unfair treatment of customers. For savers, particularly the poor and vulnerable, savings instruments are limited, expensive and inappropriate. For borrowers, particularly small and medium enterprises, access to credit is often difficult.

Regular complaints to the relevant ombuds and numerous independent studies demonstrate that fees and charges are a problem. In banking, an independent inquiry under the auspices of the Competition Commission found that bank charges are unreasonably high. In insurance, a statement of intent signed between the Minister and the industry in 2005 noted the abusive charging practices in the insurance industry.

To address this challenge, Chapter 4 proposes the following:

- *Creating a retail banking services market conduct regulator in the Financial Services Board*. This new regulator will focus on issues of market structure and bank costs and work closely with the National Credit Regulator, which has a complementary role in regulating the extension of credit.
- *Implementation of the comprehensive Treating Customers Fairly initiative*, with clear principles for market conduct backed up by rules. Over time, this initiative will ensure consistent standards of consumer protection across the sector.

Furthermore, Chapter 5 considers key issues in the regulation of pension funds, ensuring that consumers, particularly the vulnerable older population, are protected against poverty after retirement. Additionally, pension fund regulation must facilitate investment while minimising risks to systemic stability.

Policy priority 3: Expanding access through financial inclusion

Sustainable and inclusive economic growth and development will be aided by improving access to financial services for the poor, vulnerable and those in rural communities. In spite of the relative success of the "Mzansi" bank account initiative[6]in 2010, 37 per cent of 33 million South African adults did not have a bank account and only 40 per cent had a formal long-term insurance product[7]. Government will act to ensure the implementation of the transformation objectives of the Financial Sector Charter, focusing on greater access for the poor and the promotion of broad-based black economic empowerment. These objectives can be achieved without undermining financial stability or promoting reckless credit practices.

Economic development requires increased access to financial services for all

Government has created an enabling framework for co-operative banks, is working at facilitating the entry of smaller dedicated banks, is improving the governance arrangements of the Postbank and intends to introduce a micro insurance framework that will improve access to micro insurance products and services. Further details are set out in Chapter 6.

Policy priority 4: Combating financial crime

Finally, Chapter 7 discusses the need for initiatives to combat financial crime and abuses, including the stealing of trust and beneficiary funds, money laundering and addressing the financing of terror.

Managing policy trade-offs and competing objectives

These priorities, however, interact with one another, often generating difficult decisions for the policymaker. In particular, there are multiple trade-offs and competing objectives which must be balanced.

Policy objectives are competing…

- *Financial stability versus access to credit*. While unrestrained credit growth might appear desirable (for example, to allow broader access to housing), the financial crisis demonstrated that excessive household lending creates financial stability risks, with disastrous economic consequences. A careful balance needs to be struck between these competing objectives.
- *Consumer protection versus financial stability.* Arguably, a highly profitable and concentrated financial services sector is a stable one but, often, profits might be considered excessive and due to unreasonably high fees. Again, a balance is required.
- *Combating financial crime versus financial access.* Combating financial crimes is part of a comprehensive strategy to address

[6]An initiative launched in 2003 to roll out no-frills bank accounts to people who were previously regarded as "unbanked".

[7]Finscope(2010)

financial integrity. Yet, overly onerous requirements might impede access to financial services for the poor.

…and complementary

Then again, many of the objectives are complementary. For example, in South Africa, appropriate consumer protection standards, such as the National Credit Act, prohibit excessive lending, reinforce the nation's financial stability objectives.

This document addresses some of these trade-offs and recommends steps to simultaneously meet different objectives.

The way forward

Detailed consultation will follow on all aspects of the proposals

A safer financial sector to serve South Africa better outlines the underlying approach to be taken for a series of legislative and regulatory changes to be introduced over the next three years. It notes that South Africa will be shifting towards a twin peak model for financial regulation, and that the financial sector will be made safer through a tougher prudential and market conduct framework. Many of these standards are in line with international commitments agreed via the G-20 and other processes. Various regulators have already proceeded to implement these tougher standards.

Comprehensive consultations with all stakeholders will take place as each measure is implemented, through the usual governmental and parliamentary processes. The various legislative amendments that follow will be released for public comment, after approval by Cabinet. The public comments process will culminate in the normal parliamentary processes and hearings, for enactment of legislation. This year, the following bills will be introduced: Banks Act Amendment Bill, Financial Services Laws General Amendment Bill, Financial Markets Bill and the Credit Ratings Services Bill. Further bills will also be introduced next year, as most financial sector legislation is reviewed.

2

Lessons from the global financial crisis

The global financial crisis has made many countries re-evaluate their financial sector policy priorities. A system-wide, or “macroprudential”, approach to regulation has become a dominant theme in regulatory reforms. Basel III will bolster the regulatory framework for banks; similarly the implementation of the Solvency Assessment and Management regime will ensure the on-going health of insurance companies. Moreover, the scope of regulation will be expanded to cover private pools of capital, over-the-counter derivative markets, credit rating agencies and commodity markets. Finally, internationally, the supervision of global systemically important financial institutions will be stepped up.

The crisis in brief[8]

The world economy is recovering from a crisis primarily brought about by global savings and consumption imbalances and inadequate financial regulation

The global economy is emerging from the most serious financial crisis since the Great Depression of the 1930s. At its roots were the twin problems of global macroeconomic imbalances and inadequate financial sector regulation. Global imbalances in saving and consumption between different parts of the world were characterised by large savings in emerging economies such as China flowing into industrialised economies such as the United States, United Kingdom and the Eurozone.

This glut of funding fuelled an unsustainable level of debt-financed consumption in some advanced economies, coupled with rapid rises in asset prices.

[8] A list of publications providing more comprehensive discussions on the crisis can be found in the “further reading” section at the end of this document

Subprime mortgages in the US created the problem…

In many countries, but in the United States particularly, "light touch" regulation of the financial sector supported this explosion in lending and allowed household debt to rise to unsound levels. Abundant credit and scant regulation led to the proliferation of products such as "subprime" mortgages[9]. These were targeted at vulnerable households which could only afford to repay their loans on the assumption that rapid house price and income growth would continue.

The risks in indiscriminate credit extension were amplified by the innovation of sophisticated financial products and inappropriate risk management systems. Through a process of securitisation, financial institutions were able to repackage mortgage-related products into securities which they could then sell to investors around the world. As a result, toxic mortgages became deeply rooted in the global financial system. When the housing bubble finally burst, the total exposure of all financial institutions around the world to subprime products ran into trillions of dollars[10].

... which was amplified by the extremely interconnected nature of the global financial system.

The financial crisis peaked with the collapse of Lehman Brothers in September 2008. As a result of the ensuing panic and uncertainty, financial institutions became unwilling to lend to each other and liquidity in the interbank funding market dried up. Governments were forced to provide extraordinary support to financial institutions by buying debt worth hundreds of billions of dollars and bailing out distressed companies. Stock markets around the world collapsed, household wealth was wiped out and lending to corporations came to a grinding halt. The result was the largest global recession since the Great Depression of the 1930s.

The longer term effects include a worldwide recession and a sovereign debt crisis in the peripheral euro area

More than two years after the collapse of Lehman Brothers, the global financial system remains fragile. The main risks to system-wide stability stem from weak bank funding markets, deteriorating sovereign finances, and a slow and uncertain economic recovery.

The upheaval in the financial system has adversely affected the fiscal health of many governments. High-debt and high-deficit Eurozone economies such as Portugal, Ireland and Greece have been in particularly severe financial and fiscal difficulties. More generally, advanced economies face slow growth, high unemployment and mounting public debt.

Of greatest concern is the fact that global macroeconomic imbalances in savings and consumption continue to be remain skewed. The two-speed global recovery has led to large international capital flows to emerging markets, which may pose a threat to financial stability if the flows are suddenly reversed.

[9]A subprime mortgage, previously common in the United States, is a type of loan that was granted to a person with a poor credit history who did not qualify for a conventional mortgage loan product. Typically the loan was offered at a very low initial interest rate, which reset later to a higher rate.

[10] The International Monetary Fund's Global Financial Stability Report, April 2010, estimates that top US and European banks were forced to write down toxic assets worth US$ 2.3 trillion between 2007 and 2010.

Box 2.1 Financial Stability Board

The Financial Stability Board (FSB) has been established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. It brings together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts.

All G-20 countries have between one and three seats on the FSB. South Africa has one seat, held by National Treasury. Other members of the FSB include the International Monetary Fund, the World Bank, the European Commission, the European Central Bank, the Bank of International Settlements and the Organisation for Economic Cooperation and Development.

The mandate of the FSB is to:

- assess vulnerabilities affecting the financial system and identify and oversee action needed to address them;
- promote coordination and information exchange among authorities responsible for financial stability;
- monitor and advise on market developments and their implications for regulatory policy;
- advise on and monitor best practice in meeting regulatory standards;
- undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps;
- set guidelines for and support the establishment of supervisory colleges;
- manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and
- collaborate with the IMF to conduct Early Warning Exercises.

The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF). The FSF was founded in 1999 by the G-7 Finance Ministers and Central Bank Governors. In November 2008, the Leaders of the G-20 countries called for a larger and more representative membership of the FSF so as to increase its effectiveness. In April 2009, the expanded FSF was re-established as the Financial Stability Board (FSB) with a broadened mandate to promote financial stability.

The FSB consists of a plenary, a steering committee, a chairperson and a secretariat. South Africa is a member of the plenary which meets at least twice a year and additionally holds several conference calls when needed. Its secretariat is located in Basel, Switzerland, and hosted by the Bank for International Settlements.

The FSB also has, at present, three standing committees – the Standing Committee on the Assessment of Vulnerabilities (SCAV), the Standing Committee on Standards and Implementations (SCSI) and the Standing Committee on Supervision and Regulatory Cooperation (SRC). South Africa is currently the vice-chair of the SCSI and a member of the SCAV.

International lessons from the crisis

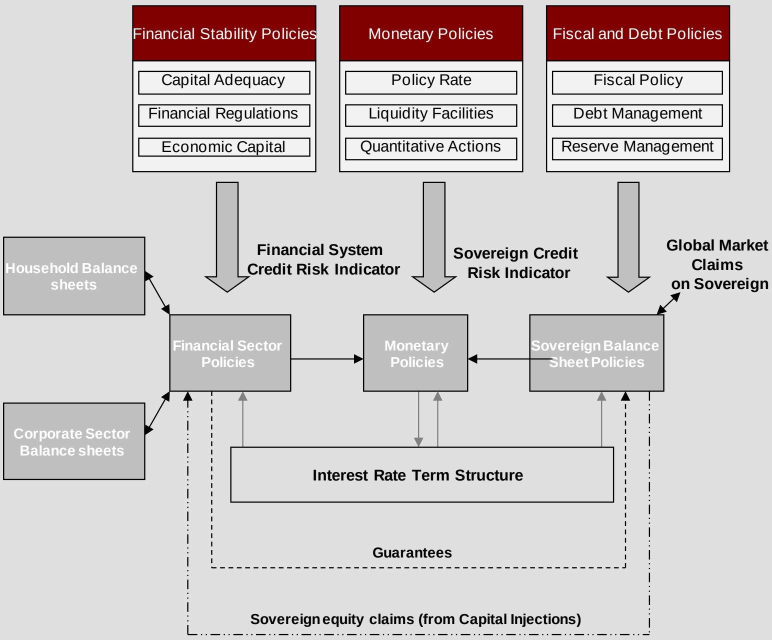
The enormous costs of these watershed events have forced governments to reconsider how they approach financial sector regulation. Most regulators, particularly in advanced economies, were taken by surprise by the events of 2007-2009 and were unable to anticipate the rise in systemic risk that culminated in the crisis.

Box 2.2 Developing a macroprudential approach to regulation

In the aftermath of the financial crisis, there is a renewed focus on managing system-wide risk across the entire financial sector. This has become known as the *macroprudential approach to regulation*, because it entails the analysis of *macroeconomic* trends and how they interact with the *prudential* soundness and stability of financial firms and the financial system. In contrast, *microprudential* supervision is mostly concerned with the prudential soundness of individual financial institutions or groups. Before the crisis, some believed that microprudential supervision was sufficient to maintain financial stability: if all institutions were soundly regulated, then the system must be stable. The financial crisis, however, has highlighted that the build-up of macroeconomic risks (such as asset bubbles, high household debt levels or the increasing linkages between large financial institutions) may pass unnoticed by microprudential regulators who focus only on individual institutions.

The macroprudential approach also attempts to identify and control risks arising from linkages between financial institutions. If one financial institution has large exposures to another, then the health of one will necessary affect the health of the other. Also, actions to boost the health of one entity might have unanticipated and adverse effects on the other.

Understanding how economic and financial sector policies interact



Source: Dale Gray and Samuel Malone, *Macro financial Risk Analysis*, Wiley Finance

There are a number of tools that can be used to reduce systemic risks. These include a leverage ratio to cap credit growth at banks; loan-to-value or debt-to-income limits on certain types of lending; the adjustment of risk-weights on specific asset classes or types of loans to discourage asset bubbles in certain sectors; and the adjustment of collateral or margin requirements to reduce the growth of leverage in the sector.

Some key lessons have emerged:

- **The need for a holistic view of financial sector regulation.** Financial regulatory reform has been focused on ensuring that authorities and regulators adopt a "macroprudential" approach towards supervision as opposed to a purely microprudential one (see box 2.2). This is particularly true for global systemically important financial institutions.

- **The failure of "light-touch" regulation of the financial sector at the global level.** The idea that the financial sector can successfully regulate itself has lost credibility in the aftermath of the crisis. Even if individual financial institutions are able to improve risk management practices, regulators must proactively monitor changes in systemic risk.
- **The importance of regulating market conduct to support prudential regulation.** The crisis has proven that it is poor policy to force banks to lend to consumers who cannot afford to repay their loans. Inappropriate lending practices in the US and the resultant fall-out of the subprime mortgage crisis demonstrated the need to balance the socio-economic objectives of increased access to credit and homeownership with the imperative of financial stability. The regulation of market conduct must eliminate lending malpractices in order to both protect consumers and reduce systemic risk.
- **Global cooperation in preventing macroeconomic imbalances.** The macroeconomic imbalances in savings and consumption that laid the ground for the crisis have shown no signs of disappearing. The global community must act together to find a sustainable solution to this problem.
- **The importance of swift regulatory action to prevent contagion.** The financial crisis swelled from a prudential crisis at a few institutions to a liquidity crisis across global markets in 2008 and 2009. By 2010, the crisis had turned into a sovereign crisis in fiscally weak European economies and has recently spilled into political crises in countries which have suffered from extended unemployment. The key lesson here is that regulatory action must be swiftly taken to prevent the spread of contagion.

As a result of these lessons, the global community is rebuilding a regulatory framework that is better equipped to supervise a sophisticated financial sector and pays more attention to systemic risk.

What protected the South African financial sector?

The South African financial sector did not experience the financial upheaval seen in advanced economies and, as a result, the economy is in a favourable situation to recover from the downturn and emerge stronger than before.

South Africa's economy is placed to emerge stronger than before

The policy components that protected the country from a financial and subsequent sovereign crisis include:

- **A sound framework for financial regulation and well-regulated institutions** ensured that potential risks were anticipated and appropriate action was taken to mitigate them. South African regulators have generally not followed a light-touch approach. Sustainable credit extension has been possible through effective legislation, such as the National Credit Act, strong regulatory action, and good risk management systems at banks. Nevertheless, we should not be complacent – additional work can and should be done to strengthen the regulatory framework bearing in mind the lessons of the global financial crisis. These are discussed in more detail in chapter 3.

- **Appropriate and conservative risk management practices at domestic banks.** The experience of the small banking crisis in 2002 and the adoption and implementation of the Basel II Capital Accord in 2008 have led to improved risk management practices and stronger crisis management arrangements. In addition, conservative practices at banks have ensured that much less securitisation and derivatives trading has taken place, relative to advanced markets.
- **Limited exposure to foreign assets.** The prudential regulation of foreign exposure as applied in the last decade, including limits on the extent of exposure to foreign assets by institutional investors and banks, has helped to limit our overall foreign risk.
- **Subsidiary structure and listing requirements.** Registered banks have to be subsidiaries of the domestic or foreign parent company, so their assets and liabilities are ring-fenced even when the parent company is in distress. The listing requirement also ensures transparency, rigorous disclosure standards and high standards of corporate governance, forcing banks to satisfy shareholders and stakeholders at all times.

Financial sector policy was complemented by prudent economic and fiscal policies

It is important to realise that the South African financial system was protected by a much broader set of prudent economic, fiscal and financial sector policies that insulated the economy from the worst of the global shocks. These include:

- **A robust monetary policy framework** that is capable of absorbing relatively large external shocks with minimum impact on the domestic economy. The flexible inflation-targeting framework provides a much-needed anchor for monetary policy during times of excessive volatility. Moreover, the flexible exchange rate can lessen the impact of disruptive capital flows. In contrast, Eurozone countries, for example, are locked into a fixed exchange rate with their neighbours. This reduces their ability to manage shocks.
- **Countercyclical monetary policy**. Leading into the crisis, rapid growth in credit extension posed a risk to the inflation target. In response, the Reserve Bank gradually raised the repo rate, from 7 per cent in 2005 to 12 per cent by mid-2008. This acted to stem excess credit growth and mitigate the risks of the global surge in financial activity. Then, as the financial crisis unfolded, the Reserve Bank reduced rates rapidly, which cushioned the domestic economy from adverse global conditions.
- **Countercyclical fiscal policy.** The crisis led to a substantial fall in domestic tax revenue and the need for increased spending to deal with the worst of the crisis. South Africa's strong fiscal position meant the country could respond appropriately. Countries that overspent during the boom years before the crisis have found it

extremely difficult to survive the crisis, and face an austere fiscal consolidation process.

- **A proactive approach to dealing with bank credit risks.** As credit extension boomed, the Registrar of Banks took proactive steps to reduce potential risks – including the raising of capital adequacy requirements and setting conservative leverage ratios. This placed sensible limits on credit extension.
- **A focus on reducing household vulnerability.** The introduction of the National Credit Act protected households and consumers from reckless lending practices.

These elements are part of a comprehensive set of policies that will continue to ensure financial stability, and provide an excellent foundation to build on to increase the resilience of the financial sector.

Box 2.3 Costs of the financial crisis

The financial crisis of 2008-09 had a devastating impact on the global financial system and the real economy, but it was by no means particularly unique. Using a dataset spanning 66 countries and 800 years, Carmen Reinhart and Kenneth Rogoff argue[1] that the recent financial crisis is not especially unique. For instance, their research finds that over the last 800 years, the aftermath of a financial crisis has been almost always been characterised by, first, a prolonged fall in asset prices such as real estate valuations, second, a deep fall in output and unemployment; and finally, an explosion in the real value of government debt, largely due to the lack of economic growth, a fall in government revenues and possible deflation.

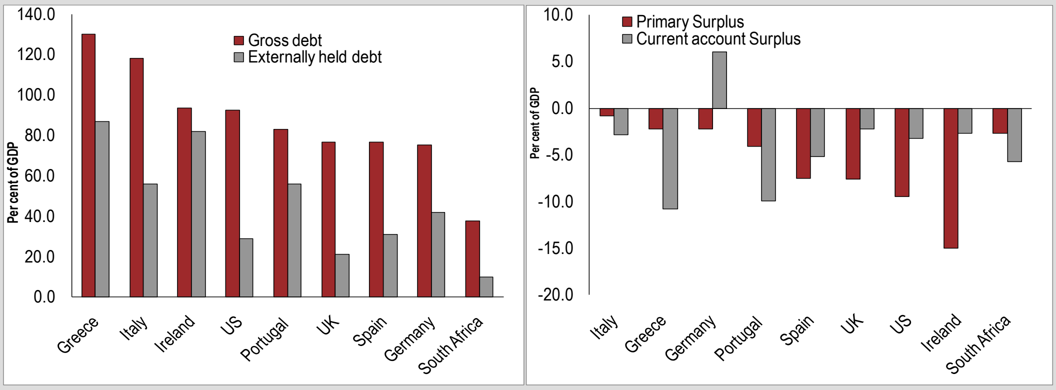
As a result of these three factors, a financial crisis is inevitably followed by a recession and an often painful restructuring of the financial system. The authors find that, on average, while recessions typically last no longer than two years, unemployment continues to rise for five years, and asset prices fall for the next six years. Public debt also rises rapidly as the government spends to fight the recession even as its revenues fall.

The recent crisis has played out in a similar way. If the first stage of the crisis was severe stress on financial institutions, the second stage was the impact on sovereign finances. The crisis has affected government funding in multiple ways. First, crisis-afflicted economies were forced to spend billions of dollars bailing out financial sectors. In the United States, for example, Congress appropriated US$700 billion to the Troubled Asset Relief Programme – the national bail-out package. However, it was recently noted that only US$25billion of this amount was actually spent. Second, governments were, however, forced to spend funds to avoid a severe recession: again, the US government spent US$957 billion in fiscal stimulus between 2008 and 2010. Facing higher expenditure and lower tax revenues during the recession, the US federal fiscal deficit widened from US$459 billion in 2008 to an estimated US$1.6 trillion in 2010. Third, central banks were forced to inject emergency liquidity into their economies in order to support the financial sector – with possible implications for future inflation. The US Federal Reserve poured US$1.7 trillion into the global financial system between September 2008 and October 2010, announcing a further US$600 billion of liquidity injections in November 2010.

Apart from these significant drains on the taxpayer, the financial crisis also sparked contagion from financial institutions to sovereign finances, and vice versa, in weaker economies. In peripheral Europe, in countries such as Greece, Ireland and Portugal, strong feedback loops have been created between the public and private sectors. While in Greece, poor fiscal management had an adverse impact on Greek banks, in Portugal and Ireland, failing financial institutions had to be supported by the state, leading to a significant deterioration in sovereign finances. Further affected by falling revenues during the recession, these governments have been forced to undertake rigid austerity programmes, worsening unemployment and slowing the economic recovery.

[1] "This Time is Different: Eight Centuries of Financial Folly", Princeton University

Countries with high debt and high deficits are most at risk



Source: IMF's World Economic Outlook and the Quarterly External Debt Database, World Bank. All figures are for 2010

The key lesson from the crisis has therefore been to emphasise the tremendous costs associated with a collapse in financial stability. Further, the crisis underscored the need for prudent macroeconomic policy: the smaller advanced economies with high levels of debt and deficits – both external and internal – have been most affected by the recession. In this light, South Africa's fiscal position is substantially stronger – both the size of debt relative to GDP and the primary budget deficit is lower than any of the major European countries. It is important both to implement sound fiscal policies and to thoroughly regulate the financial sector.

Strengthening the prudential regulation of banks

In December 2009, the Basel Committee on Banking Supervision (BCBS) proposed a set of bank supervision reforms (Basel III)[11] requiring banks to hold sufficient amounts of high-quality capital and liquid assets to see them through both a solvency and a funding crisis. The proposals took into account the lessons of the crisis, particularly the rapid spread of contagion from one bank to another.

Quantitative Impact Studies (QIS) were conducted in each of the member countries, including South Africa, to estimate the impact of the new rules on individual banks. The Basel Committee proposed several changes to the original proposals in July 2010, which took into account the QIS results. In September 2010, bank governors and heads of supervision agreed to a final set of proposals and a timetable for implementation.

Basel III will require banks to hold more high-quality capital and liquid assets

Some of the key proposals for reform are:

- **Improving bank capital.** Banks are now required to hold a higher percentage of their assets as loss-absorbing capital. There are also rules prescribing the quality of the assets that banks must hold as protection against losses. The minimum core capital ratio has been set at 4.5 per cent of risk-weighted assets, to be phased in by 2015.

[11] *Strengthening the resilience of the banking sector* and *International framework for liquidity risk measurement, standards and monitoring*, Basel Committee on Banking Supervision, Consultative Documents, December 2009

- **Reducing pro-cyclicality.** A major criticism of the pre-crisis regulatory framework is that it amplified pro-cyclicality in the financial system. In times of high asset growth and low risks, banks were permitted to hold less capital against potential losses while in high-risk periods, banks were called on to increase capital holdings at a time when they were least able to do so. The new Basel rules seek to mitigate this pro-cyclicality by instituting a countercyclical capital conservation buffer of a maximum of 2.5 per cent of risk-weighted assets over and above the core Tier 1 capital ratio. These buffers will vary according to the business cycle, encouraging banks to increase capital holdings during good times, which can be drawn down during a crisis.
- **Leverage ratio.** A simple, non-risk based and non-cyclical backstop measure has been introduced in the form of a minimum leverage ratio (the ratio of bank capital to total assets). A preliminary leverage ratio of 3 per cent (that is, assets can rise to a maximum of 33 times total capital) will start with supervisory monitoring from 2011. A parallel run from 1 January 2013 to 1 January 2017 will follow and disclosure starts from 1 January 2015. The leverage ratio will become a mandatory requirement by 2018.
- **Liquidity ratio.** In order to ensure that banks account for risks to their funding and liquidity structure, two new global liquidity standards have been proposed. The "Liquidity Coverage Ratio" (LCR) ensures that banks have enough liquid assets to survive the outflow of funds during a highly stressed scenario over a one month horizon. The "Net Stable Funding Ratio" (NSFR) is a longer-term structural ratio designed to address liquidity mismatches over a one-year horizon. The observation period for both starts in 2011. The LCR will be implemented by 2015 and the NSFR by 2018.

Implementation in South Africa

South African banks are capitalised well above the new requirements; however, they do not presently meet the global liquidity standards

In terms of the new capital regulations, South Africa is strongly placed to implement the reforms to the Basel framework. Domestic banks are already capitalised above the new levels. Even though South African bank supervision does not call for capital conservation buffers, domestic banks are capitalised in excess of the buffer requirements. The current leverage ratio is far more conservative than the proposed change. Consequently, there is no requirement for South African banks to either raise capital or deleverage.

Domestic banks, however, do not presently meet the new global liquidity standards. Moreover, compliance with the standards will require structural changes to the financial system that allow banks to increase the maturity of their funding and investment managers to increase the horizon of their investments.

In consultation with regulators, National Treasury is examining ways to reduce regulatory asymmetries that hinder banks from meeting these requirements. The first step has been to change aspects of Regulation 28 of the Pension Funds Act (see Box 5.1) to allow banks access to more long-term financing: pension funds will now be allowed to buy long-dated bank debt. In addition, there have been changes to the definition of "cash", which will reduce the incentives for pension funds to hold large amounts of short-term operational funds outside the banking system.

Further steps will be taken, such as ensuring that non-bank products are appropriately regulated given their risk profile, Moreover, as outlined in the Budget Review, work to reform the savings environment to reduce tax distortions is ongoing. In addition, banks have already begun to take proactive steps to raise the proportion of their funding from retail deposits, a step that will also benefit savers.

The bulk of the Basel III reform package should be phased in by member countries by January 2012, and the liquidity requirements over a lengthy period ending on 1 January 2019. To facilitate implementation in South Africa, the Reserve Bank has made proposals to amend the existing regulations to the Banks Act. Three drafts of the proposed amendments to the Regulations were released for comment during 2010. After comments from this draft are received early in 2011, a fourth draft will be released. Following consultation, the amended Regulations should be finalised in mid-2011 and approved by the Minister of Finance in time to be released at the *2011 Medium Term Budget Policy Statement*.

Box 2.4 Regulating banker bonuses

One of the big problems identified during the global financial crisis is the bonus structure of many overseas banks. Many banking executives believed that they were entitled to big bonuses even when their banks are clearly failed, and were dependent on taxpayer funds to save their banks. How people behave is closely linked to the incentives they receive. If salary and bonus incentives in the banking industry are structured towards short-term, risky profits, then the effect will be to encourage behaviour by the industry that is skewed toward short-term, risky investment. This may introduce undue risk. For this reason, the Financial Stability Board (FSB) undertook a detailed global review of compensation practices and issued Principles for Sound Compensation1.

South Africa fully supports these principles. However, bonuses in the South African financial services sector appear not to be substantially out of line with those in other sectors in our economy, including state-owned enterprises. Indeed, the approach taken in the FSB principles serve as a model for strengthening compensation and bonus structures for other industries where large bonuses are common.

The two global standard setters in banking and insurance (the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors) have worked to include these standards into the Basel Core Principles and the Insurance Core Principles. In South Africa, the relevant compensation guidelines issued by the two global bodies will be incorporated in to the implementation of Basel III and Solvency Assessment and Management.

Solvency assessment and management for insurers

The Solvency and Assessment Management regime will strengthen supervision of insurers

The Financial Services Board is in the process of developing a new risk-based solvency regime for South Africa's short and long-term insurers, known as the Solvency Assessment and Management (SAM) regime. SAM is based on Europe's Solvency II, and seeks to align the regulation of the local insurance industry with international standards. It is a risk-based regulatory framework which sets out strengthened capital requirements for insurers as well as guidelines on governance, risk management and disclosure. Similar to Basel II, it uses a three-pillar structure of capital adequacy (Pillar 1), systems of governance

(Pillar 2) and reporting requirements (Pillar 3). Implementation of SAM for the insurance industry is set for January 2014.

The primary purpose of the regime is the protection of policyholders and beneficiaries, with additional objectives being to align capital requirements with the underlying risks of an insurer, provide incentives to insurers to adopt more sophisticated risk monitoring and risk management tools and to help maintain financial stability.

Implementation in South Africa

National Treasury and the Financial Services Board will conduct an economic impact assessment of the proposed SAM regime. The first phase of the economic impact assessment will consider what particular national objectives need to be taken into account, such as transformation objectives, access to finance, the emergence of smaller black-owned insurance businesses, and how the principle of proportionality should be applied in light of these objectives. The Financial Services Board has released a roadmap document, appropriately named "SAM Roadmap", which outlines key milestones required for each stage of the project[12].

Other initiatives

Regulating systemically important financial institutions

During the financial crisis, governments were forced to bail out those banks that were systemically important, and whose collapse would have led to extreme turmoil in financial markets. The existence of financial institutions that are not subject to market discipline, however, creates the problem of moral hazard. Secure in the knowledge that they will be bailed out by the government, these institutions may face the incentive to undertake excessively risky investments.

Concerns have been expressed that the measures taken to support institutions, particularly the global banking sector, during the crisis, has created significant moral hazard issues that will remain a challenge well into the future, and could sow the seeds of a future crisis. The regulation of global systemically important financial institutions (G-SIFIs) has become one of the biggest regulatory challenges in the post-crisis landscape.

The Financial Stability Board has developed initial proposals for the regulation of such institutions – referred to as SIFIs – and presented these to G-20 leaders at the Seoul Summit in November 2010. Broadly speaking, the mechanisms seek to achieve the following objectives:

- **Reducing the probability of failure.** These measures will increase the ability of every SIFI to absorb losses, possibly through systemic capital and liquidity surcharges or the use of contingent[13] or bail-in[14] capital.

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[12]Available online at www.fsb.co.za

[13]Contingent capital is a debt instrument which converts to equity at a pre-specified trigger which signals that the issuing entity might be approaching distress.

[14]Bail-in capital is the equity capital obtained through the forcible conversion of the bonds of a failing company into equity.

- **Improving the framework for resolution.** These measures seek to reduce the spread of contagion that results from the collapse of a large, cross-border financial institution, and to limit the use of taxpayer money in bail-outs. An effective resolution framework includes creating colleges of supervisors and "living wills", which explain how the institution is to be wound up if in distress, while still maintaining its core functions.
- **Strengthening core market infrastructure.** To prevent contagion spreading from one financial institution or market to another, authorities must improve market infrastructure to ensure, for example, that over-the-counter derivatives and complex financial transactions take place on a centralised clearing exchange, and that funding and repo markets are well regulated and monitored.

Expanding the scope of financial regulation

The perimeter of regulation must be extended to cover previously unregulated pools of capital and activities

Regulatory reforms seek to bring all sources of systemic risk into the supervisory net. This includes the regulation of all private pools of capital, such as hedge funds, which can be an important source of systemic risk. International rules on the regulation of over-the-counter derivatives markets are being developed. Standard-setters around the world are in the process of refining high-quality accounting standards to deal with the more complex financial transactions.

The Financial Stability Board has outlined reforms to compensation practice whereby short-term compensation practices of banks should not encourage excessive risk-taking by bankers. Steps have also been taken to regulate credit rating agencies, which contributed towards excessive risk-taking in the lead-up to the financial crisis.

In South Africa, steps are being taken to extend regulation to private pools of capital, including hedge funds, unregulated financial activities such as the functioning of credit rating agencies as well as over-the-counter derivatives markets.

Improving the financial crisis resolution framework

Substantial progress on strengthening South Africa's resolution and crisis management framework has taken place over the past year. The first phase of this process focused on improving interagency coordination. Following phases include a comprehensive joint review of the crisis contingency framework, including making legal changes where necessary to ensure that the authorities have all the appropriate tools available in the unlikely event of a crisis.

3

Strengthening the regulatory framework

National Treasury initiated a review of the financial regulatory system before the financial crisis and, in light of lessons from the crisis, expanded the review. The Minister of Finance requested that this survey identify gaps and weaknesses in order to improve the financial regulatory system in South Africa and enhance the soundness of the financial system.

Reforms proposed to the South African regulatory system include shifting to a twin-peaks approach to regulation, characterised by separate prudential and market conduct regulators. In addition, South Africa will adopt a system-wide approach to financial stability and regulation, bolster the supervision of individual institutions, and ensure better coordination and information-sharing. The scope of regulation will also be extended to cover presently unregulated financial activities that have the potential to create systemic risks to financial stability.

The role of regulation in the financial sector

Effective regulation is vital for economic growth and financial stability

The nation's financial system – comprising institutions such as banks, pension funds and insurers, markets such as securities markets, and regulators, including the central bank – provides the framework for carrying out economic transactions and monetary policy. The global financial crisis has demonstrated that an unstable financial system can have far-reaching negative consequences for the wider economy. Therefore, a sound, well-regulated financial system is essential not only for financial stability, but also for supporting economic growth, development and the creation of jobs. The focus of regulation must also be on the system as a whole, and not just the individual institution.

Even before the financial crisis, regulating the financial sector was considered to be necessary because of the existence of a number of "market failures" in the provision of financial services[15]. These failures create the need for regulation to build investor confidence in the liquidity and solvency of financial institutions and to establish systemic stability in the sector as a whole.

The aims of regulating the financial sector include:

- Maintaining confidence in the financial system and sustaining systemic stability
- Ensuring providers of financial services are appropriately licensed
- Promoting appropriate market conduct and prosecuting cases of market misconduct, thereby protecting the consumer
- Maintaining the safety and soundness of financial institutions
- Enforcing applicable laws.

A number of factors need to be borne in mind when designing an effective regulatory framework

The regulatory regime chosen will depend on the type of services provided or sold, and, in general, no provider is allowed to operate outside the regulatory framework. After the financial crisis, regulators around the world have taken a tougher and more intrusive approach towards supervision. While current regulations apply to the banking, insurance, securities, collective investment schemes and pensions sectors, many countries are beginning to extend their regulatory scope to cover institutions and markets such as hedge funds, credit rating agencies, money markets and commodity futures. In particular, the regulation of the "shadow banking" system, or the provision of banking services by non-banks, is becoming very important[16].

As discussed in the previous chapter, the key reforms measures to emerge from the crisis relate to more onerous capital and liquidity requirements on banks (Basel III) and the insurance sector (Solvency II in Europe).There are even more stringent requirements on systemically important financial institutions. Additionally, the mandates of regulators and the quality of supervision have been strengthened. More importantly, many countries are also reviewing their regulatory system to reduce the scope for regulatory arbitrage, and ensure better coordination and information-sharing between regulators.

South Africa's resilient and globally connected financial system weathered the crisis well, largely on account of strong and effective regulation. The strength of the system was further confirmed by the Reports on Standards and Codes (ROSC) – an assessment of financial sector regulation conducted jointly by the International Monetary Fund (IMF) and the World Bank in 2010. There is still room for improvement, however, as indicated by the ROSC process, and it is imperative that South Africa continues to ensure that the financial system remains robust. Noting the lessons of the financial crisis, and following consultations with key regulators, National Treasury proposes a detailed set of improvements to the South African financial regulatory system. This chapter summarises the key proposals.

[15] These market failures largely stem from the presence of asymmetric information (between providers and customers) and the concentrated nature of the industry.

Principles behind reforming the financial regulatory system

Clear principles guide our regulatory reform initiatives

The proposed reforms of the financial regulatory system in South Africa are guided by the following "principles" or guidelines:

Principle 1: Financial service providers must be appropriately licensed or regulated. Entry into the market must be subject to an appropriate licensing or registration process, depending on the type of financial services provided. No provider of a financial service should be allowed to operate outside the regulatory perimeter. Once licensed, appropriate conditions will apply, including being appropriately capitalised, taking into account financial stability and safety and soundness concerns. Further conditions relate to regulated financial institutions maintaining sound corporate governance standards, encapsulating appropriate checks and balances, and including the application of sound capital management, risk management and compliance with relevant legislation and regulation.

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. Risk-based supervision requires significant investment in human capital, as supervisors typically need to develop skills to monitor risk in highly complex financial transactions.

Principle 3: The quality of supervision must be sufficiently intense, intrusive and effective. The "ability" to supervise requires appropriate resources, authority, organisation and constructive working relationships with other agencies and must be complemented by the "will to act". The "will to act" requires supervisors to have a clear and unambiguous mandate, operational independence coupled with accountability, skilled staff, and a relationship with industry that avoids "regulatory capture." As noted in a recent paper by the IMF[17], there is a need to strengthen the quality of supervision, and supervisors need to have the capacity to effectively challenge supervised entities.Given the experience in advanced economies, there must be steep penalties for financial abuse and misleading reporting within the risk-based framework.

Principle 4: Policy and legislation are set by government and the legislature, providing the operational framework for regulators. The policy framework will be set transparently via the executive, and legislative proposals will be approved by Parliament. While regulators do not set policy, it is critical to clearly demarcate what constitutes policy, and empower regulators to set the supervisory framework and necessary directives.

Principle 5a: Regulators must operate objectively with integrity and be operationally independent, but must also be accountable for

[17]International Monetary Fund, 2010 "The Making of Good Supervision: Learning to say 'No'"

their actions and performance. Regulators must be empowered to work without fear or favour and be operationally independent within an approved legislative and policy framework. They must operate transparently and fairly within the law, and be accountable for their actions – meeting agreed performance objectives and targets for each year. Special mechanisms may need to be considered to protect the integrity of regulators, and avoid abuse and unwarranted interference from those breaking the rules.

Principle 5b: Governance arrangements for regulators and standard-setters must be reviewed, so that boards perform only governance functions. The governance arrangements for all regulators must be reviewed. Where boards exist, they should be involved in governance issues only, and not policy or operational issues. Governance arrangements must ensure that regulators have operational independence, and that they can act without seeking approvals from the board when conducting their operational, monitoring, licensing or sanctioning activities. Employees of regulated entities should not be serving on the boards of regulatory bodies.

Principle 6: Regulations should be of universal applicability and comprehensive in scope in order to reduce regulatory arbitrage. Individual institutions, or classes of institutions, should not arbitrarily be exempted from regulation and supervision.

Principle 7: The legislative framework should allow for a lead regulator for every financial institution that is regulated by a multiple set of financial regulators. All regulators involved must strive to coordinate their supervisory activities. Financial institutions are generally regulated or supervised by more than one regulator, often falling under different Ministries. Regulators should be obliged to coordinate their activities, formalised through legislation or Memoranda of Understanding. The lead regulator must ensure that effective consultation takes place between regulators, and should not inadvertently undermine other regulators.

Principle 8: Relevant ministers must ensure that the legislation they administer promotes coordination and reduces the scope for arbitrage. More than one ministry is responsible for some form of legislation or regulation applying to financial institutions. Ministers must ensure that the legislation they administer allows for coordination.

Principle 9: The regulatory framework must include responsibility for macroprudential supervision. One of the key lessons from the financial crisis is the need to assess risks to the system as a whole (see Box 2.2).The overall prudential framework must be countercyclical and the regulation of entities must take place on a group-wide basis. Given the interlinkages between financial institutions, a strengthened approach to consolidated supervision is important.

Principle 10: Special mechanisms are needed to deal with systemically important financial institutions (SIFIs). The regulatory system must put in place special mechanisms to mitigate systemic risks posed by SIFIs. In particular, regulators must reduce the moral hazard risk inherent in financial institutions deemed "too big to fail" (see chapter 2), as well as reduce the possibility of requiring government-sponsored bail-outs of financial institutions. This may require special resolution legislation to deal with liquidity and solvency problems affecting SIFIs, as many generic laws cannot apply to SIFIs in a crisis.

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. The system of ombuds must be appropriately supportive.

Principle 12: Financial integrity oversight should be effective to promote confidence in the system. The optimal balance must be found between the promotion of financial inclusion and the restriction of criminal and fraudulent activities. There must be credible and punitive sanctions against those not complying with the law or misappropriating clients' funds.

Principle 13: Regulators should be appropriately funded to enable them to function effectively. A regulated sector should ideally fund the operational budgets of regulators in a way that eliminates risk of capture and conflicts of interest. South Africa uses a variety of ways to fund regulators, including levies, fees, allocations from the fiscus and own-revenue collected. The most appropriate method of funding will depend on the type of regulatory activity (prudential, market conduct or ombud regulator), and whether the regulator is a separate entity or located within another entity.

Principle 14: Financial regulators require emergency-type powers to deal with a systemic financial crisis, requiring strong and overriding legislative powers. The resolution of the financial crisis required regulators to have special powers in emergencies to quickly and effectively resolve insolvencies.

Principle 15: All the above principles are reflected in international standards like Basel III and standards set by the International Association of Industry Supervisors (IAIS) and International Organisation of Securities Commission (IOSCO). To the extent that there are any contradictions or inconsistencies in the above principles, the international standards will apply. South Africa has committed itself to international best-practice by adopting standards for banking, insurance and securities markets. Similar Organisation for Economic Cooperation and Development (OECD) and other standards also apply for pensions and other industries. These standards should not be contradicted by the principles outlined above.

Proposals to strengthen the financial regulatory system

First proposal: Given the need to prioritise and strengthen both prudential and market conduct supervision and regulatory powers, South Africa will move towards a "twin-peak model" of financial regulation.

South Africa's system of financial regulation was broadly modelled on countries it is historically linked to, particularly the UK and other former British colonies such as Australia and Canada. In the three decades before the global crisis, regulatory systems diverged significantly (see Box 3.1), with Australia[18]adopting a "twin peaks" system, and the UK[19] opting for a single regulator. Following the 1993 Melamet Commission, South Africa opted for a single-regulator approach. After the financial crisis broke out in 2007, however, there was a global shift away from the single-regulator model towards a twin-peak model (such as in the UK). South Africa, too, has decided against any shift to a single-regulator system. In line with international trends, South Africa will now be adopting the "twin-peak" model for financial regulation.

The twin-peak approach recognises the different skill sets required for prudential and market conduct regulation. Prudential regulation is designed to maintain safety, soundness and solvency of financial institutions or funds, while market conduct regulation requires the perspective of a customer, which is a different regulatory perspective and philosophy. It is inevitable that market conduct regulation and prudential regulation will frequently overlap and conflict. It is also recognised that while it may be relatively easier to separate prudential and market conduct regulation in banking and insurance, it may be more difficult in financial markets, securities and pension funds.

Under the direction of the Minister of Finance, National Treasury, the Financial Services Board and the South African Reserve Bank will establish a joint task team to examine and propose how best to move towards twin-peak regulation and supervision. This process will be phased in, taking into account the need to minimise the risk of weakening the capacity of any regulator during the transition period.

[18] In Australia, the Australian Prudential Regulation Authority (APRA) supervises banks and insurers, while the Australian Securities and Investments Commission (ASIC) is responsible for enforcing financial services and corporations laws.

[19]In the UK, the Financial Services Authority was responsible for regulating all financial services before the crisis

Box 3.1 Types of regulatory structures and why twin peaks is appropriate for South Africa

Regulatory structures differ substantially across the world. There is no generally accepted best practice on the ideal structure and each system is considered to have both strengths and weaknesses. Essentially, there are four possibilities.

In the **institutional approach**(examples are China, Mexico and Hong Kong) a firm's legal status (as a bank, broker dealer, or insurance company) determines *(a)* which regulator is tasked with overseeing its activities from both a safety and soundness and a business conduct perspective, and *(b)* the scope of the entity's permissible business activities. However, there is a tendency for regulators to reinterpret and expand the scope of permissible activities under their jurisdiction, so that over time entities with different legal statuses have been permitted to engage in similar activities but subject to different requirements by different regulators.

Under the **functional approach** (France, Italy and Spain) supervisory oversight is determined by the type of business that is being transacted by the entity, without regard to its legal status. Each type of business may have its own functional regulator. The benefit of this approach is that the regulator will apply consistent rules to the same activity regardless of the entity in which the activity is conducted. However, in practice it may be extremely difficult to distinguish which type of activity comes within the jurisdiction of a particular regulator, giving rise to disparities in regulatory positions on similar activities.

The **single-regulator/integrated approach** (Germany and, until recent reforms, the UK) utilises a single universal regulator tasked with conducting both prudential oversight and business conduct regulation for all financial services. This approach has the benefit of a streamlined focus on regulation without the conflict over jurisdictional lines that are possible under both the institutional approach and the functional approach. It also has the benefit of the regulator having a holistic view of the entity's business activities and enhances the ability of the regulator to assess the risks associated with changing market conditions and regulatory arbitrage, as information about these matters will be collected and monitored by one agency. Hence, oversight is broad as well as deep. There is, however, likely to be conflict between prudential regulation (which requires "thinking like a banker") and market conduct regulation (which requires "thinking like a customer").Effective market conduct regulation may occasionally result in lower profits; a prudential regulator may be disinclined to take regulatory action which can adversely affect profitability and solvency.

The **twin peaks approach** (Australia, Canada and the Netherlands) separates regulatory functions between at least two regulators: one that performs the prudential supervision function and the other that focuses on business conduct regulation. This approach is designed to garner the benefits of the integrated approach (regulatory consistency, jurisdictional clarity and informational efficiency), yet also addressing the inherent conflicts between prudential regulation and consumer protection. The twin peaks approach is regarded as the optimal means of ensuring that transparency, market integrity, and consumer protection receive sufficient priority, and given South Africa's historical neglect of market conduct regulation, a dedicated regulator responsible for consumer protection, and not automatically presumed to be subservient to prudential concerns, is probably the most appropriate way to address this issue.

In addition the existence of separate prudential and market conduct regulators may be a way of creating a system of checks and balances, thereby avoiding the vesting of too much power in the hands of a single agency. It should be noted however, that the flip side of creating checks and balances is the need to carefully define roles and responsibilities to avoid duplication of work and jurisdictional overlap. Moreover, separation of prudential and market conduct regulation does not eliminate the possibility of conflict between them. Hopefully, consultation between the two bodies would lead to an acceptable compromise. But if not, some external means would need to be found to reconcile objectives. In South Africa, the formal way of resolving conflict will be through the Council of Financial Regulators.

Finally, given the South Africa's current regulatory structure, it is likely that moving to a twin peaks system would cause the least amount of disruption to both market participants and to the regulators themselves.

Second proposal: Strengthen the operational independence, integrity and accountability of all regulators.

Operational independence is an essential prerequisite for an effective regulatory regime andfor maintaining a fair and equitable financial system. Institutional, regulatory and supervisory independence is necessary to create the right incentive structure for regulators and supervisors. Regulators must therefore operate independently, without fear, favour or prejudice. Operational independence includes the freedom to approve, disapprove and revoke licenses, decide to conduct an on-site examination, as well as take enforcement action (or to recommend that another government agency take action) against a person or entity based upon evidence of violation of a law or regulation.

The heads of supervisory or regulatory agencies should be appointed for a fixed term of at least five years. Once appointed, regulators should appoint their own staff, within the framework determined by their governance board or the minister of finance, eventually approved by Parliament. Regulators should not be dismissed without good causes shown, and which are transparent and reported to Parliament.

Heads of supervisory or regulatory agencies must be fair and seen to be fair, and be protected from undue pressure and interference. Regulators should have mechanisms to protect them from political and other interference when acting within their mandate. The procedures to hire and fire regulators must be transparent and subject to clear rules.

The operational budgets of regulators should be funded appropriately. Government will review the method of funding regulators and ombuds schemes to enable regulators to perform their functions without compromising their operational independence and to minimise the risk of regulatory capture. Fees should also be imposed to cover certain costs for complex licence or merger applications. The financial sector should also be obliged to contribute towards the funding of activities of consumer groups who monitor bank charges and market conduct practices, in a way that does not undermine the integrity or independence of such consumer groups.

Current legislation will have to be amended. The recent ROSC assessment of the South African financial system has identified inconsistencies with international benchmarks in three areas relevant to operational independence – dismissal of senior staff without good cause, revocation of the registration of banks, and exercising the authority to appoint a curator of a failing or failed bank. For example, some regulators cannot grant or withdraw certain licences without the approval of their board or minister. In other cases, a government ministry controls the governing body of the regulator. Despite the recent financial sector assessment programme noting that there do not appear to be any indications that the possibility of staff termination has affected operational independence, the assessors recommended amending the laws to remove this potential power of intervention by the executive. The first issue could be resolved by adding a simple requirement that the Minister of Finance or Reserve Bank Governor may dismiss board members, registrars or other senior officials only for good cause, with the reasons to be made public and tabled in Parliament. The process of licensing, registration, inspections and monitoring, and investigations will also be improved. As a result, there are already initiatives towards improving prudential oversight (including harmonising the licensing regime, monitoring, supervision and inspection), money market and consumer protection oversight, enforcement and aligning legislation.

A clear framework for the ethical behaviour of regulators should be determined by the Minister of Finance. This should include, among others, procedures to be followed regarding behaviour for dealing with regulated institutions, forbidding gifts or sponsorships from regulated institutions, confidentiality arrangements, as well as so-called 'gardening leave' arrangements (to prevent employees taking current and sensitive information when they leave the employment of a regulator).

Regulators must be appropriately accountable for their performance. Regulatory agencies must be made accountable for their actions to Parliament and strategic plans, budgets and annual reports must be submitted to Parliament, through the relevant Minister. All regulators should annually report on their activities to Parliament.

Third proposal: Expand the financial regulatory system to include macroprudential supervision, and establish an interagency financial stability oversight committee.

The primary lesson from the financial crisis is the need for a macroprudential approach to supervision (see Box 2.2), which focuses on risks within the system as a whole. All South African financial sector regulators are essentially micro-regulators, and do not focus on macroprudential risks. They are responsible for a specific sector, such as banking, insurance or securities markets, and, as such, do not monitor either the macroeconomic risks posed to financial institutions that do not fall in their jurisdictions, or the risks to other sectors of the economy.

The Reserve Bank is best placed to play the role of a macroprudential supervisor. Most (but not all) countries have given this responsibility to the central bank(see Box 3.2)and given the traditional role of the Reserve Bank, there is little doubt that only the Reserve Bank has the appropriate capacity to perform this function effectively. The role of the Reserve Bank in implementing monetary policy, and as the lender of last resort as well as the provider of emergency liquidity assistance (ELA), provides it with unique insight into the workings of the entire financial sector, as well as the macroeconomy. The implicit responsibility of the Reserve Bank in monitoring macroeconomic risks was explicitly confirmed in a letter from the Minister of Finance to the Governor of the Reserve Bank on 16 February 2010.

In common with many jurisdictions, the Reserve Bank has taken a number of steps to strengthen the macroprudential and financial stability functions within the Bank. An internal Financial Stability Committee has been bolstered and includes all members of the Monetary Policy Committee to ensure effective coordination between monetary and macroprudential policies. This committee has an important role in macroprudential oversight and crisis prevention. In addition, the exchange control department has been renamed the Financial Surveillance Department and its role in collecting and analysing cross-border data has been strengthened.

Figure 3.1: The present regulatory landscape in South Africa

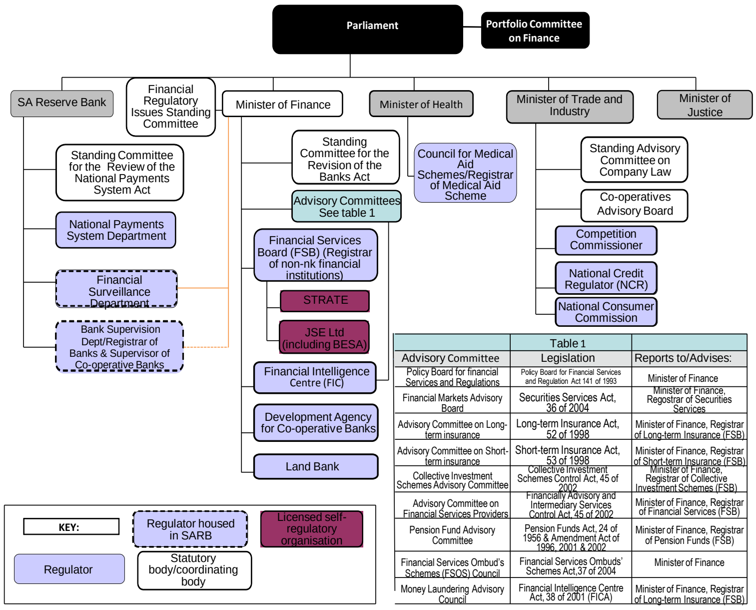


	Table 1	
Advisory Committee	Legislation	Reports to/Advises:
Policy Board for financial Services and Regulations	Policy Board for Financial Services and Regulation Act 141 of 1993	Minister of Finance
Financial Markets Advisory Board	Securities Services Act, 36 of 2004	Minister of Finance, Regostrar of 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)

While the mandate of financial stability lies with the Reserve Bank, other regulators (market conduct regulators, as well as the National Credit Regulator) must also take into account the financial stability implications of their activities, and assess all systemic risks potentially arising from any institutions that they may be supervising.

It is proposed to establish a Financial Stability Oversight Committee, jointly chaired by the Governor and the Minister of Finance. This body will enable government to oversee financial stability from a systemic perspective and to have a central role in crisis management and resolution. It will be convened at least quarterly.

Fourth proposal: Strengthen market conduct supervision and the ombuds system, and expand the scope of the Financial Services Board to cover market conduct in retail banking.

Market conduct standards must be strengthened particularly in the retail banking sector. Despite strong oversight by the National Credit Regulator (NCR) and the Financial Services Board (FSB), such powers need to be extended to cover the full range of retail banking, including the regulation of banking charges and other practices such as those identified by the report of the Banking Enquiry Panel established by the Competition Commission in 2008.

It is proposed that a separate retail banking market conduct regulator be established in the FSB, taking account of the work of the NCR. Given the asymmetry in power between consumers and financial institutions, it is also important to strengthen the current ombuds system so that it is more effective in resolving disputes that cannot be settled by customers and their financial institution. The *Treating Customers Fairly* initiative launched by the FSB is expected to significantly improve the quality of consumer protection for customers of financial services.

In setting up a dedicated retail banking market conduct regulator within the FSB, account must be taken of the work of the NCR, which covers both banking and non-banking credit. In its short time of existence, the NCR has demonstrated excellent and path-breaking work on monitoring reckless credit practices. This experience is proving to be a leading example that many countries are now following – indeed, it was reckless credit extension on the part of US banks via products like “teaser” loans to those who could not afford to pay that triggered the crisis in 2007. Consultations within government are necessary to assess the impact of having two separate regulators covering different aspects of market conduct in the retail banking sector (transactional banking in the FSB and credit extension in the NCR), and how best to coordinate the work of the two regulators.

Fifth proposal: Clarify roles and responsibilities.

In addition to the regulators, there are a number of other key players in the regulatory environment, including the Reserve Bank, National Treasury, and departments such as Trade and Industry, Justice, and the prosecuting authorities.

Current legislation does not spell out who is responsible for policy, legislation, regulation and supervision, and is often not consistent across different pieces of legislation governing the different financial regulators**.** Legislation should be revised to reflect specific roles and functions.

Policy and legislation is the responsibility of the relevant department (National Treasury or Trade and Industry, under the direction of their ministers) and ultimately of Cabinet. Given that regulators are in a unique position to provide the necessary technical expertise and insight into weaknesses that need to be addressed, National Treasury must work closely with them to prepare policy and legislative proposals. As emphasised above, regulators are not, however, mandated to determine policy, but rather to implement the policy determined by the government, via the Minister of Finance. The drafting of legislation affecting the financial sector also needs to be better coordinated between government departments.

Box 3.2 Examples of international strategies to strengthen regulatory coordination

The United Kingdom

The Tripartite Council for Financial Stability (consisting of Treasury, the Bank of England and the Financial Services Authority) has been merged with the Bank of England's Financial Stability Committee and rebadged as the Financial Policy Committee (FPC). The new committee will reside within the Bank, but will include representatives from prudential regulators, Treasury as well as some outside representation. Although the powers of the committee are yet to be finalised, the tools that are being considered for the FPC include:

- Setting system-wide cyclical capital requirements to reduce capital buffers required in a crisis and to be correspondingly tougher in good times;
- Setting leverage limits to function as a backstop against excessive lending where there are generalised concerns that could not easily be addressed through changing risk weights;
- Insisting on forward-looking loss provisioning to prepare for future losses when lending is growing quickly;
- Setting limits on borrowing with, for example, maximum loan-to-value ratios for mortgages;
- Setting limits on lending through various regulatory mechanisms.

India

Despite announcing as early as March 2010 that the Financial Stability and Development Council (FSDC) would be established to strengthen and institutionalise the mechanism for maintaining financial stability, the exact structure and responsibilities were only clarified in a Ministry of Finance circular at the end of December 2010 (available at

http://finmin.nic.in/the_ministry/dept_eco_affairs/capital_market_div/Financial_stability.pdf). The FSDC will be composed of the Governor of the Reserve Bank of India, the Finance Secretary and/or Secretary of the Department of Economic Affairs, Secretary of the Department of Financial Services, the Chief Economic Advisor of Ministry of Finance, the Chairman of the Insurance Regulatory and Development Authority, and the Chairman of the Pension Fund Regulatory and Development Authority.

Its responsibilities will include financial stability, financial sector development, inter-regulatory coordination, financial literacy, financial inclusion, macroprudential supervision of the economy, including the functioning of large financial conglomerates, and coordinating India's international participation with relevant bodies. However, it is not clear whether the FSDC will have any statutory powers.

The United States of America

The *Dodd-Frank Wall Street Reform and Consumer Protection Act*, at more than 2300 pages, takes numerous measures to improve the system of regulation in the US. Among the most significant changes for macroprudential regulations are the following:

- The act creates the Financial Stability Oversight Council (FSOC) to serve as an early-warning system to identify risks in firms and market activities, to enhance oversight of the financial system as a whole and to harmonise prudential standards across agencies. The voting members of the FSOC include the Treasury Secretary, who serves as chairperson, and the heads of the Federal Reserve, the Securities Exchange Commission, Federal Deposit Insurance Corporation, Commodity Futures Trading Commission, numerous other financial regulators and an independent member with insurance expertise.
- The FSOC will engage in data gathering, information-sharing, monitoring, and identification of gaps in regulation.
- Non-bank financial companies that are identified by the FOSC as 'systemically important' will be brought under regulation by the Federal Reserve.
- The Federal Reserve is required to establish enhanced risk-based capital, leverage and liquidity requirements, overall risk management requirements, resolution plans, credit exposure reporting, concentration limits and prompt corrective action to apply to all systemically important companies. Standards will increase in stringency based on enumerated factors including: the degree of leverage, amount and nature of financial assets.
- Many regulators have been given discretion to modify statutory standards and issue exemptions. In addition the FSOC is yet to become fully operational. As a result significant unknowns remain on the scope and content of systemic risk regulation.

Sixth proposal: Promote greater coordination and information-sharing between all financial regulators, and establish a Council of Financial Regulators.

In addition to clarifying the responsibilities of the different regulators, the regulatory framework must ensure appropriate coordination and information-sharing between them.

Most financial institutions are subject to a number of regulators (for instance, many banks in South Africa also have an insurance arm, so they are regulated by both the Bank Supervision Department (BSD) within the Reserve Bank, the insurance registrar within the Financial Services Board (FSB), the Financial Advisory and Intermediary Services registrar, as well as the National Credit Regulator (NCR)). Although most regulators effectively fall under the Minister of Finance, some key regulators are accountable to other Ministers (for instance, the NCR is accountable to the Minister of Trade and Industry). In such a case, the lack of coordination between, for example, the NCR and the BSD could pose significant systemic risk to the entire banking system.

Ensuring coordination between regulators, even when they all report to one Minister only, is a challenge at the best of times. The regulatory framework must require all regulators operating in the financial sector to coordinate their activities (unless they are exempted for good reason), and that this be formalised through legislation or Memoranda of Understanding. Ministers must ensure that the legislation they administer allows for such coordination.

Coordination and information-sharing can be achieved through formalising the Council of Financial Regulators. While each regulator will remain operationally independent, the Council will seek to ensure effective coordination between them.

The Council will comprise the heads of key financial regulators such as the BSD, the FSB and NCR; agencies such as South African Revenue Service (SARS) enforcement and the Financial Intelligence Centre (FIC); relevant standard-setters such as the Independent Regulatory Board for Auditors and the Accounting Standards Board; and non-financial regulators such as the Competition Commission and officials from the Department of Trade and Industry. The Council of Financial Regulators will be supported by technical committees comprising officials from the regulatory agencies, National Treasury and other key stakeholders.

To summarise, there will be two committees that deal with regulatory coordination:

- *the Financial Stability Oversight Committee*, which will have a mandate to coordinate on financial stability issues and would be responsible for both mitigating the risk of any crisis and for a resolution in the unlikely event of such a crisis; and
- *the Council of Financial Regulators*, which will ensure a flow of information and coordination of regulation in the other areas, such as enforcement, market conduct and legislation.

Seventh proposal: Increase the scope of regulation.

The financial crisis has revealed that many financially related activities are not regulated, self-regulated or too lightly regulated and may pose systemic risks. They include, among others, money markets, private pools of capital, credit ratings agencies, stock exchanges, payment systems and disclosure and accounting standards. Although the Reserve Bank and Financial Services Board (FSB) may play a role in guiding some of these largely unregulated sectors, regulatory powers need to be strengthened to deal with possible monopolistic practices and abuses.

It is important that all financial service providers and activities be subject to some form of regulation and if they are to be exempted, a strong rationale must be developed for doing so. A comprehensive assessment needs to be made of all unregulated activities and conflicts of interest, a process initiated with stakeholders to identify what kind of regulation is required and effective prudential and market conduct oversight executed if necessary. The governance and regulatory arrangements covering self-regulated or very lightly regulated entities which pose a systemic risk also need to be reviewed from a prudential and systemic risk perspective.

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

Many public pension funds (such as the Government Employees Pension Fund, Transnet Pension Fund, and municipal pension funds) are exempted from the Pensions Fund Act, and often have their own legislation. Similarly, many public-owned banks competing with private sector banks are also exempted from the Banks Act. The failures of Fannie May and Freddie Mac in the US demonstrate the systemic risks such banks pose when regulated lightly. Public financial institutions or funds should not be exempted from general laws and the ambit of regulations as these exemptions risk undermining the integrity of the regulatory system, and also create the false impression that the standards applied to public entities are less rigid than those applied to the private sector. This is not to suggest that many of the activities of development banks like the Development Bank of South Africa (DBSA) and Land Bank do not have good reason to be exempted through their own legislation. However, it is strongly recommended that such exemptions be reviewed and, where they continue to exist, be subject to annual review and made more transparent, with stricter oversight from National Treasury.

Ninth proposal: Improve enforcement capacity.

Several financial regulators are responsible for enforcement, including the Bank Supervision Department, the Financial Services Board, the Financial Intelligence Centre and Financial Surveillance Department of the Reserve Bank (formerly known as the Exchange-Control Department). In addition, the South African Revenue Service also has enforcement capacity with regard to tax evasion and fraud. In addition, both the police and the judicial system are involved in the case of criminal charges.

Transgressors in respect of one set of activities and institutions often transgress in other financial activities as well (for example, someone involved in money-laundering is often also guilty of tax evasion). It is therefore critical for the different enforcement agencies to work together and share information on a regular basis. This can be done through the Council of Financial Regulators. Any legislative barriers to such cooperation and sharing must be removed, without compromising the principle of confidentiality for tax affairs or market sensitive information.

Like with all other regulators, the system of accountability to the Minister and Parliament must be strengthened and should enable enforcement agencies to act without fear or favour.

Tenth proposal: Rationalise advisory and technical committees and enhance consultation processes with the industry and key stakeholders.

While consultation with key stakeholders is a critical part of good financial sector policy, there are currently more than ten separate advisory bodies, standing committees and boards operating at the expense of the taxpayer. The overly bureaucratic approach taken towards advisory bodies tends to make such bodies ineffective. It is proposed that the advisory bodies advising the Minister be rationalised into one body and that each regulator set up their own advisory bodies; legislation is not required to establish any advisory body.

The way forward

This chapter has provided more detail on proposed reforms. In shifting towards a twin peak model for financial regulation, the financial sector will be made safer through a tougher prudential and market conduct framework.

As noted in chapter 1, comprehensive consultations will take place as each measure is implemented, and all stakeholders consulted, through the normal governmental and parliamentary processes. A number of new pieces of legislation will be required and these will be introduced in the forthcoming years.

Table 3.1 Selected financial sector regulators

	Entity	Current function	Currently reports to
1	Bank Supervision Department	Banking sector (prudential) regulation	Reserve Bank
2	Financial Services Board (FSB)	Regulator of non-bank financial institutions	Minister of Finance
3	National Payments System Department	Payment system oversight	Reserve Bank
4	Exchange Control Department	Exchange control regulation	Reserve Bank / Minister of Finance
5	National Credit Regulator (NCR)	Regulator of credit provision	Minister of Trade and Industry
6	Co-operative Banks Supervision	Regulation of co-operative banks (over R20million)	Reserve Bank
7	Co-operative Banks Development Agency	Regulation of co-operative banks (under R20million)	Minister of Finance
8	Financial Advisory and Intermediary Services ombud	Resolve disputes between financial service providers and customers	FSB
9	Pensions Funds Adjudicator	Resolve disputes with respect to pension fund management	FSB
10	Industry ombuds	Resolve disputes in long-term insurance, short-term insurance and banking services industries	FSB
11	Johannesburg Stock Exchange (incl. Besa) (JSE)	Licensed self regulating securities exchange	FSB
12	Strate	Licensed self-regulating central securities depository	FSB
13	Financial Intelligence Centre (FIC)	Preventing financial crimes: Anti-money laundering and combating the financing of terrorism	Minister of Finance
14	Council for Medical Aid Schemes	Regulation of medical aid schemes	Minister of Health

4

Protecting consumers of financial services

- The South African financial services industry is characterised by high and opaque fees, and the provision of inappropriate services driven only by commissions. Over the long-term, it is expected that greater competition will bring down prices and improve behaviour. While important, this will take time, and not necessarily lead to the fair treatment of consumers.
- A stronger approach needs to be taken towards market conduct regulation. To do so, the Financial Services Board has launched the *Treating Customers Fairly* initiative, which will be implemented across the financial services sector. Consumer education will be ramped up. A retail banking services market conduct regulator will be created in the Financial Services Board.

Why regulate market conduct?

Financial services firms should treat their customers fairly

For as long as they have existed, financial sector regulators have grappled with how best to ensure that firms behave appropriately towards their customers. This chapter considers the current market conduct regulatory framework, identifies gaps, and makes proposals for a new framework that will ensure improved standards of consumer protection.

Market conduct regulation is essential because financial service providers often have far more expertise than consumers in assessing the quality of financial products and possess far more knowledge on the array of services available. Unfortunately this can create the incentive for financial service providers to exploit their superior information. Abuses range from milder complaints of providing deficient financial advice to egregious and blatant cases of fraud and misrepresentation.

Firms may charge high fees and offer inappropriate products

Moreover, big financial service providers with substantial market power may charge higher fees, sell products that are not appropriate for their clients and exploit their market power in other ways that may be deemed unfair to consumers.

Market conduct regulation restricts such abuses and also complements prudential objectives. As was demonstrated in the subprime crisis, inappropriate selling of financial products can have systemic effects and, a lack of confidence in the financial system due to poor market conduct practices causes losses to consumers and inhibits economic growth. In South Africa, now that the worst of the financial crisis is over, the focus on market conduct regulation and consumer protection will again be intensified.

Box 4.1 What have other countries done about market conduct?

In Australia, consumer protection laws are enforced by two regulators: the Australian Competition and Consumer Commission (ACCC) and the Australian Securities and Investments Commission (ASIC). The ACCC enforces Australian Consumer Law, which was introduced on 1 January 2011 and generally applies protection to any person or business as consumers of goods and services. ASIC has primary responsibility for enforcing the consumer protection provisions in law related to financial products and services including credit and aspects of the payments system. This law, which is amended to maintain consistency with the Australian Consumer Law, includes the Australian Securities and Investments Commission Act 2001, the Corporations Act 2001 and the National Consumer Credit Protection Code.

In Canada the Financial Consumer Agency of Canada, established in 2000, is the regulatory agency responsible for protecting consumers of financial services by (i) ensuring financial institutions comply with consumer protection law and regulations; (ii) monitoring the compliance of financial institutions with voluntary codes of conduct; (iii) informing consumers about their rights and responsibilities when dealing with financial institutions and (iv) providing information and tools to help consumers understand and shop around for financial products and services.

In the United Kingdom, the government has announced that it will transfer prudential regulation to a new unit of the Bank of England, and create a new consumer authority, the Consumer Protection and Markets Authority (CPMA). The new consumer agency will be independent and funded by the financial services industry. The Consumer Protection and Markets Authority once established will take on the FSA's responsibility for consumer protection and conduct regulation. The CPMA will be mandated to regulate the conduct of all firms, both retail and wholesale – including those regulated prudentially– and will take a proactive role as a strong consumer champion in the UK. The CPMA will maintain the FSA's existing responsibility for the Financial Ombudsman Service (FOS) and oversee the newly created Consumer Financial Education Body (CFEB), which will play a key role in improving financial capability. The CPMA will also have responsibility for the Financial Services Compensation Scheme. In March 2010, the FSA stated that while the Treating Customers Fairly initiative had yielded some improvements to market conduct, it had not delivered substantial on-the-ground benefits to consumers. It would need to be bolstered by a new conduct model that will take a dramatically different approach, with more pro-active intervention.

The US, in acknowledging lapses that precipitated the global crisis, moved swiftly to pass the Dodd-Frank Act which has been described as the most sweeping financial regulatory reform since the Great Depression. The Dodd-Frank Act creates a Consumer Financial Bureau. This bureau will be independent, with a budget paid for by the Federal Reserve Bank. It will also have wide powers, aiming to protect consumers from deceptive and abusive loans and other financial products and services. It will be able to conduct examinations of banks and seek information from other firms about consumer-related business. In doing its work, the Consumer Financial Bureau will consolidate existing consumer protection programmes now scattered across several agencies criticised for doing a poor job in the past. The bureau will have offices that are in charge of fair lending, financial education, armed services affairs, and financial protection for older Americans, among others.

Gaps in the current market conduct regulatory framework

South Africa: framework for market conduct regulation

Over the past few years, South Africa's regulatory framework for market conduct and consumer protection in financial services has been bolstered by the introduction of a number of laws to protect consumers, including the Financial Advisory and Intermediaries Services Act (2002), the Financial Services Ombuds Schemes Act (2004), the National Credit Act (2005), and most recently the Consumer Protection Act, which will be implemented on 1 April 2011.

New Consumer Protection Act is a milestone for consumers

The new Consumer Protection Act (CPA) sets a high standard for the protection of consumers. It establishes a single and comprehensive framework for consumer protection. It is far-reaching, applying not only to contracting parties but users, recipients and beneficiaries of goods and services. Consumers are not limited to South African citizens: the CPA defines consumers as all juristic persons. There is a focus on "vulnerable consumers" that includes many poor and uneducated persons. Goods and services have a much broader scope in terms of the Act than traditional definitions and will include, among others: retailers of goods, casinos, print media industry, airlines, estate agencies, and banking and financial services.

Why are financial services different?

The financial services industry should be held to a higher standard of consumer protection than other industries

Arguably, the financial services industry should be held to a higher standard of consumer protection than other industries for a number of 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.

However, the financial services sector also has a number of peculiarities which require slightly different treatment. For example, although the purchaser of a retirement annuity should be allowed a "cooling-off" period to reconsider her decision, someone who trades shares should not because this might introduce systemic risk. Moreover, the cost of this systemic risk will be borne by the economy as a whole, and many might lose their savings, even though the original share trader remains protected.

For this reason, consumer protection legislation for the financial services sector needs to be designed appropriately. The challenge facing the Financial Services Board, National Treasury and the Department of Trade and Industry is to develop a framework that complements prudential oversight, setting standards of conduct that are more stringent than those generally applied to other non-financial goods and services. Finally, jurisdiction of the financial sector must be clarified between financial and more generic consumer protection legislation, in order to avoid financial services firms profiting from gaps between the different legislative frameworks.

Treating Customers Fairly initiative

The Treating Customers Fairly *initiative proposes a consistent market conduct framework across the financial services sector*

The Financial Services Board published *Treating Customers Fairly*[20] in 2010, a proposal to adopt a framework for tougher market conduct oversight. It focuses on an outcomes-based approach, requiring firms to incorporate the fair treatment of customers at all the stages of the product life-cycle, including the design, marketing, advice, point-of-sale and after-sale stages. The initiative encourages firms to re-evaluate their company culture and to foster the attitude of treating customers fairly. It is hoped that the initiative will lead to more optimal outcomes from the perspective of the regulators, consumers and ultimately, firms.

The desired outcomes of the *Treating Customers Fairly*, or TCF, initiative are:

- Consumers should be confident that they are dealing with firms where fair treatment of customers is central to corporate culture.
- Products and services marketed and sold in the retail market should be designed to meet the needs of identified consumers.
- Advice should be suitable and take account of the consumer's circumstances.
- Consumers must be provided with clear information and kept informed before, during and after the point of sale.
- Consumers should be sold products that perform as firms have led them to expect, within reasonable limitations.
- Consumers should not face unreasonable post-sale barriers imposed by firms to change products, switch provider, submit claims or complain.

TCF is an important step in strengthening market conduct objectives in the financial sector, and will complement government's broader objectives in this area. The Financial Services Board will shortly publish a TCF Roadmap, which outlines the path towards implementing the initiative in South Africa. The TCF approach proposed for South Africa explicitly incorporates lessons learnt from the UK experience. As noted in Box 4.1, the FSA has recognised that a relatively hands-off approach to applying TCF, which relies on financial firms "doing the right thing" is insufficient, and that it also has to be more pro-active with specific interventions.

In particular, while broad outcomes guide the implementation of the initiative, international experience is that clear, enforceable rules and regulations also need to be in place to ensure that these outcomes are achieved. These will be developed as the programme is implemented.

[20] ftp://ftp.fsb.co.za/public/insurance/TCFDiscussionPaper052010.pdf

Specific regulatory proposals will be subject to an assessment to ensure that they are in proportion to the nature, scale and complexity of the market conduct risks that are present in different industries and business models.

Retail banking challenges

Banking enquiry focused on fees and charges, and found evidence of abuses and inadequacies in disclosure

The 2008 report of the Banking Enquiry Panel established by the Competition Commission found evidence of abuses in the setting of certain transactional fees and charges in the banking industry, and found inadequacies in the disclosure practices that made interbank comparisons by customers difficult, if not impossible.

The enquiry focused on the level and structure of charges made by banks and other providers of payment services and the feasibility of improving access by non-banks to the national payment system in order to encourage competition. The focus on transaction-based or payment services brought related fees and charges under close scrutiny. Moreover, the banking industry does not provide savers and investors with standardised interest rates, such as a nominal annual compounded monthly (NACM) rate that allows risk-return comparisons and an improved choice of savings and term deposit products.

The Banking Enquiry identified a major gap in the market conduct regulatory regime: there is no regulator that oversees the market conduct practices of the retail transactional banking sector. While the National Credit Regulator oversees the credit business of banks, it is clear that regulatory oversight needs to be extended to cover the entire banking sector, including retail banking.

The mandate of the FSB will be expanded to include market conduct in retail banking.

National Treasury strongly supported the sterling efforts of the Competition Commission in highlighting the weakness and opacity in market conduct practices, and is therefore proposing that as part of the shift to a twin-peak model of regulation, the market conduct role of the Financial Services Board (FSB) will be expanded by creating a dedicated banking services market conduct regulator within the FSB, which will work closely with the National Credit Regulator.

In particular, banks agreed to the lowering of penalty fees on dishonoured debit orders, improving the management of the current debit order system, greater transparency of ATM fees and charges, the implementation of a standardised switching code to promote ease of switching bank accounts between banks, and improving customer education. Banks also agreed on measures to ensure that all role-players in the debit order and payment system do not abuse the system. Recommendations on interchange and entry into the payment systems required policy guidance from the Reserve Bank and National Treasury, and could not be implemented by the banks unilaterally. However, the Reserve Bank and National Treasury have agreed that while non-banks should enter the clearing space, subject to strict criteria, they should not be allowed into the settlement space given the inherent systemic risks.

Insurance challenges

The market conduct record of the insurance industry is weak, measured by the volume of complaints to the statutory ombuds

There are primarily two types of insurance available to consumers – long-term insurance and short-term insurance. *Long-term insurance* includes life, health and disability insurance: these policies pay out a benefit when the insured individual dies, becomes ill or disabled. *Short-term insurance* is insurance for the possessions that an individual owns, and can be taken out on a home or car, on home contents, and on any other possessions. As noted in Box 4.2, 70 per cent of all complaints to the major financial services ombuds are for long-term and short-term insurance. Against this background, on-going efforts to strengthen the oversight of market conduct abuses in both sectors are a priority.

Long-term insurance

In the long-term insurance industry, high penalties are common on early termination of retirement and other savings policies. Also, long-term insurance companies often seek to recover full commission on termination. In 2006, National Treasury took steps to improve practices in the contractual savings market. Regulations were passed to reduce early termination penalties and limit the commission that can be paid upfront on investment products. There is on-going monitoring of potential abuses in this area.

Conflict of interest is a concern

Another area of concern relates to the role of intermediaries, and potential conflicts of interest. “Triangular association” refers to situations where an intermediary, such as a financial advisor, provides advice to the policyholder but is paid a commission by the insurer. This affects the ability of the intermediary to act independently and in the best interests of the client. Further, the inconsistent regulatory treatment of fees across the financial sector creates gaps in the treatment of investment and risk product offerings. Such treatment results in the practice of “churning” by intermediaries in the pursuit of higher fees to the detriment of the consumer. A possible solution would be to do away with commission for sales of policies and rely more on structured fees.

One of the primary focus areas of policy will be to lower costs and enhance the fairness and transparency of investment and risk policies, and to protect consumers and encourage an improved long-term savings environment. In this context, National Treasury will embark on a broad review of intermediary structures and fees across the long- and short-term insurance sectors with a view to aligning regulated and non–regulated fees and streamlining intermediary structures across the sector.

Statement of Intent

Some companies have not complied with the 2005 Statement of Intent

In December 2005, the Minister of Finance and the life insurance industry represented by the Life Offices’ Association (now incorporated into the Association for Savings and Investment South Africa – (ASISA)) signed a statement of intent. The statement of intent, among other commitments, limits the reduction of retirement annuities and endowment policies when policyholders make contractual changes such as reducing or not paying premiums or contributions (so-called “causal events”). Such reductions were as a result of long-term insurance companies seeking to recover full commission, mostly paid up front. The statement of intent also addresses ways to retrospectively rectify poor benefits paid under investment policies where contractual changes took place, going back to 1 January 2001.The statement notwithstanding, a number of rulings issued by the Pension Funds Adjudicator in 2009 highlighted the unfair and unreasonable practice by certain insurers in cases where multiple causal events occur, to deduct the maximum regulatory allowed causal event charge for each causal event.

To ensure better compliance with the statement of intent, the Financial Services Board issued draft directive 153 in mid-2010 to all long-term insurers for comment. This directive provides guidance on the maximum causal event charges that may be deducted under regulations and addresses the issue of multiple causal events. Comments received on the draft directive are currently being considered with a view to shortly issuing a final directive. Accompanying the directive will be a questionnaire for long-term insurers to report on the implementation of the statement of intent principles as of 31 December 2009 (the date by which the retrospective aspects of the statement of intent were to be fully implemented) and to confirm that the statement of intent has been consistently applied.

Short-term insurance

Short-term insurance also has a number of market conduct challenges, particularly consumer credit insurance

In the short-term insurance industry, there are also problems of high costs, the lack of appropriate disclosure and conflicts of interest.

Of particular concern is consumer credit insurance, or CCI, which is taken out increasingly by consumers to cover their indebtedness to credit providers such as banks, microfinance institutions, retailers and car dealerships. Its objective is to protect borrowers and their dependents against repossession of the underlying purchase in times of financial difficulty due to death or loss of income of the borrower, and to protect credit providers against default. Generally, the risks that are covered include death, disability, critical illness and retrenchment of the insured, or the loss, destruction or damage of the asset in respect of which the debt is incurred. Often it is taken out at the insistence of the credit provider as a form of collateral security. CCI supports the extension of credit for both consumption and asset accumulation.

National Treasury and the Financial Services Board will be reviewing the CCI market in South Africa to determine if it is delivering on its objectives, and if there is a need to revisit the prevailing policy and regulatory framework. This review will be considered in the context of consumer protection being one of the policy priorities for National Treasury, and the findings released in a 2007 report on abuses in this market[21]. National Treasury will release a public discussion document on regulatory proposals following this review.

[21]In 2007, the then Life Officers Association and the South African Insurance Association co-sponsored a Panel of Enquiry (Panel) to investigate abuses in the CCI market. The Panel's final report was released on 21 April 2008.

The ombuds system

The ombuds system is a powerful additional mechanism in the hands of consumers

International best practice in consumer protection requires the financial sector to provide consumers with speedy and affordable redress to address complaints and resolve disputes. These mechanisms are a powerful and additional weapon in the hands of consumers—but they require careful consideration and preparation. South Africa has embodied such redress in its ombud schemes (see Box 4.2). Such schemes, whether statutory, recognised or voluntary, should align with best practice standards such as independence, impartiality, confidentiality, transparency, clarity of purpose and effectiveness.

Recommendations of the comprehensive review into ombuds system will be implemented during 2011

A comprehensive review of the ombuds system was commissioned by National Treasury and the Financial Services Board (FSB), and during 2011 the two institutions will work together to ensure that the recommendations are implemented appropriately. One of the issues the review addresses is the future mandate and role of the Financial Services Ombudsman Scheme (FSOS) Council, presently fulfilling a coordinating role for all the ombuds.

A further component of the work is increasing awareness among consumers about ombuds and their role. For instance, there is now one hotline for complaints to all the ombud schemes. Access of customers to ombud services remains a concern, as is the affordability of the service. Ultimately, Treasury and the FSB intend to ensure that any new ombud scheme architecture efficiently delivers quality outcomes for consumers, and represents good value for money for the country.

Components of a comprehensive solution

In addition to strengthening and expanding the market conduct regulatory framework and implementing the Treating Customers Fairly initiative outlined above, there is a need to improve regulator coordination.

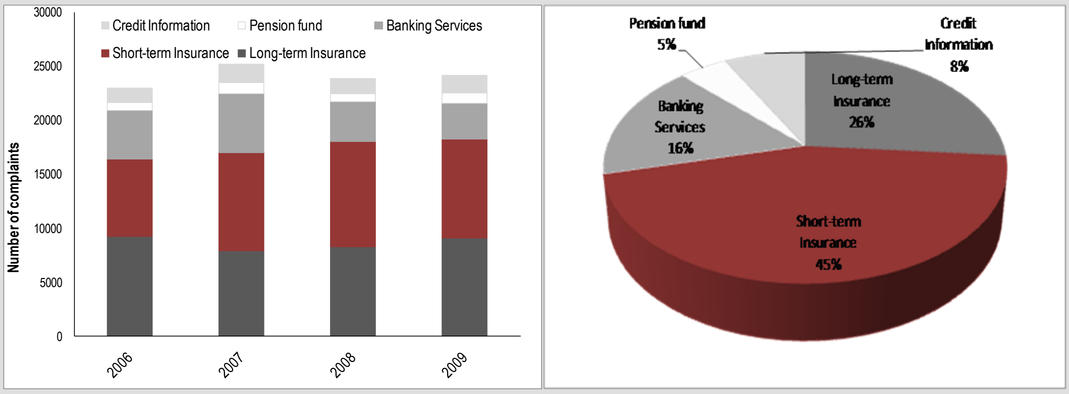
The shift to a twin-peaks system of financial regulation

As detailed in chapter 3, the regulatory system will move to a type of “twin-peaks” system. This will mean substantially stronger market conduct regulation at the Financial Services Board (FSB). To ensure this is comprehensive, FSB responsibilities will be expanded to include overseeing the market conduct of banks, including developing principles on how banks should set their fees, how these fees should be reported and what constitutes fair and unfair behaviour.

Box 4.2 Work of the financial services ombuds

Except for 2008 when complaints received by the Pensions ombud peaked, most complaints relating to financial services are received by the long-term and short-term insurance ombuds. Complaints received by the Financial Advisory and Intermediary Services (FAIS) ombud have increased each year since 2007. The banking services ombud has seen a decrease in complaints since 2007.

Distribution of complaints received by the financial sector ombuds since 2006



Long-term insurance: Most of the complaints received by the long-term insurance ombud in 2009 related to claims declined due to policy terms or conditions not met (49 per cent). The second highest complaints were about poor service or communication as well as non-provision of documents (22 per cent)

Short-term insurance: Most of the complaints received by the short-term insurance ombud in 2009 related to motor vehicles insurance (56.4 per cent). The second highest number of complaints was with respect to homeowners insurance (16.8 per cent).

Pensions: Two-thirds of complaints received by the pensions ombud were on withdrawal benefits, followed by death benefits, divorces (visible for the first time in 2009) and disabilities.

Banking service: Complaints varied from mortgage finance (20.9 per cent), credit cards (14.3 per cent), ATMs (10.7 per cent) to debit orders (2.6 per cent).

FAIS ombud: Most complaints were about long-term (24.6 per cent) and short-term (18.7 per cent) insurance products followed by investment products (13.3 per cent), retirement products (5.4 per cent) and medical schemes (1.1 per cent).

Improving regulatory coordination

Regulatory coordination is vital

The regulatory framework for consumer protection will require effective coordination between the many agencies and ministries responsible for legislation. Currently, at least three government ministries are involved: finance, trade and industry and justice, as well as many more agencies.

Also discussed in chapter 3, the new Council of Financial Regulators will play a strong role in coordination of regulators, particularly in the area of market conduct.

Consumer financial education

Consumer financial education is also important, particularly as financial products become more complex

The importance of consumer financial education lies in its ability to improve people's financial well-being. The current financial sector environment has abundant and increasingly complex product offerings. This, combined with a growing range of financial challenges facing households at the macro and micro levels, implies that enhanced financial understanding and awareness by consumers is essential. Improved consumer financial education reduces information asymmetries and promotes market transparency, competition and efficiency. It also has the potential to increase access to and demand for financial products.

The current draft consumer financial education policy rests on three pillars:

- Consumer financial education is not a substitute for effective consumer protection and market conduct regulation. Rather, it is part of a wider policy approach, which includes properly regulating and supervising the financial services industry and protecting individual consumers.
- Consumer financial education requires a multi-stakeholder approach that is centrally coordinated to ensure the active involvement and cooperation of all: government, schools, financial institutions, industry associations, employers, trade unions, community organisations, and non-governmental organisations.
- A national consumer financial education strategy with risk-based priorities is central to providing consumers with choices, informing them of their rights, instilling in them the values and confidence that empower them to make sound financial decisions, build assets and invest in the future.

The emerging consensus from the 2010 engagement process with stakeholders in consumer financial education, undertaken by the Financial Services Board in conjunction with Treasury, is that a national strategy should be developed, taking into account South African realities and international best practice. Major outputs would be a national financial literacy strategy, an action plan for its implementation and a clear assignment of roles and responsibilities of key stakeholders including the market conduct regulator.

In addition, activist consumer bodies need to be supported. Online price comparison tools and forums to complain about the quality of service provide an invaluable function for the broader community.

Next steps

While the above initiatives contribute towards a sound consumer protection and market conduct regime in South Africa, additional work needs to be done and comprehensive consultation is required between National Treasury, the regulators, consumer advocacy groups and industry.

Detailed proposals on regulatory reforms to strengthen the regime will be released for discussion in 2011, particularly the setting up of the banking services market conduct regulator and the *Treating Customers Fairly* Roadmap.

5

Safeguarding pensioners

- Pension funds play an important role in the national economy. Given South Africa's low savings rate and the present twin fiscal and current account deficits, pensions are even more important for economic development. Pension funds, smartly invested, provide a mechanism for unlocking savings, stimulating economic growth and ensuring that pensioners are provided for in retirement. By regulating them appropriately, governments can protect the elderly against poverty, facilitate investment and reduce systemic risk. While awaiting potentially far-reaching social security reforms, certain urgent steps have been taken to protect current savings.

Reforming pensions to increase savings

Pension funds play a vital role in the economy

In relation to the size of the economy, South Africa has one of the largest pension fund industries in the world, with nine million members and assets in excess of R 2 trillion. Globally and locally, pension funds are also important institutional investors. They pool funds from both employers and employees, with the aim of providing retirees and their beneficiaries with income upon the retirement, death or disability of a member. This guards against poverty in old age and reduces the potential dependency on the government.

Although pension funds are slightly different from other prudential entities like banks, which guarantee deposits upon demand, they do raise prudential concerns due to the long-term nature of contributions and the risks involved to meet such promises. This prudential concern is present in both Defined Contribution[22] (DC) schemes (guarding against

[22] With a defined contribution pension plan the employer's annual contribution is specified and guaranteed: future benefits fluctuate on the basis of investment earnings

fraud and excessive risk taking) and Defined Benefit[23] (DB) schemes (which additionally require a continuous matching of liabilities and assets). Further, although the collapse of a pension fund does not necessarily pose a threat to the entire financial system or economy, collapse due to mismanagement and fraud can profoundly damage the future of pension fund members, and also undermine the certainty and incentives of the savings regime. For these reasons, pension funds require good prudential and member protection oversight.

Pension reforms continue to be a topical policy issue in most countries, including South Africa. These reforms are necessitated by various factors associated with market imperfections, population dynamics, incomplete consumer information and literacy, low savings, investment risks, and the shortage of knowledgeable professional trustees.

South Africa has embarked on major social security reform first announced by the Minister of Finance in 2006, which will also include retirement reform; Chapter 7 of the 2011 Budget Review indicates the progress up to date. This reform has, however, taken longer than initially anticipated. In the meanwhile, National Treasury has taken urgent steps related to governance, disclosures and investment framework, in order to protect current members of pension or retirement annuity funds. This section will not cover the broader social security and retirement reform, but focus on the interim steps taken to protect current savings.

Challenges and policy issues

Maximising Savings through Preservation

Pension funds have broad coverage

The Old Mutual Savings Monitor (2010) ranks pension funds as the second most widely used savings vehicle after funeral policies in South Africa. The national savings rate – including savings by government, corporates and households – stands at around 16.7 per cent of Gross Domestic Product (GDP), with households contributing only 1.5 per cent of this total. The poor household saving rate coupled with lack of preservation presents a considerable challenge for the retirement funds industry.

Preservation is the requirement that money saved for retirement through a pension, provident or retirement annuity fund should remain in such a fund or be rolled over into another similar savings vehicle without incurring taxes or penalties until the person retires in the normal course of his or her career, reaches the age of 55 or retires on grounds of permanent disability.

[23]With a defined benefit pension plan, the employer promises a specified monthly benefit on retirement that is predetermined by a formula based on the employee's earnings history, tenure of service and age, rather than depending on investment returns.

Box 5.1 Regulation 28 to the Pension Funds Act

The aim of pension fund investment regulation is to ensure that the saving South Africans contribute towards their retirement is invested in a prudent manner that not only protects the pension fund member, but is channelled in ways that support economic development and growth. To this end, Regulation 28 of the Pension Funds Act empowers the Minister to define asset spreading requirements for pension funds.

A second draft regulation was released for public comment on 30 November 2010, following an announcement in the *Medium Term Budget Policy Statement*. Over thirty stakeholders commented on this draft. These comments were broadly representative of the retirement fund industry and ancillary services, including asset managers, insurers, asset and risk consultants, and industry associations.

The feedback received was overwhelmingly positive and mostly proposed technical refinements, although some substantive issues were put forward, namely:

- The proposed treatment of cash and debt instruments held by retirement funds was could artificially restructure the market in a way which could undermine liquidity management by a fund.
- Debt limits proposed could remain overly strict and could be relaxed in certain controlled instances.
- Limits on alternative investments, and unlisted equity in particular, were likewise considered overly strict in a manner that could impede investment into this pro-development funding channel.
- Investment into Africa, while much better enabled, could be even further so, to support economic growth in the region and the positioning of South Africa.

National Treasury has, in response, brought about several improvements to the November draft. The Regulation now better recognises and promotes the responsibility of funds and boards of trustees towards sound retirement fund investment. It expands the allowance for debt issued by listed or regulated entities, thereby supporting a stronger corporate debt market and addressing the bank structural funding mismatch between short-term borrowing and long-term lending, while crucially still protecting retirement funds and their member's savings. The regulation better enables investment into unlisted and alternative assets to support economic development that may be funded through such capital-raising channels. Investment into Africa is likewise supported through providing for alternative ways of accessing this market in a responsible way. Importantly, the Regulation continues to better align retirement fund regulation with other government policy objectives like socially responsible investing and transformation.

The Regulation will be effective from 1 July 2011. Notices and Guidance Notes on the treatment of securities lending, derivatives, and part-guaranteed insurance policies will be drafted by the Financial Services Board in consultation with National Treasury, and will also be subject to stakeholder engagement ahead of finalisation in March. Provision is made in the Regulation for transitional arrangements, and funds can apply for temporary exemption from provisions that they may not immediately be able to comply with.

To support the implementation process, National Treasury, together with the FSB, will hold stakeholder workshops to further explain the Regulation.

When changing employers, about half of respondents take benefits out in cash

According to the same Monitor, 52 per cent of 91 survey respondents who changed employers and exited their funds withdrew benefits in cash, 25 per cent transferred their benefits to the fund of the prospective employer, 18 per cent left the benefits in their previous fund, 3 per cent invested in a retirement annuity fund, and 4 per cent in a preservation fund. Further, Anderson (2010) states that following the retrenchments that took place between January 2009 and August 2010, only 10.2 per cent preserved while 89.8 per cent took cash payouts[24]. During the same period, a dismal 2.4 per cent preserved retirement benefits from divorce settlements against the 97.6 per cent that went for divorce payouts.

[24]John Anderson, *Are we saving enough?* Presentation at the Institute of Retirement Funds 2010 Conference on Retirement Funds

Withdrawals pose a policy challenge

The large withdrawals from the pension fund system could be triggered by various factors including financial hardship, retrenchments and indebtedness. Moreover, the current default system makes it easier for persons who might not even be going through financial hardship to withdraw their savings, simply because the current system does *not* compel preservation of retirement savings upon job changes, retrenchment or divorce. The Income Tax Act does encourage preservation to some extent, by allowing retirement capital to be transferred tax free to a similar approved fund, while taxing any pre-retirement withdrawals. The challenge with the current tax system is that the tax clearly does not serve as a strong disincentive since people are willing to pay it and withdraw their savings.

The introduction of mandatory preservation is therefore critical and National Treasury plans to extensively consult all relevant stakeholders.

Further, to effectively enable this change, there should also be an enhanced system of portability. Portability refers to a worker's ability to maintain or transfer accumulated pension benefits either to a preservation fund or a prospective employer's plan when changing jobs, for example. This would introduce additional competition in the industry and possibly lead to a fall in costs.

Managing Early Withdrawals within Compulsory Preservation and Retirement Annuities

Early withdrawal of funds from pension funds is usually restricted because retirement savings must be safeguarded for their intended purpose, which is to provide *sufficient* income upon retirement. Globally, sufficient income is considered to be between at least 40 and 70 per cent of income at retirement. Premature withdrawals of retirement benefits prevent people from retiring comfortably, adversely affect the growth of pension funds and result in poor savings.

In South Africa, there is an uneven treatment of the various retirement saving products. Due to lack of compulsory preservation for occupational pension funds, there are reported cases of individuals resigning from their jobs just to gain access to their pensions. At the other end of the spectrum, individuals who make use of Retirement Annuity Funds (RAs) are barred from withdrawing any of their savings in the fund before the age of 55 years. In this regard, there seems to be a need to ensure consistent treatment of the various products if the goal is to preserve retirement savings and close loopholes in the system.

A system of compulsory preservation and life annuities may need to be balanced with some highly restricted forms of withdrawals, to balance protection of savings with a limited degree of flexibility.

Products like Provident Funds will have to be treated equally with other products in terms of benefits. For example, we will need to do away with the ability to have a provident fund paying out a lump sum of the entire benefit at retirement.

Member education

Consumer education is a further challenge

As noted in chapter 4, consumer and member education is critical to improve financial well-being. Countries like the US invest significant resources in trying to reach out to consumers of financial services. In South Africa, a recent study by the Bureau for Market Research reveals that a meager 35 per cent of the surveyed "affluent" market (income cluster of above R 750 000 per annum) and the "realised" market (income cluster of between R 300 000 – 750 000 per annum) are financially knowledgeable[25].This illustrates the challenge of consumer literacy, since these are persons who would be expected to have a better understanding of the financial products and services they use.

Making permanent changes in attitudes towards pensions, and savings in general, requires ongoing education. Providing effective and regular education for actual and possible pension fund participants and retirement annuity fund holders regarding the need to save, planning for retirement and investing and financial literacy in general, can counteract poor financial decisions by members. This education, however, must start with children at home and in schools. The Financial Services Board is currently rolling out a consumer education strategy, which also targets schools.

Trustee Education

A key aspect of the governance of pension funds is the role of trustees. Trustees must have the relevant education, experience and skills to make investment decisions consistent with the best interest of the pension fund and its beneficiaries. They should at all times exercise their fiduciary responsibilities towards the fund, and not necessarily to the persons appointing them, be it employees or employers.

The impetus for demanding high levels of expertise and integrity from trustees requires the following: application of fit and proper standards to the appointment of trustees and to their conduct, mechanisms to achieve proper training of trustees, and the use of independent professional trustees. Government is also considering making it a statutory requirement that trustees be fit and proper with certain minimum qualifications, which should be achieved within a fixed period from the date of appointment.

A Code of Ethics has been proposed as one of the possible strategies to ensure that the industry operates in an ethical manner and upholds the highest standards. Such a Code would be binding on all persons operating in the retirement industry. National Treasury will facilitate meetings with the industry's representative bodies in 2011 to facilitate the drafting of such a Code of Ethics.

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[25]Prof DH Tustin, *Attitudes, beliefs and behaviour of Gauteng consumers towards saving.* Paper presented at the 2010 South African Savings Institute/Old Mutual South Africa Savings Workshop

Box 5.2 A review of the provision of annuity products

Retirement annuity products serve a critical role in encouraging long-term savings. However, they are also characterised by a reputation for high costs and consumer abuses. National Treasury will embark on a review of the annuity market with the objective of facilitating competition, reducing costs, promoting flexibility, and enhancing disclosure and consumer protection.

Increasing competition

The two main types of retirement benefits available after retirement are living annuities and guaranteed annuities. The current challenge in the sector is that collective investment scheme (CIS) companies can only offer living annuity products if they obtain a long-term insurance licence. An applicant for a licence must be able to put up capital of R10 million. This requirement seems onerous particularly since the CIS company is only offering living annuities, which by definition do not offer any guarantee. Enabling collective investment scheme companies to offer living annuities without the need for a long-term insurance licence could open the market and foster competition.

Reducing costs

The regulatory treatment of fees across the financial sector creates inconsistencies in the annuity market. There are differences in the layers of fees charged by insurers and CIS companies. For example, an annuity policy sold by an insurer includes a commission charge, an administration charge, a monthly policy fee and an annual service fee. An annuity policy sold by a CIS company includes an annual management fee, a broker commission and a trail fee. Insurers are also required to comply with commission regulations in terms of the Long-term Insurance Act; however CIS companies are not subject to commission regulations and are permitted to charge an additional unregulated trail fee for on-going advice to clients. Such discrepancies in the fee structure result in the practice of financial advisors switching products in the pursuit of high fees to the detriment of the consumer. Consequently, there is a need to align and standardise fees payable on annuity products.

This specific issue has been discussed in the 2011 Budget Review.

Improving transparency

There is a need to enhance disclosure, particularly to highlight the difference between a guaranteed annuity and a living annuity product. Guaranteed annuities provide much needed protection especially in the context of rising life expectancy, leading to people outliving their savings in retirement. Protection against this risk has become more important. However, guaranteed annuities are often more costly due to the nature of the guarantee. More effort can be made to ensure that investors are aware of the different costs upfront, and sensitised to the importance of a guaranteed annuity.

Mandatory lock in periods

Individuals who make use of annuity products are restricted from withdrawing any of their savings until the age of 55. There has been much debate about the balance between the mandatory restrictions on withdrawals and the need for flexibility of access to retirement annuity funds. Consideration is being given to enable some restricted access to retirement savings, while also promoting the need for pension fund savers to retain their savings or preserving.

Enhancing Choice through Disclosure and Transparency

Poor disclosure, high charges and inappropriate fees are a concern

The retirement funds industry is characterised by poor disclosure, which can contribute to high charges and harmful inertia, as consumers are not able to compare products. The non-disclosure of certain fees and premiums can also work against the industry; for example, it is highly possible that people are not aware that a retirement annuity fund which purchases a life annuity upon maturity incorporates a guarantee to pay a pension until the death of the pensioner. Although guaranteed annuities are important, they can also be costly since the business of managing longevity risk – the risk that people will live longer than expected – after retirement is a difficult one for insurers, and therefore needs to be priced accordingly. However, legitimate concerns and perceptions that industry costs are high for retirement annuities, as an example, can be better dealt with if the guarantee and its related premium are fully disclosed to the client prior to the annuity being purchased. In this regard, a statutory requirement to disclose certain information to the client is necessary.

Every pension fund must be obliged to provide statements to its members on a regular basis, possibly twice a year. The Chilean experience indicates that the statements should contain an optimal amount of information, since members tend not to read very detailed information. The proposed Organisation for Economic Cooperation and Development (OECD) disclosure guidelines recommend that statements should provide at least the following basic information:

- The contributions already accumulated from both employer and members
- The pension benefit you are likely to receive if you continue your contributions until retirement, adjusted for inflation and investment risk
- How much you need to contribute to reach a particular replacement ratio
- Benefits due to beneficiaries upon death, disability and so on
- A breakdown of the fees (such as administration, investment) and the net benefits.

Such disclosure enables members to take more informed decisions, including whether to supplement their retirement savings or to increase their contributions, or even switch to another fund under a portability-enabled system. It should be noted that disclosure under DC funds is relatively better than in DB funds, given the inherent transparency of DC funds.

National Treasury, together with the Financial Services Board, will also be formally engaging with the industry on the high and opaque charges, especially on products such as retirement annuities, to better understand their cost structures. This will be done through the *Treating Customers Fairly* programme.

Managing Costs through Umbrella Funds and Alternative Products

The retirement funds industry, especially retirement annuities, is correctly perceived by society as fraught with high costs. High administrative costs reduce retirement income, irrespective of whether the fund is a DB or DC, although this is more pronounced in the latter case.

Economies of scale may offer benefits in terms of cost and effective supervision

A possible solution to structurally manage retirement costs or fees is through economies of scale. A recent study by Economic Research Southern Africa (2010) shows that South Africa has unused scale economies of between 24 per cent and 30 per cent[26]. Further, the study argues that the optimal fund size to achieve economies of scale is around 220 000 members. Economies of scale can be achieved through the consolidation of small private sector pension funds into a smaller number of large funds. There are currently too many pension funds to allow for cost efficiencies at the member level.

The currently overpopulated pension fund space also makes effective supervision difficult. Although the number of active pension funds has declined significantly to 3200 active funds, further consolidation can still be achieved. A legal threshold can be set at which a fund will be registered by the Financial Services Board (FSB). Further, smaller employers should be encouraged or required to join umbrella funds. Umbrella funds have demonstrated some advantages when it comes to reducing costs, transparency and good governance. According to the FSB (2006), the cost to contribution ratio for funds with 20 members or less stood at 63.5 per cent, while funds with 10 000 or more members had a cost to contribution ratio of 0.69 per cent. Similarly, Allethauser, Hacking and Latchman (2010) found costs and fees of stand-alone funds to be significantly higher than umbrella funds[27].

Public sector pension funds: harmonising rules and regulations

Public sector pension funds (such as those of state-owned entities, the Government Employees Pension Fund or GEPF and local government pensions) are characterised by fragmented rules and supervision. For example, the largest pension scheme in the country, GEPF, is self-regulated and has different rules compared to other public sector pension funds. This is the case with many other government pension schemes.

Although the Pension Funds Act ("PFA") is a relatively old piece of legislation, having been enacted in 1956, and in need of modernising, it has managed to keep pace with certain key developments. For example, the PFA:

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[26] Economic Research Southern Africa, *Study on Economies of Scale in SA retirement funds*, Presentation at ASISA 2010 Conference on Retirement Reform

[27] Anne Cabot-Alletzhauser, Hugh Hacking and Bashkar Latchman. *Umbrella Funds - Is this where the market is going?* Presentation at the 2010 Institute of Retirement Funds Conference on Retirement Funds

- allows divorcees to immediately receive a share of their member-spouse pension upon divorce (if the benefit is prescribed by the marriage contract), and not wait for the member-spouse to first retire[28]
- affords members of pension funds registered under the PFA access to the Pension Funds Adjudicator
- incorporates a minimum benefits rule

A number of public sector pension funds do *not* incorporate these modern rules, and therefore place their members at a disadvantage.

There have been numerous complaints regarding the GEPF rules. In particular, the rule that restricts members who leave after a few years to only their portion of contributions upon resignation has been considered by many as grossly unfair. This rule also has the potential of discouraging persons from becoming government employees since pension benefit is a major consideration in the decision to join an organisation. The inability for a member to receive full benefits (that is, both contributions from employee and employer) upon withdrawal from a fund is one of the reasons why DB funds were converted to DC funds in the last decades. A process is currently underway to review the current rules of the GEPF to better align them with best practice, even though it will remain a DB fund.

Box 5.3 Pension Funds investing in government bonds

The South African bond market is very active with government issuing local bonds to fund its expenditure. Statistics indicate that both public and private pension funds are major investors in government bonds. In 2008, institutional investors, especially pension funds, were the largest investors in government bonds: around 60% of government bonds were held by the Public Investment Corporation (mainly the Government Employees Pension Fund) and private pension funds, with another 20% were held by long-term insurers. In 2009, private pension funds held around 31% of their total assets in government bonds.

It is also important to note that all entities cannot issue a bond, since a bond requires a guarantor and requires the issuer to be able to raise income to service the interest payments. The bond must also pay an appropriate return in line with the associated risk. National Treasury is able to play such a role within government, given the power to raise taxes.

Two options will be investigated with regard to the possibility of bringing all public sector pension funds within the same regulatory framework as private pension funds:

- Requiring all public sector pension funds (that is, funds of state-owned entities, the GEPF and local government funds) to register under a (revised or new) Pension Funds Act and be subject to the supervision of the FSB
- Designing a uniform dedicated public sector pension funds act, with the aim of consolidating some or all of the funds not supervised under the PFA, and subjecting them to the supervision of the FSB.

[28] This rule gives effect to the Divorce Act and Constitution.

National Treasury and the FSB will engage with the relevant public sector organs to consider the various options and best approach in facilitating this harmonisation and consolidation.

Tax proposals in the 2011 Budget

The 2011 Budget gives effect to some of the reforms. Three sets of corresponding tax changes are proposed as transitional measures (as outlined in Chapter 5of the Budget Review):

- *Uniform contribution system*: The system for obtaining deductions will be unified so that individuals will be allowed a single stream of deductions for contributions made to pension, provident and individual retirement annuity funds.
- *Provident funds*: As part of the new uniform tax system, strong consideration is being given toward subjecting provident fund withdrawals to the one-third lump sum limit currently required in relation to pensions. These changes seek to ensure that retirees preserve some of their retirement savings throughout their retirement years. This change will be subject to extensive consultations and will contain transitional relief for those with vested rights.
- *Living annuities*: Upon retirement, taxpayers can convert their retirement fund savings into guaranteed annuities or living annuities (in addition to partial withdrawals as a lump sum). While guaranteed annuities lie at the core of the insurance business because these annuities depend on the life-span of the retiree, living annuities are based solely upon the member investment. It is therefore proposed that the list of eligible living annuity providers be expanded to other intermediaries (e.g. collective investment schemes and government retail bond issues).

6

Access to financial services

- Achieving sustainable and inclusive development in the financial sector goes hand-in-hand with improving access to financial services, particularly for the poor and vulnerable. In 2010, 37 per cent of 33 million South African adults did not have a bank account and only 40 per cent had a formal long-term insurance product. To increase access to affordable, convenient and appropriate financial services, financial inclusion interventions are essential.
- National Treasury is undertaking a number of initiatives that will contribute to developing a financial sector that provides access to the poor and thereby contributes to economic growth, job creation and poverty alleviation. These initiatives include developing the role of Co-operative and Dedicated Banks, strengthening the Postbank, and introducing a micro insurance framework.
- National Treasury is also working with the financial sector, the trade unions and other stakeholders to finalise the gazetting and converting of the Financial Sector Charter into a Sector Code that will become binding on all reporting institutions.

Overview

Access to financial services is crucial in the South African context

Financial inclusion is about ensuring that all South Africans have access to financial services that encourage them to manage their money, save for the future, obtain credit and insure against unforeseen events. This is especially important for low-income households who live in or close to poverty. Unforeseen emergencies – such as the loss of a job or an income-earning asset – can push vulnerable families into vicious poverty traps. Access to credit and insurance can not only help the poor raise their standards of living but prevent those standards from falling sharply in an emergency.

Financial inclusion has gained global attention and recognition as a vehicle for sustainable and inclusive growth and development. The government played a key role in facilitating the adoption of the

Financial Sector Charter in 2004 to promote financial inclusion. This was done by committing major financial institutions to work more closely with government, labour and the wider community to transform the financial sector to better serve the poor and vulnerable, and ultimately the nation. In addition, South Africa is working towards fulfilling its commitment to implement the G-20 Principles for Innovative Financial Inclusion.

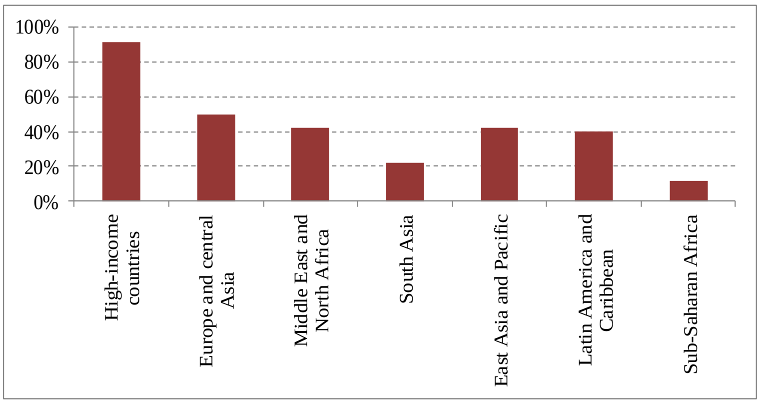
Increasing access to formal financial services for individuals, households and micro, small and medium enterprises (MSMEs) has substantial benefits for the economy, including job creation, boosting economic growth, alleviating poverty, improving income distribution, and empowering women. Improving access to financial services will entail policy interventions, and changes to the institutional environment.

Financial inclusion scorecard

More than 50 per cent of South African households have deposit accounts. More than 60 per cent of adult South Africans have a bank account

Access to financial services varies greatly across different parts of the world. The percentage of households that have a deposit account with a formal financial institution varies from 91 per cent[29] in high-income countries such as the United States to 12 per cent in Sub-Saharan Africa. In South Africa the number of households with deposit accounts is estimated to be between 50 per cent and 75 per cent (see figure 6.1 for regional comparisons).

Figure 6.1: Percentage of banked households, 2009



Source: C Gap, Financial Access 2009

When considering other financial inclusion indicators, South Africa has varying results in comparison to other economies. The number of bank branches per 100 000 adults is among the lowest in the world. The number of ATMs per 100 000 people is substantially higher than India, but roughly half that of Brazil and one-third of that of Australia. The number of point-of-sale terminals is once again much higher than India and half that of Brazil but one-quarter that of Australia. Table 6.1 compares selected financial inclusion indicators internationally.

[29] C Gap, Financial Access 2010

Table 6.1 International comparison of selected financial inclusion indicators

	Australia	Brazil	India	Mexico	South Africa	United Kingdom	United States
Deposit value (% of GDP)	75.18	35.55	55.03	15.08[1]	92.92[2]	61.32	43.91
Loan value (% of GDP)	115.67	78.61	40.93	13.36	95.96	80.64	44.81
Bank branches per 100 000 adults	32	13	10	15	8	21	36
ATMs per 100 000 adults	157	112	7	45	52	1`23	176
POS per 100 000 adults	4 040	2 247	67	592	1 068	2 331	-
Value of SME loans (% of GDP)	15.33	3.77	4.34	-	10.71	-	4.93

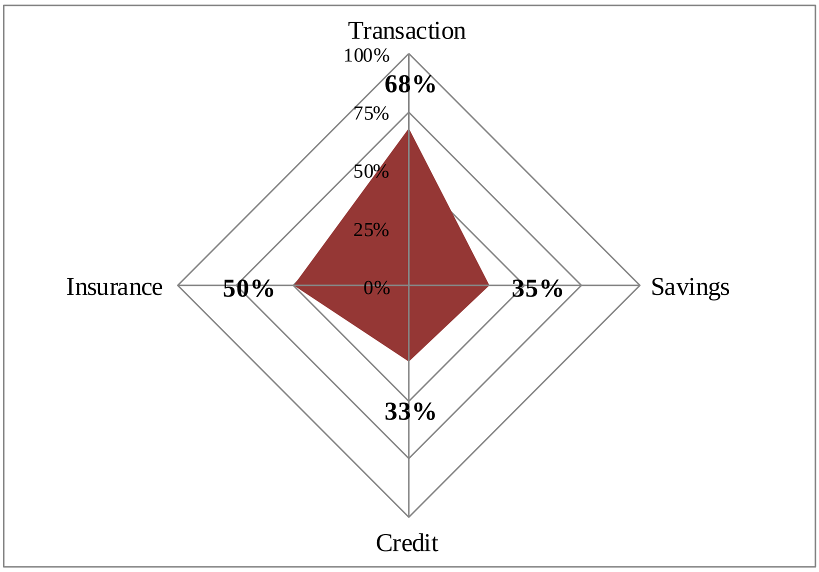
Source: C Gap Financial Access 2010 and SARB National Payment System Division

1. Red shading indicates the lowest value
2. Green shading indicates the highest value

Access for individuals

The South African Finscope survey measures access to credit across four categories of financial products: transaction, savings, credit, and insurance products. This landscape of access (figure 6.2) includes both formal and informal financial sectors of the economy and indicates that 68 per cent of adult South Africans use transaction products, 35 per cent savings products, 50 per cent insurance products and 33 per cent credit products.

Figure 6.2 Landscape of access for individuals in 2010

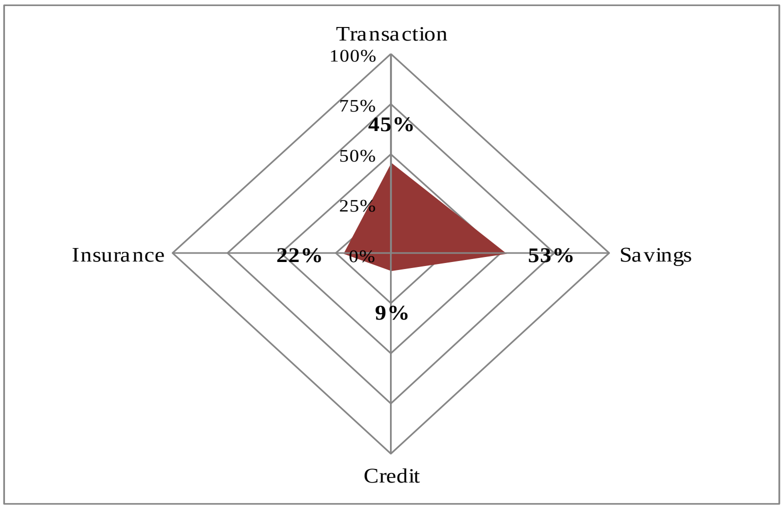


Source: Finscope South Africa 2010

Access for small businesses

According to the Finscope South Africa Small Business Survey 2010, 45 per cent of small businesses use transaction products, 53 per cent savings products, 45 per cent transaction products, 22 per cent insurance products and 9 per cent formal credit products (see figure 6.3).

Figure 6.3: Landscape of access for small businesses in 2010



Source: Finscope South Africa Small Business Survey 2010

Financial inclusion initiatives

In recent years, government has undertaken a number of initiatives to accelerate financial inclusion. These include promoting entry into the banking sector, creating an enabling framework for co-operative banks, facilitating the entry of smaller dedicated banks, improving the governance arrangements of Postbank, and introducing deposit insurance for co-operative banks, taking forward the Financial Sector Charter and improving access to housing and small business finance.

In addition, the industry has introduced a number of initiatives that harness cutting-edge technology to provide innovative and useful products (see box 6.1). Where appropriate, government will support these initiatives through legislative and regulatory changes.

Co-operative banks

Acknowledging that consumers with a common bond may wish to form an association to provide financial services to members, a legal and supervisory framework was created for the co-operative banking sector in 2007. This was designed to afford depositors in co-operative banks the same level of safety and protection as that enjoyed by depositors in mutual banks and first-tier banks.

Registration of several Co-operative banks is expected in early 2011

The purpose of the Co-operative Banks Act is to create a regulatory framework that provides for the registration of Co-operative Financial Institutions (CFIs) as co-operative banks. CFIs include financial services co-operatives, saving and credit co-operatives, community banks, credit unions and village banks. There are approximately 60 CFIs currently operating under the common bond exemption to the Banks Act. Their total assets are approximately R137 million, total savings R125 million and membership approximately 36 000. The co-operative bank supervisors are in the process of conducting assessments of 18 CFIs that have applied for registration as co-operative banks. These CFIs represent 92.7 per cent of the sector's total assets. The registration of several co-operative banks is expected in 2011.

Box 6.1 Using technology and innovation to expand access to banking

Across the world, there has been an explosion in new technologies and innovative approaches towards banking. South Africa is no different. By reducing costs, and taking banking to all corners of the country, many of the previously unbanked have benefited. Some examples of these innovations in South Africa include:

Domestic money transfer systems: Retailers have developed technologies that enable customers to transfer money on a person-to-person basis between any of the retailer's stores. A registered bank is responsible for all the deposit-taking and regulatory requirements in terms of legislation (including payment-related requirements). In other innovations, customers can also initiate payment instructions from their bank account. A message is sent to the mobile device of the beneficiaries, allowing them to withdraw the money at the account holder's bank's ATM.

Prepaid cards expand the capabilities of banks to provide card-based solutions for both banked and unbanked customers (such as shopping centre gift cards, FIFA World Cup Cards).

The community banking mobile banking account, offered by one of the Big Four banks, is a card and cellphone-based basic transactional account originated and serviced in communities by community banking sales agents, community bankers and at authorised community retailers. The account links the client's bank account to a SIM card so that transactions such as purchases, money transfers, and balance enquiries can be done via a cell phone or through a community retailer's transactional device. Clients can also use their debit cards through existing banking infrastructure. The product provides mass market customers with a cash management solution that is affordable, accessible, easy to use, and enabled through non-traditional channel access such as local community retailers (specifically cash-in and cash-out). Other retail partners include spaza shops, hairdressers, butchers and shebeens.

Virtual payments (mimoney) act as electronic cash that can be used as a payment method on platforms such as an internet website, a mobi website (a website downloaded to a mobile phone) or at a telephone booking centre (call centre) where mimoney is advertised as an acceptable payment mechanism. mimoney can even be redeemed at retailers that are mimoney acceptors.

Pure cash back at point of sale (POS) allows debit cardholders to withdraw cash at any POS device whether at a retail store or spaza shops. Pure cash-back at POS will promote access in rural areas at a lower transaction cost than an ATM withdrawal.

Cash-back at POS enables certain retailers to allow a customer to receive a cash-back with their purchase on debit cards.

Transaction notification services provide customers with immediate electronic notifications – SMS or email – alerting them to financial transactions on their accounts. Such services allow customers to better manage their finances and identify fraudulent transactions on their accounts.

Real-time Clearing (RTC) transactions are real-time EFT credit push inter-bank transactions that allow customers to make immediate payments across relevant channels and products, enabling beneficiaries to have immediate access (within 60 seconds) to the funds received. Only a single transaction is allowed with no batch processing. Only South African rand-based transactions are allowed. Straight-through-processing is utilised and no manual intervention allowed.

Early debit orders (EDOs): There are two types of EDOs - authenticated early debit orders (AEDOs) and non-authenticated early debit orders (NAEDOs). AEDOs enable the accountholders to electronically authorise future-dated deductions from their bank accounts for the payment of insurance premiums, loan repayments, asset purchases, and so on, at the point of sale by swiping their bank cards and entering their PIN. Since these deductions are authenticated by the consumer in person, they cannot be repudiated, giving the service provider and consumer certainty of payment. NAEDOs allow qualifying service providers and consumers transacting with these service providers the equivalent benefit of AEDO without the PIN authentication requirement. A NAEDO instruction is therefore similar to a standard debit order, except that it is processed earlier. Debits in AEDOs and NAEDOs (with a capped item limit of R5000 per transaction) are processed on a randomised, non-preferential basis, providing every user (including the customer's own bank) with an equal and fair opportunity to recover payments due from the account. The solution expands access to the National Payment System, improves the effectiveness of debit order payments and reduces the incidence of returned debit orders as well as the associated fees and costs. A NAEDO payment is enhanced by a tracking service, which enables the instruction to be processed from the mandated date over a selected tracking period (the instruction is kept in the background and triggered whenever a deposit is applied to the account).

The Co-operative Banks Act also provides for establishing the Co-operative Banks Development Agency (CBDA) to support, promote and develop the co-operative banking sector. The agency began operating in August 2008 and is currently designing capacity-building programmes for CFIs. The Act further makes provision for the agency to establish and manage the Co-operatives Banks Deposit Insurance Fund. National Treasury, in consultation with CBDA and the supervisors of co-operative banks, is in the process of developing a framework to establish the fund.

Financial Sector Charter (FSC)

Expectations are that the long-awaited draft Financial Sector Code will be gazetted for comment in mid-2011

The Financial Sector Charter came into effect in January 2004 as a result of the NEDLAC Financial Sector Summit. The FSC sets broader and deeper transformation targets, taking into account the specifics of the financial sector. At its launch, it was recognised by stakeholders that, given the risk of re-capitalisation expected of significant shareholders of, say, a bank, the focus of the Charter should be on access and ownership targets. Hence, the Charter includes access targets in other sectors like the financing of low-income housing, small and medium enterprise finance, transformation infrastructure, and access to financial services such as affordable banking, insurance and savings products.

One of the key initiatives flowing from the FSC process is the Mzansi account. Mzansi was launched in 2004 by the four big banks and the Postbank. It is designed as an entry-level transactional account with common features to address the obstacles that deter consumers from being part of the formal banking sector. By August 2010, there were 3 million active Mzansi accounts.

The FSC allows for a comprehensive mid-term review of its target to take into account achievements by the financial sector against the targets and to adjust the targets in line with existing challenges. The Financial Sector Charter Council, constituted to oversee implementation of the Charter between 2004 and 2014, is redrafting the Charter as the Financial Sector Code in terms of the Broad-based Black Economic Empowerment (B-BBEE) Act 53 of 2003. The draft Financial Sector Code is the product of interaction between industry associations, labour, community and government. The draft code aims at aligning the FSC with the B-BBEE Act Codes of Good Practice, which were gazetted in 2007, well after the launch of the FSC.

After making significant progress from inception until 2007, the Charter process broke down over negotiations to amend it to meet the new B-BBEE requirements. This delay slowed the process of transformation, but now, after three years, the dispute over equity ownership appears to have been resolved.

Phase one of the draft code, which represents an agreement mainly on the ownership element, was gazetted for comment end 2010. It is envisaged that phase two of the code, which will include access targets will be gazetted for comment mid-2011.

Box 6.2 A primer on *stokvels*

A *stokvel* is an association of individuals who make regular contributions to a common pool of savings, which is generally given in total or in part to each contributor on a rotational basis. The business of a *stokvel* is directed by a common bond that exists between its members.

There are different types of *stokvels*:

- General savings clubs are established for a variety of purposes, such as women's *stokvels*, where members pool their savings to buy groceries in bulk at reduced prices or party *stokvels*, where members takes turns to organise parties at which food and liquor are sold and the host takes the profits.
- Burial societies are *stokvels* established to assist members with funeral costs. They are formed between people with a social connection, such as members of the same church, to provide a way for members to save for and insure themselves against the death of a family member.
- Investment *stokvels* save for capital projects or to invest in a business venture, property or shares.

There are divergent estimates of the size of the industry. In 2003, the University of Cape Town estimated that adults in South Africa invested about R12billion a year in *stokvels*. In 2007, Old Mutual estimated that informal savings in South Africa amounted to R33 billion. The National *Stokvels* Association of South Africa estimates that approximately 8.3 million adults are members of 800 000 *stokvels*. Finscope 2010 found that 38% of adults – 12 million people – use *stokvels*.

Stokvels accept deposits in a manner that is identical to conducting the business of a bank. Subject to certain exceptions, no person may conduct the business of a bank in South Africa unless such a person is registered as a bank in terms of the Banks Act, or as a mutual bank in terms of the Mutual Banks Act. However, in recognition of, among other things, their social and economic role, the Reserve Bank made an effort to legalise them and in January 1994, the Registrar of Banks, with the approval of the Minister of Finance, issued Government Notice No. 2173 based on the common-bond principle, whereby *stokvels* can lawfully conduct their operations within South Africa, provided they operate within the scope and conditions of the common-bond exemption notice. In December 2006, the common-bond exemption notice was revised to, among other things, prohibit *stokvels* from undertaking activities of pension fund organisations as defined in the Pension Funds Act.

Restructuring the governance of the Postbank

Legislative framework in place to improve and expand the role of the Postbank

The Postbank is among the financial institutions best suited to take the lead in satisfying the financial services needs of rural and poor communities in South Africa. Given this important role, government embarked on a process to bring the banking activities of the Postbank under the legislative and regulatory ambit of the financial services sector.

The first leg of this process saw the drafting and approval of the South African Postbank Limited Act, which seeks to create a legislative framework to establish the Postbank and improve and expand its role as a dedicated bank (see below).

Overall, the idea is to expand the Postbank's products and services, particularly for the rural and lower income markets as well as communities that have little or no access to commercial banking services. National Treasury is working with the Postbank and the Department of Communications to make this vision a reality.

Dedicated banks

Dedicated banks will receive renewed attention

Government is committed to promote legislation to encourage greater competition in the retail banking sector, by facilitating entry for banks that are limited in complexity, scope and size. "Dedicated banks" are envisaged to be narrow or core banks that specialize in certain retail activities such as deposit taking or lending or both. The idea of narrowing the activities of such banks to the funding of risk-free or lower-risk retail assets is attractive as it reduces the bank-default risk of depositors.

A number of proposals suitable for a post-crisis industry are being considered. A discussion paper in this regard is being prepared and will be published for comment in mid-2011.

Deposit insurance

A number of challenges complicate the introduction of deposit insurance. Discussions are on-going.

Deposit insurance seeks to protect bank depositors, in part or in full, in the event of a bank failure. It is one way to balance the often conflicting policy objectives of financial inclusion and financial sector stability. Although National Treasury circulated a draft Deposit Insurance Bill in 2008 for comments, a range of challenges complicate the conclusion of this initiative. These include the need to take into account the specifics of the South African financial system – the domination of the sector by four big banks, and the leading role of corporate depositors in previous bank-run episodes. The introduction of deposit insurance is particularly important for encouraging new entrants to the sector. In the absence of deposit insurance there is a strong possibility that customers will prefer saving with the big four as these banks are considered to be "too-big-to-fail" and, as such, safer. This attitude might prevail even if smaller banks have a better and cheaper product offering.

Discussions between the relevant parties are on-going. A timeline for public consultation on the proposals is being finalised.

The IMF/World Bank Reports on the Observance of Standards and Codes (ROSC) assessment in March 2010 highlighted the limited progress made in launching a deposit insurance scheme in South Africa and emphasised – in light of the recent draft liquidity proposals issued by the Basel Committee on Banking Supervision in December 2009 – that the absence of explicit deposit insurance regulation may have an adverse effect on South African banks.

Micro insurance

The regulatory framework for the insurance sector should better support access for the poor

Informal insurance or risk pooling is probably the single largest financial service in South Africa. For example, 23 per cent of black South Africans and 15 per cent of coloured South Africans surveyed by Finscope in 2009 obtained protection against funeral expenses through membership of informal burial societies.

The formal sector has struggled to keep pace, partly because of regulatory barriers. As a result, a large proportion of the South African population continues to be excluded from obtaining access to an appropriate range of formal insurance products and services. Finscope 2010 reports that only 50 per cent of adults hold or are covered by insurance, and that this is dominated by funeral and what are considered hugely under-reported credit policies (policies issued against a credit purchase). Moreover, many of these policies are sold by unscrupulous, and in many instances illegally operating, intermediaries.

The challenge South Africa faces is threefold: we need to enable better take-up of insurance policies by poorer and more vulnerable households, change the composition of the insurance market to better reflect the needs of these families (so that they are protected in life and not just against funerals), and ensure protection against unscrupulous operators.

Government believes that the current regulatory framework for the insurance sector should better support the provision of appropriate insurance products to low-income South African households.

National Treasury has finalised its micro insurance policy framework, which will be released in March 2011. The framework aims to achieve the following objectives: (i) extending access to a variety of good-value formal insurance products appropriate to the needs of low-income households; (ii) enabling current informal insurers to provide formal insurance, in the process establishing new, well-capitalised insurers and promoting small business development; (iii) lowering the barriers to entry to encourage broader participation in the market and promote competition among providers; (iv) ensuring protection of the consumers of microinsurance; and (v) facilitating effective supervision and enforcement.

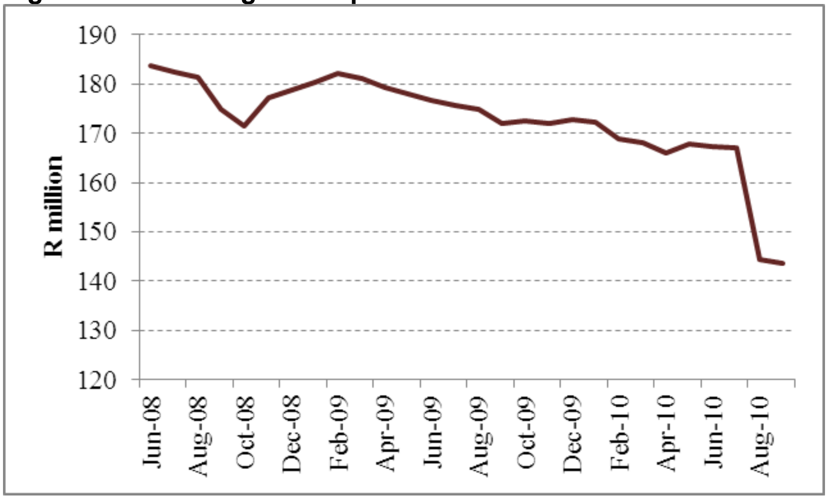
Access to small business finance

Treasury is taking forward FSC proposals to improve SME access to finance and supporting dti's strategic initiatives to increase financial services to small business

Ensuring the success of small business is high on government's agenda as small business is seen as a major force for economic growth and employment creation.

Banks' gross credit exposure to retail SMEs[30] decreased from R183.8 million in June 2008 to R143.7 million in September 2010[31] (see figure 6.4). This downward trend indicates the credit constraint under which SMEs are operating in the current economic environment.

Figure 6.4: Banks' gross exposure to retail SMEs



Source: Bank Supervision Department BA200 data

[30]Retail SMEs have an aggregate exposure of less than or equal to R7.5million

[31]There is no consistent national definition of the term SME. Improving this is a core priority for Treasury.

A number of Development Financial Institutions (DFIs) provide finance to SMEs and micro-enterprises. These include the Industrial Development Corporation (IDC), Khula Enterprise Finance, South African Microfinance Apex Fund (samaf), National Empowerment Fund (NEF) and National Youth Development Agency. The New Growth Path recently endorsed by Cabinet contemplates a remake of the mandates and roles of DFIs. In particular it proposes a "one-stop shop and single funding agency for small and micro businesses through the consolidation of Khula, samaf and IDC, among others". As announced, in the 2011 State of the Nation address, many of these will be rationalised to make them more effective.

According to the Finscope South Africa Small Business Survey 2010 there are roughly six million small businesses with fewer than 200 employees. One in six South Africans aged 16 years and older generates an income through a small business and 58 per cent of small business owners are women.

Almost a quarter of small business owners – 22 per cent – cited sourcing money as their main obstacle when starting up, while 14 per cent named access to or cost of finance as the biggest hurdle to growing their business.

What is significant is that 76 per cent of small business owners were unaware of any organisation that helps or advises small businesses. Only nine per cent of small business owners are aware of the use of banks as a potential basis of support and only two per cent sought help there.

In terms of its regulatory environment for easy access to credit for businesses, South Africa is rated joint second with the UK out of 183 economies

In international rankings for the ease of doing business[32], South Africa is ranked second out of 183 economies in terms of the ease of obtaining credit. This is based on the depth and coverage of credit information as well as the strength of legal rights, which is the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and facilitate lending; South Africa's rankings in other index constituents are not as favourable (see table 6.3).

[32]World Bank Group, Doing Business, 2010

Table 6.3: South Africa rankings on ease of doing business

Topic	Ranking out of 183
Starting a business	67
Dealing with construction permits	52
Employing workers	102
Registering property	90
Getting credit	2
Protecting investors	10
Paying taxes	23
Trading across borders	148
Enforcing contracts	85
Closing a business	76

Source: World Bank Group, Doing Business 2010

Apart from its work with G-20 efforts aimed to improve access to finance by micro, small and medium enterprises, Treasury is presently examining FSC proposals to improve access for black small and medium enterprises and supporting the trade and industry department's strategy initiatives[33] to increase supply of financial services to small business.

Access to Housing Finance

Addressing housing challenges is a major priority of government. The twin problems of supply and affordability continue to hamper the growth of the affordable housing finance market in South Africa. An analysis of the South African housing finance market is shown in table 6.4.

Table 6.4: South African housing market

Market segment	Monthly income	Households		Average mortgage granted Q2 2010 R'000
		Number (million)	% of total	
Housing subsidy market[1]	< R3500	8.3	60%	R0[1]
Gap market[2]	R3500 to R10000	3.2	23%	R184.3
Affordable market	R10001 to R15000	0.7	5%	R245.3
Traditional market	> R15 000	1.6	12%	R687.5

[1]Households qualify for a fully subsidised house of R140 000
[2]Households earning between R3501 and R7000 qualify for a state subsidy in terms of the Finance Linked Individual Subsidy Programme (FLISP)

Source: National Credit Regulator, June 2010, Consumer Credit Market Report, FinMark Trust, 2010, Enhancing access to housing finance, unpublished report

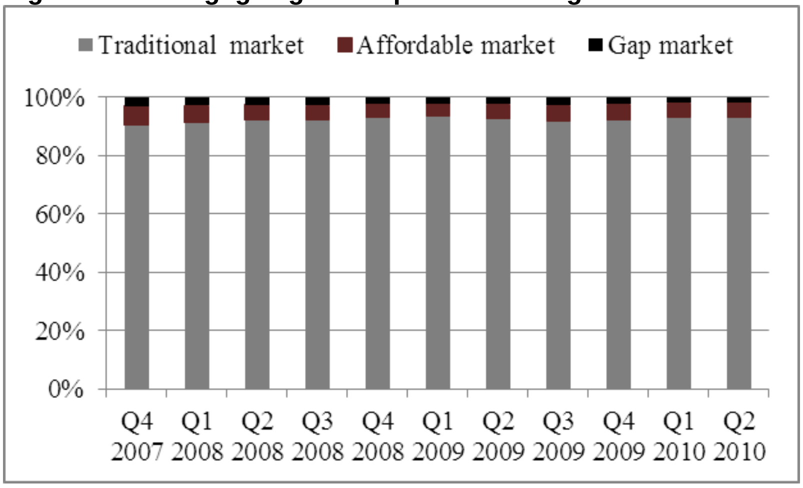
Despite the progress made in the last 16 years, an estimated 2 million households live in informal and inadequate housing. The subsidy

[33]dti, I*ntegrated strategy on the promotion of entrepreneurship and small enterprises.*

instrument has created distortions in affordable housing, which has resulted in a housing stock gap. Over 1.3 million households in the "gap market segment" who do not qualify for a housing subsidy live in inadequate, overcrowded or informal housing. Other than resale stock, there is no housing available in this market segment. Consequently, any housing finance goes towards home improvements and not new supply. There is housing delivery in the "affordable market segment" although not yet at the required scale. Only in the "traditional market segment" – households earning more than R 15 000 per month – does housing supply and finance operate efficiently and without distortion.

The trend in mortgages granted since the last quarter of 2007 is shown in figure 6.5. The mortgages granted to the gap market as a proportion of total mortgages has decreased from 3.1 per cent at the end of 2007 to 1.8 per cent in the second quarter of 2010. The same trend is observable in the affordable market, with mortgages declining from 6.3 per cent to 5.0 per cent over the same period. The proportion of mortgages granted to the traditional market increased from 90.6 per cent to 93.2 per cent over the same period.

Figure 6.5: Mortgages granted per market segment



Source: National Credit Regulator Consumer Credit Market Reports

The World Bank contracted FinMark Trust to undertake research and explore policy options on enhancing access to housing finance in the affordable and gap markets. The study is underway and results are expected by early 2011. National Treasury will carefully consider the recommendations for implementation.

Financial Inclusion data and measurement

Data deficiencies and inconsistencies hinder the effective measurement of progress and the formulation of appropriate and informed policy intervention. Efforts aimed at improving the availability of authentic, credible and reliable data that will facilitate progress-tracking and monitoring have commenced. The critical first step is to design financial inclusion performance indicators across the dimensions of financial inclusion – products, services, target groups and institutions – to focus and guide the development and implementation of the data and measurement framework.

South Africa is currently taking part in the data collection initiatives of G-20Financial Inclusion data and measurement subgroup, the Alliance for Financial Inclusion Group, and Finscope. The Finscope survey is a Finmark Trust initiative supported by syndicate members including National Treasury. It is the only survey that focuses on access to and usage of financial products and services.

Trade-off between inclusion and maintaining the integrity of the financial system

A key trade-off for the policymaker lies between the objective of financial inclusion and the desire to protect the sector from financial crimes and other abuses, such as money-laundering and terrorism financing. Protecting against financial crime requires the mandatory disclosure of client and transaction information through the "Know Your Client" (KYC) principle – disclosures that are sometimes onerous for low-income households. Through a special dispensation under Exemption 17, under the Financial Intelligence Centre Act, we saw the emergence of Mzansi account products which effectively lowered the KYC requirements of disclosure in order to accommodate the informal sector. Mzansi account and similar low value products carry a low money laundering and terror financing risk and as a result they pose no significant threat to the financial system. Exemption 17 complements South Africa's drive to enhance financial inclusion.

South Africa is currently part of an international project on financial inclusion run by the Financial Action Task Force (FATF) – a 36-member inter-governmental body established by the 1989 G-7 Summit in Paris, of which South Africa is a part. The project will be finalised in June 2011. The Alliance for Financial Inclusion (AFI), which is also an international standard setting body in matters relating to Financial Inclusion, is working together with FATF in order to enhance access to financial services, particularly in developing countries.

Remittances

Remittances, in particular, can pose a challenge to financial integrity while at the same time performing a very important function for the poor. Poverty is the motivating factor for people immigrating to South Africa and remitting money to their home countries. The FinMark Trust and the Consultative Group to Assist the Poor (CGAP) commissioned research on remittances in Southern Africa in 2005 to estimate market potential and assess regulatory obstacles for migration remittances within South Africa and the Southern Africa region.

The results of the FinMark and CGAP survey suggest that less than half of the remittances in both the domestic and international markets have been processed via informal channels (for example, taxi drivers, friends and relatives), which poses a major risk to the remitter since the money might not even reach its destination. Further, these informal channels can easily be abused by money launderers and terrorism financiers. Various alternative formal money transfer channels were identified by the report in terms of serving the banked and unbanked remitters in the domestic and regional remittance market. These technological and market innovations include mobile airtime transfer, mobile banking, internet transfers to money transfer agents, the Mzansi Transfer product, the Western Union model and a prepaid card model.

A number of regulatory challenges remain to the formalisation of remittances in the Southern African region. In terms of South African exchange control regulations, cross-border remittances can only be facilitated by authorised banks and Authorised Dealers in foreign exchange with Limited Authority (ADLAs) – usually referred to as bureaus. These entities are strictly supervised by the Reserve Bank and the Financial Intelligence Centre in order to safeguard the integrity of the remittance system. In line with FATF recommendations, South Africa is on the path of adopting the risk-based regulatory approach towards AML/CFT compliance. The risk-based approach will seek to balance the important role remittances play in alleviating poverty, with the need to ensure that they are not misused and abused. The cash-threshold reporting system has also been introduced to ensure that accountable and reporting institutions must, within a prescribed period, report to the FIC those transactions that involve an amount of cash in excess of a prescribed amount.

Regulatory reforms in this area are important to deal with high volumes of remittances in the informal and low-income sectors of the economy. In addition, remittances have a direct bearing on immigration laws and regulations on exchange control and anti-money laundering. Proper accreditation and supervision of ADLAs is important to not only maintain the integrity of the system but also to enhance access and efficiency of the system. National Treasury will continue to work together with the FIC and the Reserve Bank to ensure that the remittance system works effectively and efficiently.

Box 6.3 Ownership and financial stability

Due to the structure of their balance sheets and their role as intermediators of capital banks pose a systemic risk. A failing bank can trigger a systemic crisis that not only risks causing other banks to fail (“contagion”), causing disastrous disruption to the functioning of the entire financial system and the economy to shrink severely, with the tragic loss of millions of jobs. The global financial crisis demonstrated this in practice.

Precisely to prevent such a banking crisis, South Africa’s Banking Act requires regulatory approval from the banking registrar in the Banking Supervision Department to approve any significant change in ownership. These requirements include a test of whether the directors and owners of financial institutions are fit and proper, whether there are proper governance structures in place to be able to exercise sufficient oversight over the funds with which they are entrusted, and minimum capital requirements to provide members and depositors with an additional layer of protection against financial losses.

Shareholders who have significant shareholding (of more than 15 per cent) are required to be shareholders of reference, and must be in a position to inject more unleveraged and unencumbered cash in the event of a run or liquidity crisis in the financial institution. Section 37(1) and (2) of the Banks Act, Act No. 94 of 1990 requires that any person wishing to acquire more than 15 per cent of the total nominal value or voting rights of a bank’s shares may only do so with the approval of the Registrar of Banks. The purpose of these provisions is to ensure that the shareholders are “fit and proper” persons and understand the implication of owning a bank. Importantly, the Banks Act also requires any shareholding exceeding 15 per cent to be liable for funding the recapitalisation of banks that experience capital shortages. This means that such shareholders will need to have deep pockets to fund such capital shortages, at short notice, should a bank have liquidity or solvency problems.

Shareholders of reference cannot borrow to fund the purchase of bank shares, as borrowed funds are treated as encumbered. This reason for this can be seen in the global financial crisis, were shareholders have been forced to provide more funds, or lose their market share as outside funders (e.g. governments) have come in as new shareholders. The global financial crisis demonstrated that banks are best owned by institutions with broad and deep balance sheets and access to international and domestic lines of credit. Allowing banks to be owned by a handful of individuals, no matter how wealthy, would pose substantial systemic threats to the system. These threats would be even larger if these individuals or groups of individuals purchased their bank shares with borrowed money.

7

Combating financial crime

- Finance is central to almost every economic activity. It also attracts criminal elements bent on securing ill-gotten gains. As the financial system has developed and technology has advanced, financial crimes have also become more sophisticated.
- South Africa has prioritised the fight against crime and continues to develop strong structures that identify, investigate and prosecute money laundering cases as well as strengthen compliance, oversight and regulatory measures.
- Measures to promote financial integrity bring transparency to the financial sector by requiring financial institutions to conduct proper due diligence on their customers and capture and maintain customer and transaction information in records that are accessible by supervisory and investigating authorities.

Integrity is a critical aspect of financial stability

Financial crime poses an enormous risk to the safety and strength of the financial system

Finance is central to almost every economic activity. It also attracts criminal elements bent on securing ill-gotten gains. As the financial system has developed and technology has advanced, financial crimes have also become more sophisticated. Criminals tend to have more resources to cheat the system, thereby requiring the state to build more capacity to fight such crimes. The criminal justice system must be able to channel more resources into the speedy and efficient investigation and prosecution of financial crimes.

Types of financial crimes include corruption, blackmail, money-laundering, advance fee fraud ("419 scam"), banking fraud, identity theft, and organised crime. Widespread abuse of the financial system can adversely affect the macroeconomic environment within which South Africa operates, endanger financial stability and deter foreigners from investing in the country. It is, therefore, fundamentally important that the sector is protected from criminal activities and South Africa takes a very strong view on the maintenance of financial integrity.

Financial institutions play a vital role at the frontline in the fight against financial crime

Measures to promote financial integrity aim to detect and address abuses of the products and services offered by financial institutions. These measures bring transparency to the financial sector by requiring financial institutions to conduct proper due diligence with respect to their customers, and maintain customer and transaction information in records that are accessible by supervisory and investigating authorities.

Internationally, the Group of 20 nations (G-20) has, in a number of statements on strengthening the international financial regulatory system, referred to steps such as strengthening transparency, promoting market integrity and reinforcing international cooperation. In this context, the G-20 called on the Financial Action Task Force – a 36-member inter-governmental body established by the 1989 G-7 Summit in Paris – to revive the review process for assessing compliance by jurisdictions with standards on financial crimes.

South Africa is a member of the FATF, which works closely with other key international organisations, including the IMF, the World Bank, the United Nations, and regional bodies such as the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), of which South Africa is also a member. The United Nations, through Conventions and Security Council resolutions, also plays a significant role in the campaign against illegal financial activities.

Framework for targeting financial crimes

Tackling organised crime, money laundering and the financing of terror are all priorities

South Africa has prioritised the fight against crime and continues to develop strong structures that investigate and prosecute financial crimes as well as strengthen compliance and regulatory measures. The Financial Intelligence Centre (FIC) was established in 2002 to lead the fight against illegal financial activities. The legislative framework for maintaining financial integrity rests on three pillars: the Prevention of Organised Crime Act of 1998, criminalising money laundering; the Protection of Constitutional Democracy Against Terrorism and Related Activities Act of 2004, criminalising terror financing; and the Financial Intelligence Centre Act of 2001 (FICA). The FICA prescribes a list of accountable institutions[34] and, as part of the "Know Your Client" (KYC) principle, requires them to identify the clients with whom they have business relationships and conduct due diligence with respect to them. These institutions are required by law to keep proper records relating to the identity of their clients and to report any large or suspicious transactions.

[34] The business sectors required to report to the Financial Intelligence Centre include banks and other financial services providers, authorised foreign exchange dealers with limited authority, insurance companies, collective investment schemes, stock and bond brokers, casinos, bookmakers, estate agents, accountants, auditors, attorneys and motor vehicle dealers.

As part of South Africa's drive to protect the integrity of the financial system, more advanced mechanisms are been put in place through, among other things, the introduction of new legislation and amendments to existing ones. The Financial Services Board (FSB) Act of 1990 has created an Enforcement Committee, which efficiently deals with non-compliance and imposes administrative sanctions to enhance the integrity of the financial sector regulatory regime. Through other legislation administered by the FSB, such as the Inspection of Financial Institutions Act of 1998, a number of undesirable business practices have been successfully prosecuted; some of the cases are still pending in courts.

Those that steal from trust funds and fleece the public through elaborate pyramid schemes will face the full might of the law

During 2010, the FSB issued 19 inspection reports that enabled them to take decisions on, among others, institutions conducting unregistered businesses and those implicated in the misappropriation of investor funds[35]. The outcomes of these inspections have prompted several applications to the High Court to place certain financial institutions under curatorship, as well as referrals to law enforcement agencies. Through the Financial Institutions (Protection of Funds) Act of 2001, a framework has been put in place to deal with "the investment, safe custody and administration of funds and trust property by financial institutions". The theft and misappropriation of trust funds by financial institutions and other bodies such as estate agents and attorneys have resulted in massive losses to the unsuspecting public. The FSB's successful prosecution of one of the leading masterminds behind the so-called 'Ghavalas option', which involved the stripping of the surplus assets of several pension funds, has helped to build faith in the South African financial system. Other efforts such as proper training of pension fund trustees and addressing broader governance challenges within the financial sector will also enhance the integrity of the system. The Bank Supervision Department of the Reserve Bank has also successfully targeted Ponzi and pyramid schemes.

International principles of effective supervision to prevent criminal activity require supervisors to have adequate resources, sufficient independence, access to information, and the power both to make rules and to impose sanctions, and yet be held accountable[36]. The 2010 joint World Bank/IMF Financial Sector Assessment Programme (FSAP) report on South Africa hails the country for upholding a strong regulatory and supervisory architecture of the highest international standard.

Challenges facing financial integrity in South Africa

Despite existing policy and regulatory measures, the financial system remains at threat. According to the 2009 FATF/ESAAMLG Mutual Evaluation Report on South Africa:

[35] FSB Annual Report, 2010.

[36] The World Bank, *Preventing Money Laundering and Terrorist Financing: A Practical Guide to Bank Supervisors*, 2009.

> *"Major profit-generating crimes include fraud, theft, corruption, racketeering, precious metals smuggling, abalone poaching, '419' Nigerian-type economic/investment frauds and pyramid schemes, with increasing numbers of sophisticated and large-scale economic crimes and crimes through criminal syndicates. South Africa remains a transport point for drug trafficking. Corruption also presents a problem. However, the South African authorities are committed to pursuing this issue through a range of initiatives such as the introduction of measures to entrench good governance and transparency. Security agencies indicated that the current threat from international and domestic terrorism is low, and will remain low for the foreseeable future. Nevertheless, the authorities are vigilant about the concern that South Africa could be used as a transit or hideaway destination for people with terror links."*

The Financial Intelligence Centre (FIC), together with National Treasury, will be working on a more comprehensive financial integrity policy to enhance our interaction with the relevant local and international bodies. It is also important to be able to effectively respond to international instruments such as sanction resolutions by the United Nations Security Council. Further, the global financial system continues to be threatened by weak financial controls in some high-risk jurisdictions. Currently, South Africa is working together with other countries through FATF to identify such high-risk jurisdictions.

It is also important that the FIC, in its Annual Report and through other means, makes available information relating to patterns and techniques that are utilised by criminal elements to commit financial crimes. Such information will raise awareness of illegal activities among policymakers, supervisory bodies, business entities and individuals. Another possible strategy to raise awareness is the development and regular release of threat indicators with respect to, say, money laundering and terrorism financing.

Combating money laundering and terror financing

Reducing money laundering is part of a comprehensive fight against crime

The events of 11 September 2001 increased the global focus on Anti-Money Laundering (AML) and Combating of Financing of Terrorism (CFT). Since then, apart from establishing the Financial Intelligence Centre (FIC), South Africa has implemented various policy and regulatory measures to strengthen the AML/CFT framework.

Money laundering consists of three stages, namely; (i) placement, which is a stage at which criminals introduce the illicitly obtained money into the financial system; (ii) layering, which involves the separation of the proceeds from their source by creating layers of transactions designed to disguise the audit trail of the criminal proceeds; and (iii) integration, which takes place when the criminal proceeds are integrated into the financial system as legitimate funds. All these stages commonly occur in the banking, securities, insurance and microfinance sectors of the economy.

Abuses within the banking, securities and insurance sectors

The cash-based nature of the South African economy poses challenges

Although South Africa has a sophisticated financial sector characterised by well-developed infrastructure and technology, the economy remains primarily cash-based due to the large informal sector. During 2009-10, the Financial Intelligence Centre (FIC) reported to the authorities R66.1 billion in financial transactions in the country that were suspected to be proceeds of crime and money laundering[37].

The FIC has recorded a number of criminal incidences through suspicious transaction reports (STRs). During the 2009-10 period, the FIC received 29 4111 STRs, which reflects a 28 per cent increase from the previous reporting period (22 762 in 2008-09). The available data reflects that 91 per cent of the STRs are from the financial sector, with only 9 per cent from the non-financial sector. This demonstrates clearly that the financial sector continues to be at a higher risk of attracting financial crimes.

In June 2003, the Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commissions (IOSCO) published a joint note providing a record of the initiatives taken within each sector to combat money laundering and the financing of terrorism. The note provided an overview of the common AML and CFT standards that apply to all three sectors and an assessment as to whether there are serious gaps or inconsistencies in the different approaches. These standard-setting organisations identified the following vulnerabilities that required increased due diligence:

- Transactions involving accounts in multiple jurisdictions
- Securities accounts introduced from one intermediary to another without adequate customer due diligence through Know Your Client investigations or from high risk jurisdictions
- The use of front persons or entities (such as corporations and trusts)
- Entities with complex corporate structures
- Politically exposed persons
- Dealing with financial institutions and intermediaries or customers operating in jurisdictions with ineffective AML/CFT systems
- Unregistered or unregulated investment vehicles, cross-border omnibus and correspondent accounts, and fictitious trading schemes.

According to FATF, there are comparatively low levels of suspicious transactions reported in the securities industry relative to other industries, such as banking[38]. In South Africa there are no empirical studies which analyse the vulnerabilities in this sector. As a result, there is inadequate information to establish if and to what extent the securities market in South Africa is subject to criminal abuse. According to studies in other countries, the following areas in securities markets are vulnerable to money laundering: wholesale markets, unregulated funds,

[37] FIC Annual Report 2009/10

[38] FATF, *Money Laundering and Terrorist Financing in the Securities Sector-October*, 2009

wealth management and investment funds, bearer securities, and bills of exchange[39].

The insurance industry, as part of the financial sector, is also susceptible to criminal abuse. However, although no extensive studies have been conducted in South Africa, FATF believes that the insurance sector is not as badly affected by illegal activities as the banking sector. This could be attributed to the nature of the insurance business and the safety checks already in place. The IAIS issues AML Guidance Notes for insurance entities and their supervisors. South Africa is currently in the process of developing a new risk-based solvency regime for short and long-term insurers and risks posed by money laundering and terrorism financing are likely to be factored into the new regime.

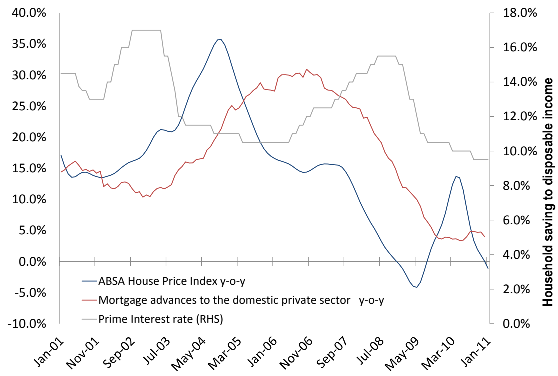
[39] MONEYVAL Typologies Report, 2008

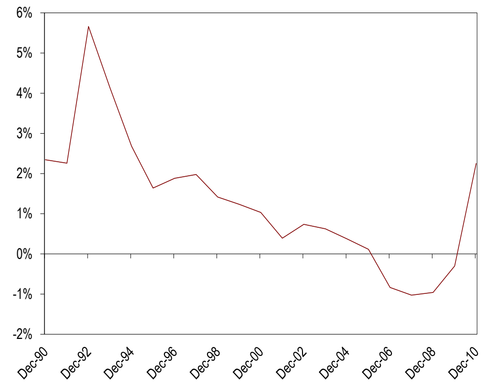
Selected data

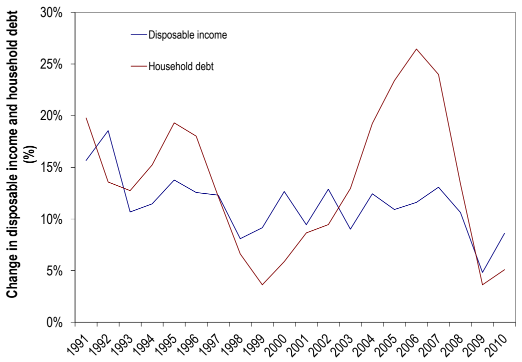
South Africa: Selected economic indicators (2006-2010)						
	2006	2007	2008	2009	2010	Most recent data
GDP and prices (% change)						
Real GDP growth	5.6	5.6	3.6	-1.7	2.6*	
Real GDP per capita growth	4.2	4.2	2.5	-2.8	1.5*	
CPI	3.2	6.1	9.9	7.1	4.3	
Public Finance (% of GDP)						
Revenue	26.3	26.6	26.3	24	23.8*	
Expenditure	26	25.9	26.7	28.9	29.5*	
Overall balance	-0.3	0.7	0.4	-4.9	-5.7*	
Government debt	32.6	28.6	24	22.2	30.7*	
Labour in non-agricultural sector (% change)						
Remuneration per worker	7.5	6.7	12.8	11.8	15.8	Q2
Labour productivity	2.8	2.9	1.6	1.5	4.3	Q2
Nominal Unit Labour Costs	4.5	3.7	11.0	10.9	11.0	Q2
External Sector (% change)						
Merchandise exports f.o.b	24.4	20.7	31.8	-23.2	6.3	Q3
Merchandise imports f.o.b.	32.4	20.3	28.9	-25.1	3.2	Q3
Terms of trade	3.6	1.6	-0.1	8.1	2.4	Q3
Nominal effective exchange rate	-5.9	-9.6	-17.1	2.4	1.0	Q3
Real effective exchange rate	-3.2	-3.5	-10.4	7.8	1.9	Q3
External Sector (% of GDP)						
Current account balance	-5.3	-7.0	-7.1	-4.1	-3.0	Q3
Financial account balance	6.0	7.6	4.2	4.4	4.8	Q3
Foreign debt	22.7	26.3	26.3	27.7	24.1	Q2
Gross reserves (US$bn)	25.6	33	34.1	39.7	44.1	Q3
Monetary Aggregates (% change)						
Broad money (M3)	22.5	23.5	14.7	1.7	5.1	Q3
Income velocity of circulation of money	1.4	1.3	1.2	1.2	1.3	Q3
Repo rate in per cent	9	11	11.5	7	6.5	Q3
Savings and Investment (% of GDP)						
Gross National Saving	14.7	13.4	16.3	16.3	16.7	Q3
Household savings	1.1	1.1	1.2	1.6	1.5	Q3
Corporate savings	10.6	9.5	11.1	14.4	17.4	Q3
Government savings	2.7	3.5	2.6	-0.5	-2.3	Q3
Gross capital formation	19.1	20.4	23.5	21.6	19.5	Q3

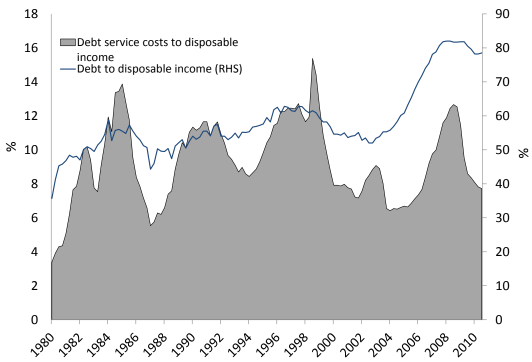
** projected value*

South Africa: Selected household indicators









Credit Standing of consumers	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010
Credit active consumers (million)	17.2	17.5	17.6	17.6	17.8	18.0	18.1	18.2	18.32	18.35
Consumers in good standing (million)	10.4	10.4	10.3	10.2	9.9	9.9	9.9	9.8	9.73	9.86
Consumers with impaired records (million)	6.8	7.1	7.3	7.5	7.9	8.1	8.2	8.4	8.59	8.49
Consumers in good standing (%)	60.5	59.5	58.4	57.6	55.9	55.1	54.7	54.0	53.1	53.7
Consumers with impaired records (%)	39.5	40.5	41.6	42.4	44.1	44.9	45.3	46.0	46.9	46.3
Total Credit granted (Rbn)	85.6	72.3	65.8	51.7	50.7	53.6	63.3	61.6	67.5	75.1
Gross debtors book (Rbn)	1117	1131	1134	1141	1125	1129	1133	1145	1155	1167
Applications received (million)	–	6.3	6.6	5.7	5.6	5.8	6.5	6.0	6.5	6.9
Applications rejected (million)	–	2.8	2.9	2.5	2.5	2.6	2.8	2.4	2,633	2,690
Applications rejected %	–	44.8	44.3	43.9	44.3	44.1	43.5	40.3	40.3	39.1
Credit Enquiries (million)	103	114	102	99	122	146	147	125	135	190

South African banking sector: Analysis of deposits 2006-2010

	2006	2007	2008	2009	2010	% of total deposits
			In R billions			in 2010
Interbank deposits	90	111	134	154	169	7.8
Public sector	176	199	222	213	219	9.8
Government deposits	60	58	52	51	70	3.1
Local government deposits	28	29	37	31	27	1.2
Public enterprises	88	112	123	125	117	5.2
Other monetary institutions	NA	NA	11	6	5	0.2
Insurers and pension funds	90	103	105	112	129	5.7
Other companies and close corporations	651	834	1,036	1,107	1,140	50.7
Households	338	400	469	510	517	23.0
Total domestic deposits	1,345	1,648	1,966	2,098	2,175	96.8
Non-resident deposits	56	62	106	80	73	3.2
Total deposits	**1,401**	**1,710**	**2,072**	**2,178**	**2,248**	**100.0**

South African banking sector: Analysis of liabilities 2006-2010

	2006	2007	2008	2009	2010	% of total liabilities
			In R billions			in 2010
Cash, cheque and transmission deposits	309	362	391	392	422	13.9%
Other demand deposits	294	362	429	412	457	15.1%
Savings deposits	67	81	100	117	119	3.9%
Short-term deposits	218	254	352	346	300	9.9%
Medium-term deposits	280	336	372	438	436	14.4%
Long-term deposits	234	314	428	472	513	16.9%
Total domestic deposits	1,345	1,648	1,966	2,098	2,175	71.8%
Non-resident deposits	56	62	106	80	73	2.4%
Total deposits	1,401	1,710	2,072	2,178	2,248	**74.2%**
Non-deposit liabilities	153	197	264	266	270	8.9%
Total deposits and liabilities	1,554	1,907	2,336	2,443	2,518	**83.1%**
Capital	370	423	591	607	514	16.9%
Total equity and liabilities	1,925	2,330	2,927	3,050	3,031	**100.0%**

South African financial soundness indicators 2008-2010

	2008	2009	2010 *(to Nov)*
Capital Adequacy			
Regulatory capital to risk-weighted assets	12.5%	13.6%	14.3%
Regulatory tier 1 capital to risk-weighted assets	9.6%	10.6%	11.2%
Asset Quality			
Impaired advances to total gross loans	3.2%	5.4%	5.9%
Specific credit impairments	1.1%	1.6%	1.8%
Share of mortgage advances of gross loans and advances	40.8%	43.3%	44.6%
Credit losses	0.11%	0.13%	0.10%
Profitability			
Profit after tax (% of gross operating income)	21.5%	17.9%	19.1%
Interest income (%Gross operating income)	50.2%	49.7%	49.0%
LIQUIDITY			
Liquid assets to total assets (%)	9.8%	11.3%	12.0%
Share of short-term assets in total deposits	61.4%	58.2%	57.7%

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List of abbreviations

ACCC	Australian Competition and Consumer Commission
AML	Anti-Money Laundering
ASIC	Australian Securities and Investments Commission
ASISA	Association for Savings and Investment South Africa
BCBS	Basel Committee on Bank Supervision
BSD	Bank Supervision Department
CBDA	Co-operative Banks Development Agency
CCI	Consumer credit insurance
CFEB	Consumer Financial Education Body
CFT	Combating of Financing of Terrorism
CPMA	Consumer Protection and Markets Authority
CPA	Customer Protection Act
ELA	Emergency liquidity assistance
DBSA	Development Bank of South Africa
FAIS	Financial Advisory and Intermediary Services
FIC	Financial Intelligence Centre
FOS	Financial Ombudsman Service
FSAP	Financial Sector Assessment Programme
FSB	Financial Services Board
FSC	Financial Sector Charter
FSDC	Financial Stability and Development Council
FSOC	Financial Stability Oversight Council
FPC	Financial Policy Committee
G-20	Group of 20 nations
GEPF	Government Employees Pension Fund
GDP	Gross domestic product
G-SIFI	Global systemically important financial institutions
HHI	Herfindahl-Hirschman Index
IMF	International Monetary Fund
LCR	Liquidity Coverage Ratio
NCR	National Credit Regulator

NSFR	Net Stable Funding Ratio
OECD	Organisation for Economic Cooperation and Development
ROSC	Reports on Standards and Codes
SADC	South African Development Community
SAM	Solvency Assessment and Management
STRATE	South Africa's central securities depository
QIS	Quantitative Impact Study
UNIDROIT	International Institute for the Unification of Private Law

INFORMATION FLOWS REGULATION SUPERVISION FINANCIAL SECURITY COHESION GDP ECONOMIC GROWTH MACRO PRUDENTIAL GLOBAL FINANCIAL CRISIS JOB CREATION POVERTY ALLEVIATION FINANCIAL INTELLIGENCE 11 SEPTEMBER 2001 FINANCIAL INCLUSION HIGHEST INTERNATIONAL STANDARDS ENHANCE OUR PARTICIPATION DEVELOPMENT FINANCIAL CONTROLS MICROPRUDENTIAL PRUDENTIAL REGULATION REGULATION REGULATORY ARBITRAGE REGULATORY CAPTURE REGULATORY FAILURE REGULATORY RISK RESIDUAL RISK BALANCE OF PAYMENTS BANK BASEL II AND III G-SIFIS BONDS BOUNDED RATIONALITY BRAND BRETTON WOODS COMPETITIVE ADVANTAGE PROTECTIONISM EXCHANGE CONTROLS MOBILITY GLOBALISATION HOT MONEY INVESTMENT LIQUIDITY VOLATILE CAPITAL FLOWS DIVERSIFICATION ASSET PRICE BUBBLES ADVANCED ECONOMIES INFLATION COST-EFFECTIVE LIBERALISATION CONSUMER PROTECTION FINANCIAL SERVICES BOARD MARKET CONDUCT NEW GROWTH PATH ROSC G-20 CAPITAL ADEQUACY FSB SYSTEMIC RISKS FOREIGN CURRENCY FINANCIAL FREEDOM GOOD DEBT GOOD INVESTMENT RESERVE BANK ROSC G-20 SECURITISATION SOVEREIGN FINANCES WORLD BANK CREDIT DERIVATIVE HEDGE MARKET FORCE BONDS COMPOUND GROWTH PRUDENTIAL PRUDENTIAL REGULATION REGULATION REGULATORY BANK SOLVENCY II GREAT DEPRESSION(1930) FSB EURO-ZONE RAND SUBPRIME MORTGAGES G-20 SECURITISATION SOVEREIGN FINANCES ECONOMIC RECOVERY DEFLATION RISK-MANAGEMENT FOUR-PILLAR POLICY MONETARY POLICY IMF BONDS HEDGE

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