national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

Financial Sector Regulation Bill

Impact Study of the Twin Peaks Reforms

April 2016

Introduction

This impact study has been prepared by the National Treasury to support scrutiny and debate of the Financial Sector Regulation (FSR) Bill which will establish the Twin Peaks institutional framework for financial regulation and supervision.

The study uses the methodology of the Socio-Economic Impact Assessment (SEIA) required for draft policies, bills and regulations submitted to Cabinet since October 2015. The SEIA template provides the structure and key issues in assessing and presenting the benefits and costs of the FSR Bill. The study is set out in four parts:

Part 1 is the problem statement. This sets out the motivation and objectives of the FSR Bill together with a description of the main features of the Bill. The intended outcomes of the Bill are summarised and the expected benefits and costs of the reforms are described. An outline of the intended changes in the behaviour of main stakeholders is provided, linked to mechanisms set out in the Bill. Also provided in this section is a report on the consultation process in developing the FSR Bill and an outline of the measures for resolving disputes incorporated in the Bill.

Part 2 is the impact assessment. This part considers the costs and benefits of implementing the Bill for the main affected stakeholders, including the expected impact on costs and staffing for government and the approach to minimising implementation and compliance costs. It also identifies the main risks to achieving the intended objectives of reforms.

Part 3 focuses on managing risks. This part describes measures for managing the risks to achieving the objectives of reform. Mechanisms for monitoring and evaluation of the reforms are also outlined.

Part 4 is a summary. It outlines the expected impact of the reforms on the national priorities of social cohesion, security, economic growth and investment, economic inclusion, and environmental sustainability. The groups that benefit most and bear the most cost are stated and measures to reduce costs, maximise benefits and manage risks are summarised.

Part 1: Problem Statement

Socio-Economic Impact Assessment:
1.1 Summarise the proposal, identifying the problem to be addressed and the roots (causes) of the problem that will be addressed by the new rule.

Nature of the problem

A stable and more inclusive financial sector is needed to support increased economic growth in South Africa. At a macroeconomic level, a stable and well-developed financial sector supports real economic activity through the efficient channelling of savings into productive forms of investment, contributing to the country's objectives on job creation and a more inclusive economy (as set out in the National Development Plan). For individuals and firms, access to affordable and reliable financial products and services enables people to engage in economic transactions on a daily basis, to save for retirement and other long-term goals, to insure against varied risks, and to avoid an over-reliance on debt and exploitative or reckless lending practices. Access to appropriate financial products and services in South Africa is necessary if economic growth and well-being is to be genuinely inclusive.

Regulation and supervision of financial institutions and markets seeks to respond to the market failures that can arise due to the particular nature of risks and challenges in the financial sector, including:

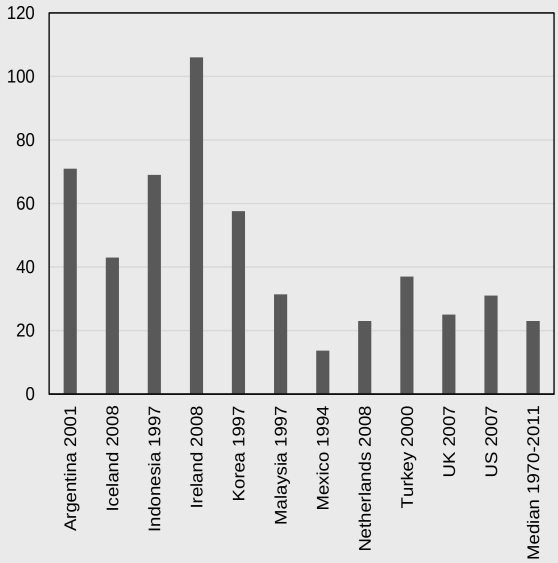
- the risk that the failure of one institution will spill over into systemic instability through the interconnections between financial institutions and a general loss of confidence in the financial system as a whole
- the substantial costs imposed on taxpayers (and society) in responding to financial crises, especially in the case of systemically important financial institutions
- the real losses imposed on savers and depositors from the failure of financial institutions
- insufficient information (or capability) and information asymmetries that limit the ability of consumers to make sound decisions on financial matters with adverse implications for welfare
- where market power is concentrated in a small number of financial institutions, the risk of abuse as a result of limited competition over costs, charges and transparency
- other barriers to the development of appropriate financial products and services to serve the needs of poor households and small businesses.

The global financial crisis of 2008 demonstrated the scale of costs that can arise from insufficient or poorly designed regulation, reflecting weaknesses in prudential supervision and market conduct (see also Box 1). More recently high-profile cases of market abuse have further demonstrated the importance of conduct standards and supervision to protect confidence in financial systems[1].

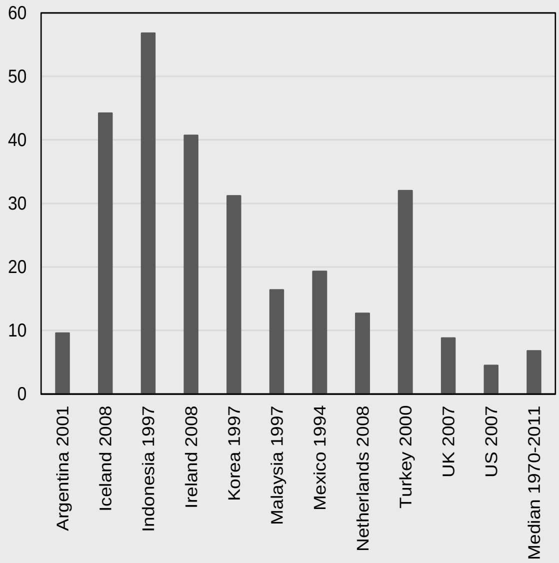
Box 1: International evidence on the costs of systemic banking crises

International data developed by Laeven and Valencia (2012) demonstrate the economic costs imposed by systemic banking crises. The graphs below show the calculated output losses and fiscal costs of a selection of major banking crises from a mix of advanced and emerging economies, including episodes linked to the global financial crises of 2008, the Asian crises of 1997, and other examples. The median outcomes across the 147 crises (between 1970 and 2011) examined by Laeven and Valencia are also shown. While there is substantial variation in the scale of costs, the data indicate that the economic losses arising from recent crisis periods have been significant.

Selected systemic banking crises: Cumulative output losses, % of GDP



Selected systemic banking crises: Fiscal costs, % of GDP



Source: Data from Laeven, L and F Valencia (2012), "Systemic Banking Crises Database: An Update", *IMF Working Paper WP/12/16*, International Monetary Fund, June 2012

Cumulative output losses are calculated as the sum of the difference between actual and trend real GDP over the period T to T+3 (where T is the first year of the crisis), as % of trend real GDP.

Fiscal cost captures the gross fiscal costs related to the restructuring of the financial sector, mainly in the form of bank recapitalisations, asset purchases and loans.

Internationally, governments have responded through strengthening financial sector regulation, including an increased emphasis on international cooperation in developing and implementing regulatory standards, not least in light of the globalised nature of financial flows. Although the financial sector in South Africa was resilient through the period of the global crisis, National Treasury has recognised that the country must not be complacent in assuming that the current regulatory framework will provide sufficient protection from financial instability in the future. For this reason, the development of reforms to the institutional framework for financial regulation has been informed by the experience of the

[1] Internationally, substantial fines have been imposed on major banks involved in the manipulation of the benchmark London Inter-Bank Offer Rate (Libor) and in collusion to manipulate benchmark exchange rates in the foreign exchange market. Between 2012 and 2015, fines amounting to several billions of US dollars in total were imposed in these two misconduct cases by financial regulators in the US, UK and Europe.

global crisis and international responses, as well as international peer review of the current regulatory framework[2]. Table 1 provides a snapshot of the financial services sector in 2015, demonstrating its importance in the South African economy. Financial institutions manage over R12 trillion in assets, with gross value added of services contributing 8% of GDP. The sector accounts for around 3% of total employment and provides approximately 14% of corporate income tax.

Table 1: Snapshot of the financial services sector in South Africa

	2015	Relative size
Gross value added of financial corporations	R336.5 billion	8.4% of GDP
Assets:	R12,014.3 billion	301.0% of GDP
Banks	*R4,827.3 billion*	*121.0% of GDP*
Long-term insurance[1]	*R2,558.7 billion*	*64.1% of GDP*
Short-term insurance	*R148.0 billion*	*3.7% of GDP*
Retirement funds (official and private funds)[2]	*R2,652.7 billion*	*66.5% of GDP*
Collective investment schemes	*R1,827.6 billion*	*45.8% of GDP*
Employment[3]	439,962	2.7% of total employment
Tax contribution[4]	R26.9 billion	14.4% of total corporate tax

Source: GVA and assets from SARB Quarterly Bulletin, March 2016 ;employment based on data from the Quarterly Labour Force Survey, Q4 2015, Statistics South Africa; tax based on data provided by SARS on provisional payments in 2014/15.

Notes:

1. *Long-term insurance includes the assets of the retirement fund business of insurance companies*
2. *Retirement funds excludes funds underwritten by long-term insurance companies*
3. *Financial intermediation, insurance and pension funding, and auxiliary activities, based on disaggregated industry data from the Quarterly Labour Force Survey, Statistics South Africa*
4. *Estimated share of financial services in the provisional tax payments of the finance, insurance, real estate and business services sector. The share of tax is approximated using the share of GVA of financial corporations in the GVA of the finance, insurance, real estate and business services sector.*

National Treasury has further identified issues relating to the conduct of business in the financial sector that lead to poor outcomes for financial customers, and also potential financial customers that remain excluded. High and opaque fee structures, weak disclosure and transparency of products, and a lack of appropriate financial instruments (especially for the poor and most vulnerable) have emerged as particular concerns, as well as the need to combat financial crime effectively. Box 2 sets out a range of poor practices that have been identified by National Treasury. Linked to many of these issues is the policy objective of enabling individuals to make sound financial decisions, for example through implementing financial education strategies and responding to behavioural factors that lead to poor outcomes[3]. Efforts are underway within the current regulatory framework to address conduct

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[2] The challenges raised by the global crisis are explored in *A safer financial sector to serve South Africa better*, National Treasury Policy Document, February 2011. The Financial Stability Board published a peer review of financial regulation and supervision in South Africa in February 2013.

[3] In particular in the area of savings, financial choices are inherently complex with long-term consequences, and individuals may struggle to reach decisions on what is best for them. Behavioural studies have also highlighted

issues, for example, through the *Treating Customers Fairly* principles developed by the Financial Services Board, the proposed regulatory approach for micro-insurance to support financial inclusion, and various initiatives to support financial education and capability. While it is acknowledged that many financial firms have made significant progress in improving conduct practices, the conclusion is that much more remains to be done to improve standards across the sector[4]. The Twin Peaks reforms outlined below aim to provide the institutional structure necessary to implement a more comprehensive and consistent strategy to improve market conduct and deliver better outcomes for financial consumers.

Box 2: Market conduct challenges in South Africa

Transactional banking

- Complex fee structures undermine product comparisons and competitiveness, e.g., fees relating to account transactions, penalties and ATM charges
- Incentives reduce customer scrutiny of core product features and distort decision making
- Unfair debit order practices, e.g., penalties on dishonoured debit orders and double debit orders
- Payment system issues relating to competition, pricing transparency and poor outcomes for end-users
- Lack of regulatory oversight of market conduct practices has slowed reforms
- Insufficient focus on new customer channels and technologies, e.g. mobile banking
- Fraud risk, particularly through electronic channels.

Savings and investment

- Opaque, high and sometimes inappropriate charges, especially in multi-layered investment products
- Some product design features can weaken returns and competition, e.g., causal event charges.
- Gaps in the regulatory net allow for structuring of investment vehicles to avoid regulation
- Scope for weak understanding of risk exposure in money market funds by retail investors
- Poor disclosure of risk of securitised assets in the wholesale market

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how individuals tend to place a strong weight on rewards in the short-term (present bias) – with the implication that consumption today is preferred over savings to provide for consumption in the future. Responses to these behavioural factors may include some mix of “rules” - for example preservation rules in retirement savings - and “nudges”- for example default options in financial decisions that support the long-run interests of individuals.

[4] *Treating Customers Fairly in the Financial Sector: A Draft Market Conduct Policy Framework for South Africa*, National Treasury Discussion Document, December 2014

Box 2: Market conduct challenges in South Africa (*continued*)

Credit (banking and non-banking)

- Reckless lending practices that lead to over-indebtedness, especially payday lending
- The sale of unsuitable, incorrectly targeted credit products
- Poor sales incentives that drive unfair lending practises
- Multiplicity of fees and commissions that are often high and opaque; inadequate disclosure to customers
- Abuse of the payments system to collect debt, including abuse of suretyships; abuse of emolument attachment (garnishee) orders; and abusive debit order practices e.g. abuse of NAEDO system
- Poor conduct in consumer credit insurance, especially linked to mandatory cover, bundled products, interconnected business models and conflicted distribution models

Risk insurance (asset and life)

- Poor disclosure of product terms and weak understanding by customers of technical policy language
- Weak governance in outsourcing arrangements
- Conflicted commission-based remuneration structures of intermediaries or service providers
- Poor claims handling practices, e.g., repudiations and non-transparency of exclusions, unreasonable excesses on asset cover, "underwriting at claim stage"
- Too much focus on premium price rather than value, where costs to the consumer are displaced to higher excesses, especially in short-term insurance
- High incidence of illegal operators in the funeral insurance market

Sales and distribution

- Conflicts of interest, especially around remuneration and outsourcing; complicated relationships between product providers and intermediaries compromise accountability and transparency of advice
- Selling is incentive driven (product provider focused), rather than advice driven (customer focused)
- Unclear regulatory framework for non-advice selling; an uneven playing field
- 'Tick box' compliance approaches which do not fulfil the intent of financial sector policy
- Structuring of intermediaries that leads to regulatory arbitrage and consumer confusion.

Source: Based on Table 1.1 in *Treating Customers Fairly in the Financial Sector: A Draft Market Conduct Policy Framework for South Africa*, National Treasury Discussion Document, December 2014. National Treasury's analysis draws on a range of inputs including from the FSB, customer complaints to ombuds, retail customer surveys, investigative media reports, and Government's own engagement with industry and its customers.

Summary of the proposal

In light of these financial stability, prudential and conduct challenges, the Twin Peaks reforms are structured around the following policy objectives[5]:

- Maintaining the stability of the financial system as a whole (a financial stability objective)
- Maintaining the safety and soundness of regulated financial institutions and market infrastructures (a prudential objective)
- Protecting consumers of financial products and services and ensuring financial institutions treat their customers fairly (a market conduct objective)
- Expanding access to appropriate financial products and services (a financial inclusion objective)
- Combating market abuse and financial crime (a market integrity objective)

Following a review of the domestic financial regulatory system and international experience, National Treasury has concluded that a Twin Peaks structure is most appropriate for achieving these objectives[6]. The model proposed for South Africa is chiefly characterised by:

- Separate regulators for prudential (Prudential Authority) and market conduct (Financial Sector Conduct Authority) functions, to allow for a dedicated and comprehensive focus on the distinct challenges raised.
- A mandate to maintain financial stability - i.e., the stability of the financial system as a whole - allocated to the South African Reserve Bank.
- Mechanisms for cooperation and consultation across government and all financial sector regulators to promote consistency and coordination in delivering policy objectives.
- A harmonised system of licensing, supervision, enforcement, consumer recourse (ombuds), and appeal mechanism (tribunal).
- An emphasis on pre-emptive, risk-based and outcomes-focused approaches to regulation.

The Twin Peaks reforms will address the fragmented nature of the current regulatory framework which has created gaps and inconsistencies in the application of financial regulation and scope for regulatory arbitrage.

The Financial Sector Regulation Bill (FSR Bill) and related Financial Sector Levies Bill will implement the Twin Peaks model for financial regulation and supervision.

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[5] More fully, the FSR Bill has as its core objective: "to achieve a stable financial system that works in the interests of financial customers and that supports balanced and sustainable economic growth in the Republic, by establishing, in conjunction with the specific financial sector laws, a regulatory and supervisory framework that promotes— (a) financial stability; (b) the safety and soundness of financial institutions; (c) the fair treatment and protection of financial customers; (d) the efficiency and integrity of the financial system; (e) the prevention of financial crime; (f) financial inclusion; and (g) confidence in the financial system".

[6] *A safer financial sector to serve South Africa better*, National Treasury Policy Document, February 2011

Financial stability: The FSR Bill allocates powers and responsibilities for preserving and enhancing financial stability to the South African Reserve Bank, together with the establishment of the Financial Stability Oversight Committee tasked with supporting the Reserve Bank and facilitating the cooperation and coordination of financial sector regulators in maintaining financial stability. A Financial Sector Contingency Forum will further assist in managing systemic risks, including cooperation and coordination with representatives from the financial sector industry.

Prudential regulation: The Bill establishes a Prudential Authority, operating within the administration of the South African Reserve Bank, with the objectives of: promoting and enhancing the safety and soundness of financial institutions and market infrastructures; protecting financial customers against the risk of failure of financial institutions; and assisting in maintaining financial stability. The Bill further provides for the powers, responsibilities and governance of the Prudential Authority.

Market conduct regulation: The Bill establishes a Financial Sector Conduct Authority (FSCA) with the objectives of promoting fair treatment of financial customers; promoting financial education and capability; enhancing and supporting the efficiency and integrity of the financial system; and assisting in maintaining financial stability. The Bill further provides for the powers, responsibilities and governance of the FSCA.

Cooperation, collaboration and consultation: Cooperation, collaboration and consultation between financial sector regulators and the South African Reserve Bank is required in the Bill to promote consistency in regulatory and supervisory strategies and actions and in policy positions. Mechanisms to support cooperation and collaboration are further established in the form of the Financial Stability Oversight Committee, Financial System Council of Regulators and the Financial Sector Inter-Ministerial Council.

Ombuds: The Bill establishes an Ombud Regulatory Council to promote and coordinate financial sector ombud schemes, providing for powers, responsibilities and governance. The Ombud Regulatory Council is tasked with ensuring that financial consumers have access to appropriate dispute resolution processes for complaints relating to financial products and services.

Appeals: The Financial Services Tribunal (and associated process) is established under the Bill with the power to review the decisions of the financial sector regulators and the Ombud Regulatory Council, thereby providing an independent mechanism for appeal.

To give effect to this institutional structure, the FSR Bill sets out various powers and responsibilities of the financial sector regulatory agencies including provisions for setting prudential and conduct standards and the licensing of financial institutions; powers in relation to significant owners of financial institutions and financial conglomerates; and steps in relation to systemically important financial institutions. It further provides powers and responsibilities to the regulators in relation to gathering information, conducting inspections and investigations, and the enforcement of financial sector laws. Other provisions are further intended to facilitate the implementation of the new regulatory framework.

The related Levies Bill will provide for the necessary funding mechanism for the new regulatory structure, setting out the basis for levies that will be imposed on financial institutions to cover the costs of regulation and supervision.

Socio-Economic Impact Assessment:
1.2 Describe the intended outcomes of the proposal.

The FSR Bill and related Levies Bill are intended to establish a comprehensive and consistent regulatory framework for the financial sector to achieve the policy objectives as outlined above. The stability of the financial system, and its resilience to shocks, will be strengthened through the emphasis on a system-wide view, clarity in the powers and responsibilities of the South African Reserve Bank and the financial sector regulators, and the cooperation and coordination required of all regulators in this space. Better outcomes for financial customers will further be delivered – in the form of affordable and appropriate products and services, underpinned by principles of fair treatment of customers – through the strengthened focus on market conduct, financial capability and inclusion, and market integrity.

Together these features are intended to contribute to a safer financial sector that works in the interests of a broader base of financial consumers. The overarching outcome will be to enhance the role of financial sector in supporting balanced and sustainable growth in South Africa. Moreover, a sound regulatory system, consistent with international standards, should work to support South Africa's comparative advantage in financial services, as a prerequisite for developing an international financial centre for investment into Africa.

Socio-Economic Impact Assessment:
1.3 Describe the groups that will benefit from the proposal, and the groups that will face a cost. These groups could be described by their role in the economy or in society. As a minimum, consider if there will be specific benefits or costs for the poorest households (earning R7000 a month or less); for black people, youth or women; for small and emerging enterprise; and/or for rural development.

Who will benefit?

The regulatory framework set out in the FSR Bill seeks to support a stable and more inclusive financial sector. As outlined in the problem statement above, the regulatory framework aims to benefit *society in general* through:

- maintaining financial stability and correspondingly protecting from the substantial costs associated with systemic crises;
- improving access to good quality financial products and services; and
- supporting the efficient channelling of savings into investment, forming part of a conducive environment for doing business in South Africa.

These benefits will contribute to broader economic strategies for increased job creation and inclusive growth.

Retail financial consumers in general will benefit from a substantially strengthened market conduct framework, buttressed by strategies on financial capability and inclusion. The implementation and supervision of the strengthened conduct framework should work to improve the transparency, suitability and costs of financial products and services and assist in building greater confidence and trust in financial institutions, addressing the market conduct risks that have been identified by National Treasury (see Box 2).

Well-managed *financial institutions* (and their shareholders) should benefit from the consistent regulatory system envisaged under the FSR Bill as it will support a competitive playing field in financial services that adheres to sound standards of conduct and integrity. There should also be important gains for financial institutions from the emphasis placed on system-wide (or macro-prudential) supervision, through protection from the risks of systemic instability. A more harmonised and consistent approach across financial sector regulators - supported by mechanisms for coordination between regulatory authorities - should also benefit regulated entities.

Poorest households should benefit from improved conduct of business and the related promotion of strategies on financial education and financial inclusion. Better access to appropriate financial products and services should increase the ability of poor households to transact at low costs, save for long-term goals and manage risks, and limit an over-reliance on debt. Measures to maintain financial stability should also benefit the poorest households through limiting the macroeconomic impact of systemic financial shocks – these shocks affect the poorest households as they are often the most vulnerable to job losses and the effects of inflation.

Black people, youth and women will benefit to the extent that society in general benefits from a stable and inclusive financial sector with sound standards of conduct and integrity. To the extent that these groups are also represented in the poorest households then further benefits should derive from the promotion of financial education and financial inclusion as noted above, as well as the management of risks to systemic stability.

A stable and efficient financial sector should assist the development of *small and emerging enterprises* through providing access to financial capital for investment and to affordable transactional services. The new regulatory framework will benefit small businesses through supporting financial stability and its impact on the supply and cost of capital, and facilitating access to financial services reinforced by conduct standards to ensure fair treatment.

Rural development should be supported by strands on market conduct, financial education and inclusion, to the extent that these feed into the development of financial products and services that are suitable for the particular needs of rural communities. More generally, financial stability is a necessary condition for supporting access to capital to fund investment in rural areas.

Who will face a cost?

The new regulatory institutions established by the FSR Bill will be primarily funded through levies imposed on financial institutions and fees for services provided by the regulators. Levies will be set out under the Financial Sector Levies Bill and will cover the costs of the Prudential Authority, FSCA, Ombud Regulatory Council, and Financial Services Tribunal. The cost of the financial stability oversight role of the Reserve Bank is expected to be covered by the general revenue of the Bank. A once-off implementation levy charged to financial institutions may also be considered to meet the costs of establishing the new entities created under the regulatory framework. In addition, the changes in compliance costs at financial institutions arising from the new regulatory framework should also be taken into account in assessing the overall costs of reforms.

Costs at the South African Reserve Bank, Prudential Authority and FSCA

Full projections of the expected operating costs of the Twin Peaks institutional framework are not yet available and will be provided with the Levies Bill. However, data on the current costs of financial supervision provide a useful benchmark for assessing the potential costs of the new institutions. Costs under the new institutional framework should be met in large part through the reallocation of the existing resources spent on financial regulation, although it is likely that some new funding will be required to implement the strengthened market conduct policy framework and the increased emphasis on system-wide supervision.

Table 2 provides a preliminary estimate of initial costs at the new institutions based on the reallocation of existing expenditure on financial regulation and supervision at the South African Reserve Bank and Financial Services Board[7]:

- Based on estimates for 2015/16, the costs of financial regulation and supervision at the South African Reserve Bank and Financial Services Board currently amount to around R907 million. Holding this total constant and adjusting for inflation (assumed to be 6%) provides an estimate of the costs of the current institutional framework in 2016/17 of around R962 million.

- Using a mix of forecasts for 2016/17 and adjusted estimates from 2015/16, it is estimated that the initial costs of the Twin Peaks institutional framework could increase to around R1,033 million. This represents an estimated 7% increase over the cost of the current institutional framework. The main increase is associated with the introduction of market conduct supervision of retail banking at the FSCA, where it should be noted that estimates are tentative. It may also take some time for the new institution to reach full capacity. Costs associated with the financial stability role of the Reserve Bank are also projected to increase.

- The direct costs of regulation and supervision of financial institutions is equivalent to a relatively small fraction of the value generated by the industry in the economy. The

[7] The methodology draws on an earlier analysis of funding by PwC in study on “Twin Peaks Funding Options” for National Treasury in 2014.

estimate of initial costs under Twin Peaks is equivalent to 0.27% of the gross value added of financial corporations.

Table 2: Preliminary estimate of initial costs under Twin Peaks[1]

1. Costs under the current institutional framework		
Financial Services Board	R679m	Forecast for 2015/16 provided by FSB
SARB: Financial Stability	R29m	Forecast for 2015/16, based on data for April to December provided by SARB
SARB: Bank Supervision	R200m	Forecast for 2015/16, based on data for April to December provided by SARB
Total for 2015/16	**R907m**	
Total held constant for 2016/17	**R962m**	Forecast for 2015/16, uprated for inflation at 6%.
2. Estimated initial costs under Twin Peaks institutional framework		
SARB: Financial Stability	**R44m**	Forecast for 2016/17 provided by SARB
Prudential Authority[2]	**R294m**	
Bank supervision	R198m	Forecast for 2016/17 provided by SARB
Insurance supervision	R96m	Annualised value of expected six months costs of Prudential Authority in 2016/17 provided by SARB.
Financial Sector Conduct Authority	**R696m**	
Supervision of non-bank financial institutions	R624m	Based on costs at FSB less the estimated cost of prudential supervision of insurance in 2015/16[3], uprated for inflation at 6%.
Additional costs: conduct supervision of retail banking[3]	R72m [3]	Assumed to be in line with the estimated cost of market conduct supervision of the insurance industry at FSB in 2015/16, uprated for inflation at 6%[3, 4]
Total[4]	**R1,033m**	
% of GVA of financial corporations[5]	0.27%	

Notes:

1. *Own calculations based on data provided by South African Reserve Bank and Financial Services Board.*
2. *Costs associated with prudential supervision of financial market infrastructure are not included in this analysis.*
3. *No estimates are yet available for the costs of implementing market conduct supervision of retail banking at the FSCA. It is therefore assumed that these costs will be broadly similar to the costs of market conduct supervision of the insurance industry. This approach was used for illustration purposes by PwC in the study on "Twin Peaks Funding Options" for National Treasury in 2014.*
4. *The reported costs of insurance supervision at FSB have been split into prudential functions - 57% and market conduct functions - 43%. The estimated shares are based on the costs analysis in the PwC study on "Twin Peaks Funding Options" for National Treasury in 2014.*
5. *Costs expressed as a percentage of the gross value added (GVA) of financial corporations. GVA measures the contribution of a sector to the economy (output less intermediate consumption). Data on GVA of financial corporations is from the production, distribution and accumulation accounts in the South African Reserve Bank Quarterly Bulletin.*

Importantly, these initial estimates do not fully take into account potential efficiencies generated by the institutional structures or additional governance or operational costs that might arise in the new system. Moreover, the longer-term shift to a more harmonised system, with an emphasis on pre-emptive, risk-based and outcomes-focused approaches may also have implications for funding that are yet to be estimated. Finally, no data are currently available on the potential costs of the Ombud Regulatory Council and Financial Services Tribunal established by the FSR Bill, although the Ombud Regulatory Council will in effect build from existing resources allocated to the ombud system supported by the Financial Services Board. As noted above, more detailed projections on costs will be provided with the Levies Bill.

Levies paid by regulated financial institutions

Banks: Under the current regulatory system, the costs of prudential regulation of banks are not explicitly recovered from banks by the South African Reserve Bank. Instead, these costs are funded from the general revenue of the Reserve Bank, which includes revenue generated from the unremunerated cash reserves held by commercial banks with the central bank[8]. Banks have therefore not previously paid levies to fund the full costs of prudential and market conduct supervision of banking activities (with the exceptions of levies to the FSB under the FAIS Act and fees to the National Credit Regulator). Under the new regulatory framework, it is proposed that a financial sector levy will apply to regulated financial institutions to fund the Twin Peaks system (to be set out in the Levies Bill). Further work is required to assess the appropriate division and structure of funding associated with prudential and market conduct supervision of banking. Some increase in the amount that banks contribute to the cost of regulation could be expected in the context of the new remit of market conduct regulation of retail banking located at the FSCA.

For all *other financial institutions* (including long and short-term insurance companies, retirement funds, collective investment schemes, intermediaries, service providers, exchanges, depositories, and credit rating agencies), the proposed levies framework will replace existing levies paid to the Financial Services Board. At least in the short-term, the expectation is that the impact should be limited but some increase could be expected in the longer term in light of the strengthened framework for market conduct regulation at the FSCA. Forecasts for 2015/16 provided by the Financial Services Board indicate that levies collected from financial institutions currently amount to R611 million, with a further R33 million collected from fees for services provided by the regulator[9]. Together, levies and fees account for 96% of the total income of the Financial Services Board (the remainder is mainly accounted for by investment income). The largest source of levies is attributed to FAIS supervision, followed by insurance and pensions (Table 3).

An assessment of the proposed structure and level of levies under Twin Peaks will be provided with the Levies Bill, to be informed by more detailed costings of the regulatory institutions.

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[8] Unremunerated reserve requirements form part of the monetary policy tools of the Reserve Bank.

[9] The current value of levies and fees is equivalent to 0.19% of the gross value added of financial corporations.

Table 3: Levies and fees collected by the Financial Services Board Forecast for 2015/16 in R'000s

Department	Levies	Fees	Total levies and fees
FAIS	205,917	8,520	214,437
Pensions	173,541	6,029	179,570
Insurance	161,706	2,528	164,234
Collective Investment Schemes	29,480	11,836	41,316
Market Abuse	19,917	0	19,917
Capital Markets	16,588	1,350	17,938
Credit Rating Agencies	3,200	0	3,200
Hedge Funds	574	2,571	3,145
Total levies and fees	**610,922**	**32,834**	**643,756**
Total income of FSB			**670,127**

Source: Data provided by the Financial Services Board

Compliance costs at financial institutions

Financial institutions require highly-skilled staff supported by information and communications systems to ensure compliance with applicable financial sector legislation and regulations. Reforms to the regulatory system therefore have implications for the internal costs of compliance functions at financial institutions, in addition to the direct cost of the levies paid to regulators.

A questionnaire was sent to a small group of financial institutions to identify issues for further engagement in understanding the impact of the Twin Peaks reforms. The questionnaire aimed to gather information to illustrate: (1) the current costs of compliance functions at financial institutions linked to financial sector legislation and regulation; (2) expectations of how these compliance costs might change as a result of the shift to the Twin Peaks institutional structure; and (3) expectations of changes in the overall regulatory costs and benefits of the Twin Peaks system. The questionnaire was managed by an independent researcher[10] and the responses used in the analysis have been anonymised.

Responses were received from 16 financial institutions, with activities including banking, long and short-term insurance, asset management, collective investments, pension administration, and other financial services. Respondents mostly held senior positions in risk and compliance management, actuarial, finance, legal and other executive posts. While this is not necessarily a fully representative sample of the financial sector, the exercise has helped to identify likely sources of additional costs for these regulated financial institutions.

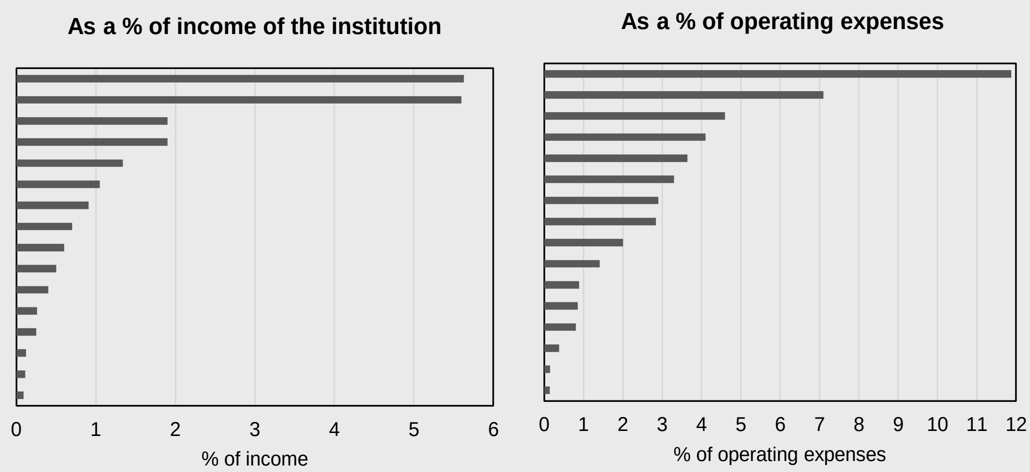
[10] The Association for Savings and Investment South Africa (ASISA) and the South African Insurance Association (SAIA) also provided valuable assistance in identifying and contacting members to participate in the study.

Current costs of compliance functions

Respondents were asked about the current costs of compliance functions at their institution linked to financial sector legislation and regulation. Figures were provided relative to the income of the institution and also as a share of the operating expenses of the institution. Responses varied across the institutions, with some differences in the reported coverage of estimates across various compliance-related functions, for example, across risk and compliance management, internal audit, actuarial, forensics, legal, finance and other areas. Although potential differences in coverage limit the comparability of these estimates, the main findings are as follows:

- As a percentage of the institution's income, the median value of reported costs was 0.7%. The lowest cost reported was 0.1% of income (three institutions); the highest was 5.6% (two institutions that are outliers in this group). Ten institutions reported costs amounting to 1.0% of income or less.
- As a percentage of operating expenses, there was more variability across institutions, with estimates ranging from 0.1% of expenses up to 11.9%. The median value was 2.4%.
- Internal compliance costs were generally greater than the direct costs of levies currently paid in respect of financial sector regulation. The median value for levies represented 0.06% of the total income of the institution and 0.25% of operating expenses.

What are the current costs of compliance functions at your institution in relation to financial sector legislation and regulation?



Respondents reported that the cost of compliance functions has increased since 2008. Higher costs have been driven mainly by an increase in the skilled compliance staff required to respond to changes in legislation and regulatory requirements, as well as the associated technology costs of changing and developing systems. Several responses highlighted the challenges faced by compliance personnel in managing the volume and pace of regulatory change in South Africa; a related issue reflected in four responses was a scarcity of suitably skilled personnel in this area (including actuarial, risk management, compliance, audit and finance), which also contributes to costs. Other specific regulatory cost factors identified by respondents included the impact of changes in regulation such as SAM, Treating Customers Fairly and Retail Distribution Review, capital and liquidity adequacy requirements, enhancements to financial crime prevention, new information protection requirements, increased senior management time, training, legal and external advisor costs, and increased oversight, monitoring, reporting and information management system requirements.

Two respondents in particular emphasised that the costs of compliance functions do not fully reflect the indirect costs of compliance and managing change in regulation for institutions, including management and director's time devoted to regulatory issues, the resources required for training and systems development to ensure compliance, and amending business processes and strategies. Regulatory change was also noted as a source of uncertainty for institutions, with implications for business strategies and investor sentiment.

Expectations of changes in compliance costs under Twin Peaks

Respondents were asked to describe expectations of changes in compliance costs under the Twin Peaks institutional framework, setting out the aspects of the framework that are likely to increase costs and to decrease costs as well as the overall impact.

Most of the respondents reported that overall compliance costs were expected to increase as a result of the Twin Peaks reforms. Only one respondent expected costs to stay broadly the same on balance.

Respondents identified a range of implementation costs and ongoing costs that are expected to arise from the reforms, with one response suggesting that the timeframe for Twin Peaks changes is expected to be at least five to six years. The most common areas identified across the responses include:

- Additional resources needed to engage with multiple regulatory authorities, including skilled personnel, senior management and directors' time and external advisors. Resources for monitoring and advocacy on issues of regulatory change are also expected to increase.
- Significant amendments and enhancements to IT systems infrastructure to adapt to the new regulatory framework and to meet increased monitoring and reporting requirements of multiple regulators. Implementing these changes across large institutions is a complex process.
- Additional management and Board time devoted to more intensive supervision and risk management processes under the new regulatory framework – for both prudential and market conduct supervision.
- The pre-emptive, risk-based and outcomes-focused approach to regulation under Twin Peaks will require the development of new risk and compliance management systems; an increase in the skills and experience of compliance staff; training, awareness and change management activities across the institution, and associated changes in business strategy,

process and practices. Resources for monitoring and guidance on the interpretation of principles-based regulatory and supervisory approaches are also expected to increase.

- Additional licensing requirements and costs
- Possible duplication in requirements from multiple regulators could increase costs, for example, on implementing standards, reporting and onsite inspections.
- Greater responsibility for due diligence, oversight and supervision of product distribution channels and business partners, also with implications for costs at business partners.
- An increase in levies to cover the costs of multiple regulators with greater responsibility for oversight.

Most respondents did not quantify the expected change in costs, possibly reflecting uncertainty about the scale of impact at this stage of the reform process[11]. While three of the responses indicated that potential increases in compliance costs could be significant, given that most respondents did not quantify the impact, no firm conclusions can be drawn from the questionnaire.

Few respondents identified aspects of the framework that might work to decrease compliance costs. In several cases, respondents noted that there was not yet sufficient information available to assess impacts, especially in the longer term. One respondent identified potential scope for cost efficiencies arising from coordination between regulators and combined processes. Another noted that increased automation of reporting processes was anticipated. A third response highlighted a concentrated focus on risk areas and benefits for the management of risk.

Expectations of overall costs and benefits of Twin Peaks system

Respondents were also asked to describe expectations of changes in the overall costs and benefits of financial regulation under Twin Peaks for financial institutions, financial consumers (customers) and other stakeholders. This helped to place the expectations on compliance costs in a broader context.

For *financial institutions*, the main costs recognised related to the compliance resources discussed above. Placed against these costs, many respondents also identified scope for benefits of the reforms for financial institutions, including the following aspects[12]:

- Improved financial stability and integrity of the financial system, including confidence.
- Greater harmonisation, consistency and coordination; reduced duplication and elimination of contradictory requirements across regulators
- A more level playing field for financial institutions and removal of regulatory arbitrage

[11] One respondent commented that it was not clear what the requirements of the regulators would be at this stage.

[12] Four respondents did not identify benefits or were uncertain about the benefits for institutions.

- Prompt identification of systemic risks
- Alignment to international best practice
- Financial soundness and robust capital management
- Improved expertise and efficiency of regulators

Three respondents highlighted potential risks for *shareholders of financial institutions* in terms of a decrease in investment returns as the costs of regulatory change are absorbed. One respondent viewed this as a short-term effect, with potential longer-term benefits for shareholders from improved efficiencies in regulation and customer satisfaction. Four respondents also identified potential benefits of improved governance and oversight in terms of reducing risk for shareholders and the Board.

Responses relating to *financial consumers* are discussed in the next section.

The responses to the pilot questionnaire indicate that the increasing costs of regulatory compliance will need to be taken into account in implementing the new institutional structure of Twin Peaks and further legislative change. Opportunities for coordination and consistency across regulators will need to be explored to help limit the cost of compliance functions and enhance the efficiency of regulation. From the regulators' perspective, the application of risk-based and outcomes-focused approaches will also need to ensure that the compliance burden placed on financial institutions is proportionate and in support of overall policy objectives.

Financial consumers

Financial institutions may ultimately pass some of the cost of compliance onto their customers in the form of fees and similar charges for products and services, with the implication that *financial consumers* (customers) will indirectly bear part of the cost of the new regulatory framework.

Eleven of the 16 respondents in the pilot questionnaire indicated that increased regulatory costs could possibly be passed on to financial consumers to some extent[13]. However, one respondent also noted the possibility of a decrease in costs in the longer term as a result of the focus on the appropriateness of products. Another respondent highlighted the risk that over-regulation could stifle innovation and competition, with corresponding costs for consumers. Two respondents highlighted the possibility of increased costs of advice for consumers.

Potential benefits for consumers were also noted by many respondents, including:

- Improved consumer trust, confidence and satisfaction
- Appropriate financial products and services
- Improved consumer protection, awareness and recourse mechanisms
- Better transparency and disclosure on financial products

[13] Only one respondent indicated that costs might not get passed on to consumers.

- Increased financial stability and a more effective financial services environment.

Predicting the extent to which costs are shifted onto consumers is clearly difficult as it will depend on a number of factors and responses at different financial institutions. Any sharing of costs will need to be considered in the context of the strengthened market conduct framework and the application of Treating Customers Fairly principles. To the extent that better conduct regulation addresses high and opaque fee structures and improves competition between financial products and service providers, then the net impact on the costs of regulation faced indirectly by financial consumers may be reduced to some degree.

There should be no additional direct or indirect costs for the *poorest households*, *black people, youth and women*, *small and emerging enterprises*, and *rural development*, over and above those costs that generally apply to financial consumers and institutions.

Total direct and indirect costs of financial regulation and supervision

Table 4 combines the estimates of the initial direct costs of regulation and supervision at the South African Reserve Bank, Prudential Authority and FSCA[14] with data on indirect costs of compliance functions reported by financial institutions participating in the questionnaire[15]. Aggregate data on the indirect costs reported by these institutions has been scaled up to represent the industry level[16]. The estimate of indirect costs is based on a small group of institutions that is not necessarily fully representative of the industry in terms of size and breadth of activities. There are also some differences in the costs that have been included by respondents in the questionnaire group (see discussion above). For this reason, the overall estimate should be considered only as an approximation based on the questionnaire group, to inform further analysis of costs as the reforms are implemented.

While nearly all institutions in the questionnaire group expected the costs of compliance to increase under the Twin Peaks framework, no firm conclusions can be drawn about the likely scale of impact at this stage. For illustration purposes, Table 4 sets out four scenarios for the increase in indirect costs, ranging from no change in real terms to an increase in annual costs of 50%.

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[14] Full projections of the direct costs of regulation and supervision will be provided with the Levies Bill.

[15] It is likely that additional costs will also be incurred by the financial industry associations as a result of the introduction of the Twin Peaks reforms, most notably in participating in research and consultation on new financial sector legislation and regulations on behalf of their members. While in aggregate these additional costs are likely to be small in relation to the direct and indirect costs of the regulators and financial institutions shown in Table 4, the continued consultation on the Twin Peaks reforms is likely to represent an important aspect of the work programme for the associations in the coming years.

[16] The combined assets reported by the institutions in the questionnaire group amount to approximately 56% of the total assets of financial institutions. The measure of total assets of financial institutions used here is the sum of assets of banks, long and short-term insurance companies, collective investment schemes and official and privately-administered pension funds in 2015, as reported in the SARB Quarterly Bulletin. There are some differences in the timing of data reported across the questionnaire responses and the aggregate figures from the Quarterly Bulletin. Based on this approximate share of total assets, it is assumed that the institutions responding to the questionnaire also account for around 56% of the costs of compliance functions at the industry level.

Table 4: Estimate of direct and indirect costs under Twin Peaks

	Rand, in millions	% of GVA of financial corporations[1]
Benchmark of costs under the current regulatory framework, 2015-16:		
Direct costs of financial regulation and supervision at SARB and FSB[2]	907	0.27%
Indirect costs of compliance functions at regulated financial institutions[3]	3,266	0.97%
Total direct and indirect costs for 2015/16	**4,173**	**1.24%**
Total costs held constant for 2016/17[4]	**4,424**	**1.24%**
Projected costs under Twin Peaks for 2016-17		
Direct costs of financial regulation and supervision at SARB, Prudential Authority and FSCA[2]	1,033	0.29%
Indirect costs of compliance functions at regulated financial institutions:[5]		
Scenario 1: overall costs unchanged in real terms	3,462	0.97%
Scenario 2: overall costs increase by 10%	3,808	1.07%
Scenario 3: overall costs increase by 25%	4,328	1.21%
Scenario 4: overall costs increase by 50%	5,193	1.46%
Illustrative range for total direct and indirect costs	**4,495 to 6,226**	**1.26% to 1.75%**

Notes:

1. *Gross value added of financial corporations, from South African Reserve Bank Quarterly Bulletin.*
2. *From Table 2.*
3. *Derived from questionnaire. Aggregate rand costs of compliance functions reported by the questionnaire group scaled up to the industry level. The scaling factor is based on the approximate share of combined assets of institutions in the questionnaire group in the total assets of financial institutions.*
4. *Total direct and indirect costs for 2015/16 increased for inflation at an assumed rate of 6%. GVA of financial corporations is also adjusted for inflation at a rate of 6%.*
5. *Four scenarios are used to illustrate the potential scale of increases in costs. The lower bound (scenario 1) assumes that costs remain unchanged in real terms, where an inflation rate of 6% is assumed relative to costs in 2015/16. Scenarios 2 to 4 apply further increases to the costs under scenario 1. GVA is held constant in real terms and thus does not include any net change in the value of the sector arising from regulatory reform.*

The benchmark for total direct and indirect costs under the current regulatory framework is R4.2 billion, equivalent to 1.24% of the gross value added of financial corporations. Adjusting for inflation at a rate of 6%, the estimated cost for 2016/17 of the existing system would be R4.4 billion. Based on the four scenarios in Table 4, the illustration of total costs under Twin Peaks is between R4.5 billion and R6.2 billion - or 1.27% to 1.75% of gross value added of financial corporations[17]. A substantial rise in indirect compliance costs at financial institutions would have significant implications for the overall rand costs of the

[17] In these scenarios, gross value added of financial corporations is held constant in real terms and thus does not include any net change in the value of the sector to the economy arising from regulatory reform.

Twin Peaks reforms. However, the increase in regulatory costs does not appear excessive when compared to the overall value of financial services in the economy and the wider importance of maintaining financial stability for strategies on investment and inclusive economic growth.

Socio-Economic Impact Assessment:

1.4 Describe the behaviour that must be changed, and the main mechanisms to achieve the necessary changes. These mechanisms may include modifications in decision-making systems; changes in procedures; educational work; sanctions; and/or incentives.

1.5 Identify the groups inside and outside of government whose behaviour will have to change to implement the proposal.

Groups inside and outside government whose behaviour will have to change	**Behaviour that must be changed**	**Main mechanisms to achieve the necessary changes.**
Financial sector regulators and the South African Reserve Bank	Adopting a more comprehensive, consistent and coordinated approach to financial regulation to deliver financial stability and better outcomes for financial customers.	New institutional structure for financial regulation. Clarity in the respective powers and responsibilities of the South African Reserve Bank and financial sector regulators. Mechanisms for coordination and collaboration between financial sector regulators and South African Reserve Bank.
Government	Stronger coordination and collaboration between Ministers, government departments and agencies that have policy and legislative roles that affect the financial sector.	Mechanisms for coordination and collaboration include the Financial System Council of Regulators and the Financial Sector Inter-Ministerial Council.
Bank Supervision Department at the South African Reserve Bank	BSD will cease to exist. Prudential supervision of banks will shift to the Prudential Authority. Supervisors will need to perform functions in line with the mandate of the Prudential Authority as set out in the FSR Bill, including consultation and cooperation with other financial sector regulators and South African Reserve Bank.	Establishment of the Prudential Authority, together with associated powers and responsibilities in the FSR Bill.

Financial Services Board	FSB will cease to exist. Supervisory functions in respect of non-bank financial institutions will shift either to the FSCA or Prudential Authority as appropriate. Supervisors will need to perform functions in line with mandates of the Prudential Authority and FSCA as set out in the FSR Bill, including consultation and cooperation with other financial sector regulators and South African Reserve Bank.	Establishment of the FSCA and Prudential Authority, together with associated powers and responsibilities in the FSR Bill.
National Credit Regulator and Financial Intelligence Centre	Consultation, cooperation and collaboration with the FSCA, Prudential Authority and the South African Reserve Bank will be required.	NCR and FIC will participate in the Financial Stability Oversight Committee. Mechanisms and responsibilities for consultation, cooperation and collaboration are included in the FSR Bill.
Financial sector ombud schemes	Ombud schemes will need to operate within a strengthened and consistent framework for external dispute resolution.	Establishment of the Ombud Regulatory Council in the FSR Bill together with associated powers and responsibilities.
Financial institutions	Financial institutions will need to respond to a strengthened market conduct environment: providing affordable and appropriate products and services and treating customers fairly. Financial institutions will need to adapt to the new Twin Peaks framework for financial regulation, including the adoption of risk-based and outcomes-focused approaches to regulation. New systems and resources may be needed to ensure compliance with prudential and market conduct requirements set out by the new regulators.	Establishment of FSCA as a dedicated market conduct regulator in the FSR Bill and the implementation of a comprehensive market conduct framework. Regulations to be implemented in line with the powers and responsibilities in the FSR Bill. Consultation processes required in making regulatory instruments Emphasis on the need for pre-emptive, risk-based and outcomes-focused approaches. Enforcement actions as set out in the FSR Bill.

Financial customers	More effective participation in the financial sector through appropriate and affordable financial services and products Supported by standards for fair treatment and protection.	Implementation of a comprehensive market conduct framework by FSCA, including promoting financial education and inclusion.

Socio-Economic Impact Assessment:

1.6 Report on consultations on the proposal with the affected government agencies, business and other groupings. What do they see as the main benefits, costs and risks? Do they support or oppose the proposal? What amendments do they propose, and have these amendments been incorporated in your proposal?

Affected stakeholders - Government Departments and Agencies

The reforms set out in the FSR Bill have been developed jointly by the National Treasury, South African Reserve Bank and the Financial Services Board, supported by a Financial Regulatory Reform Steering Committee co-chaired by senior officials from these institutions. Consultation between these three institutions and other government departments and agencies with a role in the financial sector has taken place, including the Department of Trade and Industry, National Credit Regulator, Financial Intelligence Centre, Department of Health and Council for Medical Schemes. The FSR Bill reflects the development of a broad consensus within government and its agencies on proposals for the implementation of a Twin Peaks model as approved by Cabinet in July 2011 and the establishment of the two new regulators as approved by Cabinet in December 2013.

The main benefits are seen to be an institutional framework that supports a risk-based and outcomes-focused approach to regulation, delivering a safer financial sector with better outcomes for financial customers. The main risks and costs explored in the consultation phase within government have included: potential conflicts between policy objectives and between the mandates of financial sector regulators; potential inconsistencies in implementation as a result of gaps and overlaps in the regulatory framework and in legislation; and the risk of short-term disruption in the financial system during implementation of the new framework. Measures to address these risks have been incorporated in the final proposal in the form of explicit mechanisms for cooperation and consultation between the financial sector regulators and the South African Reserve Bank. Moreover a phased approach to implementation is intended to limit shocks to the financial system. The FSR Bill will establish the institutions of the Twin Peaks structure and provide for appropriate powers and responsibilities, while leaving the main provisions of industry-specific financial sector legislation in place. Further phases will aim to achieve greater harmonisation of legislative and regulatory frameworks in the financial sector to give full effect to the Twin Peaks reforms.

Affected stakeholders - Business and other groups

Public consultation on the Twin Peaks reforms has been extensive. Prior to drafting legislation, a policy document was released by National Treasury in February 2011 setting out proposals for the move to a Twin Peaks model of regulation[18]. This was followed in February 2013 by a document setting out more detailed aspects of the implementation of a Twin Peaks model in South Africa (the "Roadmap"), released for public comment by the Financial Regulatory Reform Steering Committee[19].

The first draft of the FSR Bill was released for public comment in December 2013. The first draft attracted comments from 24 stakeholders, including the financial services industry, government agencies, legal experts, academics, non-governmental organisations and individual South Africans[20]. These comments, together with internal review, led to amendments to the draft to: improve the legal enforceability of the Bill; address inconsistencies and confusion; clarify the role of other regulators under the Twin Peaks system; align and clarify governance arrangements for the new authorities; clarify Reserve Bank powers for systemic oversight; provide authorities with powers in addition to industry-specific laws; empower both authorities to issue standards; and introduce a legal framework for regulating and supervising financial conglomerates[21].

The second draft of the FSR Bill was released for public comment in December 2014, with associated public workshops. The draft Bill was accompanied by a response and explanatory document that set out further explanation of the Twin Peaks reform process and the intentions of the second draft of the Bill. A comments matrix running to 233 pages was also provided detailing the responses to comments received on the first draft of the Bill. A National Treasury discussion document setting out the draft market conduct policy framework was provided for public comment to further inform the consultation process[22].

Comments on the second draft were received from 26 stakeholders, again reflecting the financial services industry, government agencies, legal experts, academics, non-governmental

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[18] *A safer financial sector to serve South Africa better*, National Treasury Policy Document, February 2011

[19] *Implementing a Twin Peaks model of financial regulation in South Africa*, published for public comment by the Financial Regulatory Reform Steering Committee, February 2013

[20] These included: the Actuarial Society of South Africa, ASISA, Bakgatla Group, Banking Association of South Africa, Cape Chamber of Commerce and Industry, Competition Commission, Deloitte, Financial Intelligence Centre, Financial Intermediaries Association of Southern Africa, Free Market Foundation, JSE, Melbourne Law School, MicroFinance South Africa, MMI Holdings Limited, National Housing Finance Corporation, Parliamentary Monitoring Group Subscriber, Promontory, Resolution Policy Working Group, South African Institute of Chartered Accountants, South African Insurance Association, Standard Bank South Africa, STRATE, Voluntary Ombudsman Schemes and the World Bank.

[21] Amendments to the first draft of the FSR Bill are discussed in *Twin Peaks in South Africa: Response and Explanatory Document, Accompanying the Second Draft of the Financial Sector Regulation Bill*, National Treasury, December 2014

[22] *Treating Customers Fairly in the Financial Sector: A Draft Market Conduct Policy Framework for South Africa*, National Treasury Discussion Document, December 2014

organisations and individual South Africans[23]. Several stakeholders expressed general support for the objectives of the Bill and the shift to a Twin Peaks model, while others raised concerns around the increased regulatory burden on institutions; the risk that a "one-size-fits-all" approach to regulation might be adopted; and the apparent complexity of the framework. The comments received during this process highlighted the need for: clarification of definitions to remove ambiguity; the need to ensure alignment with other legislation affecting the financial sector and to address potential gaps and overlaps; the need for greater clarity on the cost of the new framework and the funding mechanism; clear definitions of the scope of powers and responsibilities of the regulators and the Reserve Bank; and the need for regulators to operate efficiently.

The detailed comments on specific sections of the Bill have helped to improve the quality of the legislative drafting and to identify and respond to potential pitfalls. No substantive changes in the proposed policy framework were deemed necessary in response to these inputs; however further refinements were made to the Bill to ensure technical accuracy and appropriate alignment with existing legislation. National Treasury have provided a comments matrix running to 337 pages to explain responses to the detailed comments submitted by stakeholders. The FSR Bill was tabled in Parliament in October 2015 and will be followed by a Levies Bill which will set out the funding mechanism.

Socio-Economic Impact Assessment:

1.7 Describe possible disputes arising out of the proposal, and the system for settling and appealing them. How onerous will it likely be for members of the public to lodge a complaint and how burdensome and expeditious is the proposed dispute-settlement procedure?

The FSR Bill will establish the Ombud Regulatory Council to provide for the appropriate regulation of ombud schemes and to support a more unified and consistent approach to external dispute resolution for financial sector customers. These measures are intended to strengthen the existing financial ombuds system, as part of the overall objective of improving outcomes for financial consumers. Members of the public with a complaint regarding a financial product or service will have access to either an applicable ombud scheme, or to an ombud scheme designated to handle the complaint by the Ombud Regulatory Council.

The FSR Bill also makes provision for disputes concerning the actions and decisions of financial sector regulators. The Financial Services Tribunal, established by the Bill, will adjudicate on applications for reviews of decisions taken by financial sector regulators or the Ombud Regulatory Council.

[23] These included: ASISA; Banking Association South Africa; Cliffe Dekker Hofmeyr Inc; Centre for Applied Legal Studies at Wits; Compliance Institute Southern Africa; Deloitte; IMF; JSE; Melbourne Law School; Micro-Finance South Africa; National Credit Regulator; Payments Association of South Africa; Professional Provident Society; SDK Compliance Consultants; South African Institute of Professional Accountants; South African Insurance Association; Southern Africa Venture Capital and Private Equity Association; Standard Bank; STRATE; Transaction Capital; The Unlimited; Voluntary Ombuds Schemes; Warwick Wealth; the World Bank; and private individuals.

Part 2: Impact Assessment

Socio-Economic Impact Assessment: *2.1 Describe the costs and benefits of implementing the proposal to the groups identified in point 1.6 above.*

Group	Implementation costs	Cost of changing behaviour	Costs/benefits from achieving desired outcome
Government	Limited costs to fiscus - funding mechanisms will be introduced by the Financial Sector Levies Bill.	Limited costs to fiscus - funding mechanisms will be introduced by the Financial Sector Levies Bill.	A stable and more inclusive financial sector contributes to Government's objectives on increasing investment, job creation and inclusive growth.
South African Reserve Bank	Costs of implementation of financial stability role to be covered by SARB general revenue. SARB to allocate staffing and resources to the Prudential Authority.	Operational costs of financial stability role to be covered by SARB general revenue. Operational costs of the Prudential Authority to be funded through levies and SARB revenue.	Clarity in the powers and responsibilities of the Reserve Bank and other financial sector regulators will support the Bank in achieving the objective of financial stability.
Financial sector regulators	Implementation costs associated with establishing the new regulators and transferring staff and resources from existing regulators. A once-off implementation levy may be imposed to meet costs.	Operational costs of the new regulatory authorities established by the FSR Bill to be funded from levies and fees Some operational costs may arise for other financial sector regulators from the cooperation and consultation required under the FSR Bill.	The mandates, powers and responsibilities of regulators and mechanisms for cooperation and consultation established by the FSR Bill will better enable regulators to achieve their stated objectives.

Group	Implementation costs	Cost of changing behaviour	Costs/benefits from achieving desired outcome
Business: Financial institutions	A once-off implementation levy may be raised from financial institutions to cover the costs of setting up the new institutional framework. Financial institutions may need to implement new systems, training and change management processes to comply with the requirements of the new regulatory system. Estimates of costs are not yet available. A pilot study finds that financial institutions expect the overall cost of compliance functions to increase under Twin Peaks, including implementation costs.	Levies and fees will be imposed on financial institutions to cover the operational costs of the financial regulators. Financial institutions will also face internal regulatory compliance costs and additional resources may be required to ensure compliance under the new system. Estimates of net impact relative to existing costs of regulation (levies and compliance costs) are not yet available. A pilot study finds that financial institutions expect the overall cost of compliance functions to increase under Twin Peaks.	Financial institutions will benefit from a stable financial sector underpinned by a more harmonised, consistent and risk-based regulatory framework and level playing field. Financial education and inclusion strategies should benefit those institutions that are able to serve a broader customer base. As regulated entities, financial institutions may face new challenges in complying with a more consistent, risk-based and outcomes-focused regulatory framework, especially in the area of market conduct.
Other: financial customers and households	Indirect costs may arise if financial institutions pass implementation costs onto their customers.	Indirect costs may arise if financial institutions pass on the ongoing costs of regulation to their customers. Estimates of the impact relative to existing indirect costs of regulation are not available. Indirect costs may be offset to the extent that improved market conduct brings down fees and other charges for financial customers.	Financial customers will benefit from a stable financial system that provides appropriate and affordable financial products and services. Awareness, confidence and trust in the financial system should increase. Households benefit from the stability of the financial system as a whole, in particular poor households who are vulnerable to the effects of economic shocks.

Socio-Economic Impact Assessment:
2.2 Describe the changes required in budgets and staffing in government in order to implement the proposal. Identify where additional resources would be required for implementation. It is assumed that existing staff are fully employed and cannot simply absorb extra work without relinquishing other tasks.

It is anticipated that there will be no significant implications for the fiscus as the financial sector regulators will be funded through levies and fees paid by regulated financial institutions. Staffing for the new regulators will initially be drawn from the existing staff of the predecessor agencies (Bank Supervision Department and Financial Services Board). Resources required to fulfil the Reserve Bank's mandate on financial stability will build from existing resources that have been allocated to developing this function. Some additional resources may be required at the National Treasury to support policy development, to maintain the Financial Sector Information Register and to participate in the Financial Stability Oversight Committee and the Financial System Council of Regulators. Other government departments and agencies represented on the Oversight Committee and Council of Regulators will similarly need to allocate some resources to participation.

Socio-Economic Impact Assessment:
2.3 Describe how the proposal minimises implementation and compliance costs.

A phased approach to the introduction of the Twin Peaks regulatory system has been adopted in order to minimise disruption to the financial sector, with an extensive consultation process to identify and respond to potential risks around implementation and compliance. In the first phase, the FSR Bill will implement the new institutional framework and allocate the relevant powers and responsibilities to the new regulators and the South African Reserve Bank, while existing industry-specific legislation remains in place. In later phases it is anticipated that the legal frameworks for prudential and market conduct regulation will be further developed, harmonised and strengthened.

One of the proposed elements of the Twin Peaks regulatory reforms is an emphasis on risk-based and outcomes-focused approaches, where regulation and supervision is proportional to the nature, scale and complexity of risks present in a regulated institution and the system as a whole. While the intention is to establish a comprehensive and consistent regulatory system, the use of risk-based and outcomes-focused approaches, coupled with monitoring and consultation processes, will need to take into account the implementation and compliance costs for regulated entities and ensure the compliance burden is proportionate and in support of policy objectives.

Implementation costs of establishing the two new regulatory authorities should be minimised through drawing on the existing staff and facilities of predecessor agencies (i.e., the Bank Supervision Department and the Financial Services Board). Similarly, the establishment of the Ombud Regulatory Council will build from existing arrangements for the oversight of ombud schemes supported by the Financial Services Board. A single mechanism for appeal - the Financial Services Tribunal - will be established to review decisions of the financial regulators and the Ombud Regulatory Council, removing the need for separate independent appeal processes for each regulator.

Socio-Economic Impact Assessment:
2.4 Describe the main risks to the achievement of the desired ends of the legislation and/or to national aims that could arise from adoption of the proposal.

The main risks to achieving the objectives of the reforms are:

a. Conflicts between financial sector regulators and the South African Reserve Bank arise in meeting different objectives and fulfilling responsibilities, leading to inconsistent application of regulation.

b. Complexity of the regulatory framework creates uncertainty within the financial sector regarding changing compliance obligations in respect of the different regulatory entities and different requirements under financial sector legislation, with implications for the development of business strategies and growth.

c. The new regulatory system creates a substantial increase in the compliance burden for financial institutions, raising costs for consumers and stifling the development of new financial products and services.

d. Regulatory standards fail to achieve their intended objectives in terms of prudential soundness of financial institutions and better outcomes for financial consumers.

e. Mechanisms for responding to major financial shocks fail to prevent a systemic crisis.

Part 3: Managing Risk

Socio-Economic Impact Assessment:
3.1 Describe the measures taken to manage the identified risks.

Identified risk	Mitigation measures
a. Conflicts between financial sector regulators and the South African Reserve Bank arise in meeting different objectives and fulfilling responsibilities, leading to inconsistent application of regulation.	The FSR Bill establishes mechanisms for consultation, collaboration and cooperation to deal with the risk of conflicts that might arise between the regulators. The FSR Bill further aims to clearly define the powers and responsibilities of each regulator and the Reserve Bank, taking into account the need for cooperation and the mandate to maintain financial stability.
b. Complexity of the regulatory framework creates uncertainty within the financial sector regarding changing compliance obligations in respect of the different regulatory entities and different requirements under financial sector legislation.	The public consultation process has helped to identify concerns within the financial sector regarding complexity of the framework and to clarify powers and responsibilities of the new regulators to limit uncertainty. Ongoing consultation will be needed as the reforms are implemented. The phased approach to implementation of the Twin Peaks regulatory framework reflects a cautious approach to limit disruption, within a long-term agenda of developing a more harmonised and consistent regulatory approach that should support regulatory certainty for the financial sector.
c. The new regulatory system creates a substantial increase in the compliance burden for financial institutions, raising costs for consumers and stifling the development of new financial products and services.	The FSR Bill requires the Prudential Authority and FSCA to take into account the need for a risk-based and outcomes-focused approach when performing their functions. Furthermore, the FSR Bill requires the Prudential Authority and the FSCA to regularly review the perimeter and scope of financial sector regulation, and take steps to mitigate risks identified to the achievement of objectives. The Bill also requires a consultation process in making regulatory instruments. These requirements should take into account the compliance processes and costs faced by financial institutions and the implications for achieving policy objectives.

d. Regulatory standards fail to achieve their intended objectives in terms of prudential soundness of financial institutions and better outcomes for financial consumers.	Regular review of the perimeter and scope of financial sector regulation by the Prudential Authority and FSCA, as required under the FSR Bill, should provide a mechanism for identifying and assessing gaps or weaknesses in regulatory standards. The requirement for the Reserve Bank to monitor strengths and weaknesses in the financial system should also contribute to the identification of risks to these objectives.
e. Mechanisms for responding to major financial shocks fail to prevent a systemic crisis.	The FSR Bill sets out mechanisms and responsibilities relating to systemic events. The South African Reserve Bank is required to monitor the risks to financial stability, including the risk that systemic events will occur. The Financial Stability Oversight Committee and Financial Sector Contingency Forum will assist in the identification of systemic risks and the coordination of measures to mitigate those risks. These pre-emptive measures will strengthen the crisis management framework. The Bill sets out the intervention powers of the South African Reserve Bank that are triggered by a systemic event or the risk of a systemic event, requirements to consult with the Minister of Finance, and the responsibilities of the financial regulators.

Socio-Economic Impact Assessment:

3.2 Describe the mechanisms included in the proposal for monitoring implementation, evaluating the outcomes, and modifying the implementation process if required. Estimate the minimum amount of time it would take from the start of the implementation process to identify a major problem and remedy it.

Monitoring and evaluation of the new regulatory system is built into the FSR Bill. The South African Reserve Bank is required to monitor the strengths and weaknesses of the financial system and take steps to mitigate any risks to financial stability. Similarly, the Prudential Authority and FSCA are required to regularly review the perimeter and scope of financial regulation and take steps to mitigate any risks to achieving objectives. These monitoring functions should provide mechanisms for identifying any weaknesses or gaps in the regulatory framework that create risks to financial stability. In addition, the mechanisms for consultation and cooperation between financial sector regulators and the South African Reserve Bank should assist in identifying and resolving instances where regulatory actions aimed at one policy objective create risks for objectives in other areas. Requirements in the

FSR Bill for the regulatory authorities to provide information to the Minister and National Assembly provide further mechanisms for monitoring the implementation of the regulatory framework.

The FSR Bill provides for flexibility to respond to the dynamic nature of the financial sector, through establishing the institutional framework and empowering the Reserve Bank and financial sector regulators to act (subject to any required consultation) in line with their mandated responsibilities. For example, this would include the ability of regulators to set standards and issue directives, which should provide for rapid intervention as risks emerge.

The phased approach to implementation of the Twin Peaks model further provides a transitional period following the establishment of the new regulators to identify the necessary changes to legislation required to move towards a more harmonised and consistent regulatory framework.

Part 4: Summary

Socio-Economic Impact Assessment: *4.1 Summarise the impact of the proposal on the main national priorities.*

Priority	Impact
Social cohesion	Social cohesion will be supported by broadening access to appropriate and affordable financial products and services. The FSCA will have a mandate to deliver better outcomes for financial consumers through promoting fair treatment of financial customers and supporting financial education and financial inclusion. The market conduct framework should enable more people to undertake economic transactions on a daily basis, to save for retirement and long-term goals and to manage major risks to well-being.
Security (Safety, Food, Financial and etc.)	Financial security is one aspect of the objectives of the Twin Peaks reforms through the emphasis on financial stability and financial inclusion. The FSR Bill also makes provisions for financial sector regulators to act and cooperate on combating financial crime, thereby further contributing to security.
Economic growth and investment	Economic growth and investment are supported by a stable and inclusive financial sector, in particular through encouraging higher levels of saving and channelling funds efficiently into productive forms of investment.
Economic inclusion (employment creation and equity)	Financial inclusion is an important aspect of economic inclusion through providing access to affordable and appropriate financial products and services to facilitate participation in the economy. To the extent that a stable and inclusive financial system also supports the funding and financial management of small businesses, then economic inclusion will further be enhanced.
Environmental sustainability	There are no direct implications for environmental sustainability arising from the Twin Peaks reforms. One potential area to monitor, however, would be the extent to which the regulatory framework is able to support appropriate financial instruments for investing in environmental technologies and strategies.

Socio-Economic Impact Assessment: *4.2 Identify the social and economic groups that would benefit most and that would bear the most cost.*

Main beneficiaries	Main cost bearers
Financial customers: a financial sector which works in the interests of customers	**Financial institutions**: the system of levies and fees imposed on institutions to fund the regulators, together with internal regulatory compliance costs.
Financial institutions: a more harmonised and consistent approach to financial regulation and supervision to maintain financial stability and provide a competitive playing field based on sound standards of conduct and integrity	

Socio-Economic Impact Assessment: *4.3 In conclusion, summarise what should be done to reduce the costs, maximise the benefits, and mitigate the risks associated with the legislation. Note supplementary measures (such as educational campaigns or provision of financing) as well as amendments to the draft itself, if appropriate.*

a. Further harmonisation of financial sector legislation in the second phase of the Twin Peaks reforms is seen as an important component of maximising the benefits of the new institutional framework set out in the FSR Bill.

b. Continued consultation with stakeholders on further regulatory reforms (prudential and market conduct) will be needed to support the intended outcomes of the FSR Bill, taking into account the impact of regulatory change on financial institutions.

c. Monitoring and evaluation at the new regulatory authorities and within the various forums for collaboration should assist in identifying any legislative changes needed to further clarify powers and responsibilities, especially during the implementation phase.

d. Existing regulatory staff who will move into the new regulatory authorities may require training and support to successfully transition to the new institutional framework and the associated risk-based and outcomes-focused approach to regulation (a change management process).

e. Financial institutions and consumers will need to be fully informed of their rights and obligations under the new regulatory framework.

Socio-Economic Impact Assessment:

4.4 Please identify areas where additional research would improve understanding of the costs, benefits and/or risks of the legislation.

Extensive research and consultation has informed the development of the FSR Bill. Further work to set out the operational requirements and financial costs of the new regulatory framework (relative to existing costs of regulation) will enhance the assessment of costs, benefits and risks of the Bill.