

Conduct of Financial Institutions Bill

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Kershia Singh



national treasury

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The Twin Peaks reforms

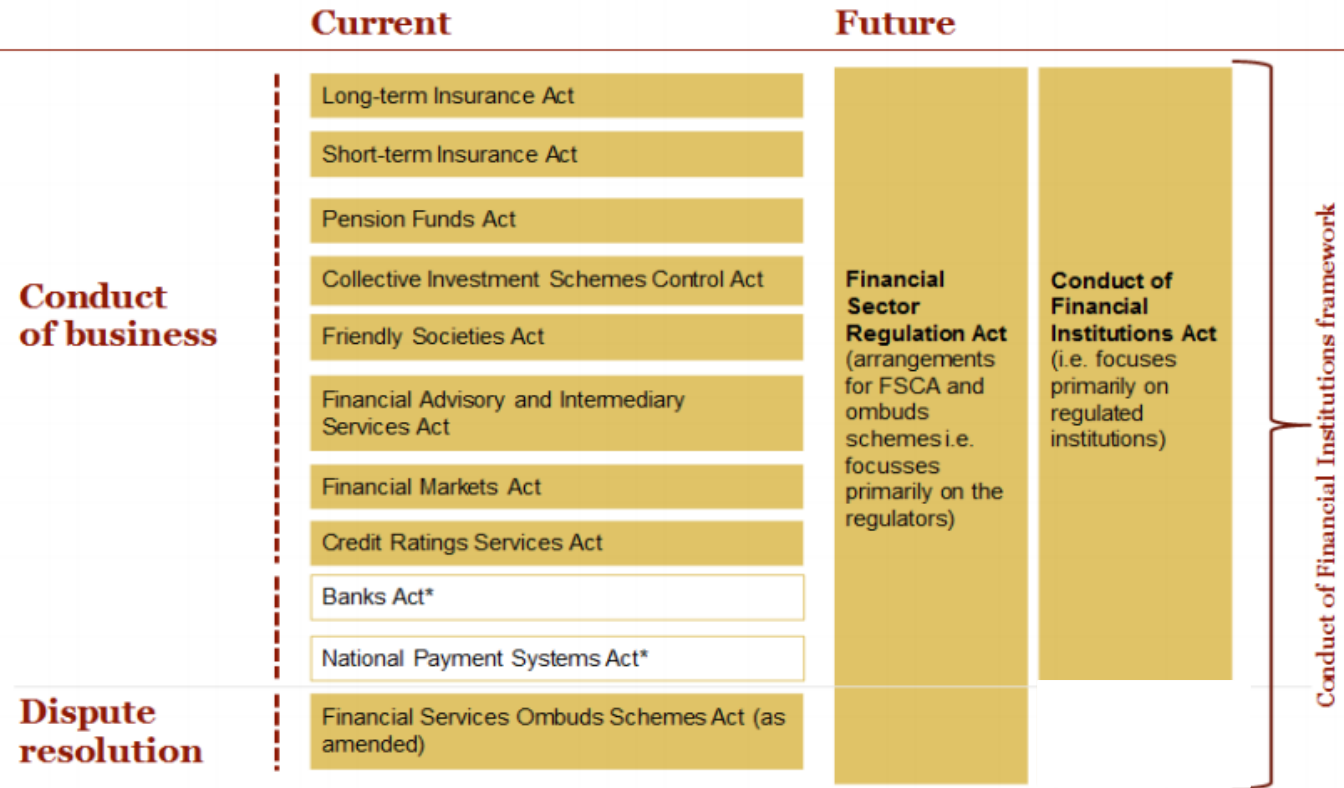
- **National Treasury in 2011** published a policy document '*A Safer Financial Sector to Serve South Africa better*', which proposed a shift toward a new Twin Peaks model of financial sector regulation. The approach was adopted by Cabinet in 2011.
- The first draft of the **Financial Sector Regulation (FSR) Act** was published in 2013 for consultation. After extensive consultation, a revised Bill was tabled in Parliament in 2015 and signed into law in August 2017.
- The FSR Act **establishes the Twin Peaks architecture**. It is a **regulator-facing** law. The two 'peaks' – the Prudential Authority for prudential regulation and the Financial Sector Conduct Authority (FSCA) for market conduct regulation - have full scope of jurisdiction, and powers to fulfill their mandates. Both were established on 1 April 2018..
- The FSR Act acts as an **overlay** of existing legislation. Consequential amendments made to existing laws to ensure consistency, but **13 existing financial sector regulatory Acts** largely remain in place.

Improved market conduct in South Africa

- A crucial driver of the Twin Peaks reform is the need for **stronger market conduct regulation**, so that the financial sector produces **better customer outcomes** and **treats customers more fairly**.
- The 2014 discussion document *“Treating Customers Fairly in the Financial Sector: A Draft Market Conduct Framework for South Africa”* noted that creating a new market conduct regulator would not be sufficient to improve customer outcomes:
 - The number of different financial sector laws causes **fragmentation** in regulatory requirements, **regulatory arbitrage**, a **silos approach to regulation**, and a compliance-focused, **tick-box** regulatory focus. This has contributed to **persistent poor customer** outcomes in the financial sector, in some instances even while the letter of the law is followed.
 - The legislative environment is also not all-encompassing (e.g. banking conduct not covered) and had not kept pace with the **dynamic and increasingly interconnected** operation of the financial sector in South Africa
- The document proposed creating a **single law for market conduct regulation** of **all financial institutions** – the Conduct of Financial Institutions Act. This law would provide for a **consistent, activity-based** and **proportionate** approach to conduct regulation, ensuring proper customer outcomes

Proposed revised legal landscape

Transition towards the new legal framework



*The two acts administered by the Reserve Bank are prudential with no conduct provisions. As a result, while the FSCA will have jurisdiction over these market segments, the acts themselves will remain largely unchanged, absorbed into the new PA and Reserve Bank Structures

Subordinate law

Note: repealing provisions in existing sectoral laws, or the laws themselves, will not result in subordinate regulation issued under those laws falling away.

A careful transitional process will be followed to ensure that required subordinate legislation remains effective under the COFI Bill framework until migrated into conduct standards.

Figure 3.2. of 2014 discussion document. Note credit services, debt collectors and forex dealers not reflected in 'Current' legislation, but will be captured for conduct regulation in terms of FSR Act definitions

Treating Customers Fairly initiative

The COFI Bill has also been informed by the TCF outcomes, introduced in 2011:

- 1 Customers can be confident they are dealing with firms where TCF is central to the corporate culture
- 2 Products & services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly
- 3 Customers are provided with clear information and kept appropriately informed before, during and after point of sale
- 4 Where advice is given, it is suitable and takes account of customer circumstances
- 5 Products perform as firms have led customers to expect, and service is of an acceptable standard and as they have been led to expect
- 6 Customers do not face unreasonable post-sale barriers imposed by firms to change product, switch providers, submit a claim or make a complaint

COFI Bill Principles

- The COFI Bill is designed to be:
 - **Activity-based:** The Bill shifts away from institutional to activity based regulation. Licensing schedule sets out financial activities requiring license. Same regulation will apply to similar activities, regardless of the institution performing the activity.
 - **Principles and outcomes focused:** Provisions have been drafted setting principle requirements in law; will allow regulator to monitor and enforce the achievement of outcomes rather than compliance with the letter of the law
 - **Risk-based and proportionate:** Proportionality will affect the regulator's supervisory approach, the standards it sets, and the enforcement action it takes. Chapter 1 of the COFI Bill sets out guidelines for what the FSCA should consider in applying a proportionate approach

COFI Bill Principles (cont)

- **Supportive of transformation:** Financial institutions will be required to have policies in place to comply with the B-BBEE Code, and the supervision of institutions' implementation of policies in that regard will be undertaken by the FSCA
- **Supportive of inclusion:** The protection of customers in the financial sector, and meaningful financial inclusion are mutually reinforcing objectives. An explicit objective of the Bill is to support financial inclusion
- **Supportive of competition and innovation:** The Bill will allow for different licensing and supervisory requirements to be applied to different types of companies, meaning that smaller/new entrants that pose less risk will not be required to bear similar compliance burdens as larger and more complex businesses. Proportionate implementation of the regulatory and supervisory framework will encourage level playing fields, innovation and competition.

Chapter summary

- **Chapter 1:** sets out the definitions, object and application of the Act. The objectives include protecting and promoting the fair treatment of customers, as well as promoting transformation, financial inclusion and innovation in the sector.
- **Chapter 2:** sets out licensing requirements. It will be read together with the schedule of activities requiring a license (Schedule 2 of the Bill). Provides for license conditions and exemptions. Note licenses required **per legal entity**
- **Chapter 3:** sets out culture and governance requirements for financial institutions, so that financial customers can be confident that they are dealing with firms and persons where the fair treatment of customers is central to the corporate culture. (Specific provisions for fair treatment of retail customers, e.g. disallowing unfair contract terms).
- **Chapter 4:** sets requirements to promote the supply to financial customers of financial products that are appropriate to customer needs, circumstances and expectations, while facilitating efficiency, flexibility and innovation in the provision of financial products.

Chapter summary (cont)

- **Chapter 5:** sets requirements to ensure that financial services provided to customers are suitable and take into account the needs, circumstances and expectations of financial customers, including those customers who may be indirectly impacted as a result of financial services provided to a financial institution.
- **Chapter 6:** aims to ensure that financial customers are given clear, complete and accurate information about a financial product or a financial service across its life cycle, to enable customers to assess whether it meets their needs, and make comparisons across similar financial products and financial services.
- **Chapter 7:** provides for distribution models that support the delivery of appropriate products and provide access to suitable advice. The chapter also deals in detail with the provision of advice, and the provision of discretionary investment management.

Chapter summary (cont)

- **Chapter 8:** sets requirements to ensure that customers do not face unreasonable post-sale barriers when wanting to change a financial product or service, switch from one provider to the other, submit a claim or make a complaint.
- **Chapter 9:** sets requirements to ensure that financial institutions (other than prudentially regulated institutions) have operational capital to perform their required functions, and ensures that institutions that invest, hold, keep in safe custody, control or administers funds of the financial institution, or any trust property, have appropriate safeguards in place.
- **Chapter 10:** sets provisions regarding reporting and public disclosure, and the information financial institutions provide to the FSCA for supervisory purposes.
- **Chapter 11:** sets out provisions for redress and remedial action for financial customers, as well as for court orders.

Chapter summary (cont)

- **Chapter 12** sets out the application of the Bill in relation to other laws, provides for additional matters in respect of which conduct standards can be made and the process for making conduct standards, provides for recognising equivalence with foreign jurisdictions and vice versa, and details the process for applications and notifications to the regulator.
- **Chapter 13** sets out final provisions, including the review of the Act at least every five years to assess whether the object of the Act is being achieved, and that the purpose of the various Chapters of the Act are being achieved.
- Chapters allow for **conduct standards** to be set. Can include both overarching (cross-sectoral) requirements where appropriate and “activity specific” requirements where necessary
- Consider: is the level of detail in substantive clauses, and standard-setting clauses, appropriate?

The FSCA's new approach

The COFI Bill should be read in the context of FSCA's new regulatory and supervisory approach (set out in its *Regulatory Strategy*):

- Adopting a set of guiding principles including (among others) being pre-emptive, proactive, risk-based, **proportional**, intensive, intrusive, transparent, and **outcomes-focused**
- Embedding TCF outcomes in regulatory and supervisory frameworks
- Outcomes-focused regulation entails developing conduct standards that combine principles and rules in a way best designed to achieve desired outcomes – not relying only on rules and “box ticking”
- Moving from an “industry silo” structure to an activity-based structure
- Building capacity for new functions – e.g. overseeing banks, payments, aspects of credit, conglomerates, etc.
- Using the new FSR Act toolkit to strengthen regulatory, supervisory and enforcement processes – including customer redress

A changing approach to compliance

- A key aim of Twin Peaks is stronger accountability at **executive and senior manager level**, particularly from a conduct perspective
 - A integral culture of fair treatment can't be “owned” by compliance; part of business
 - How can the compliance team support strategic decision making?
- Conduct of Business Returns already replacing FAIS Compliance Reports – instead of ‘tick box’, now require a combination of quantitative and qualitative info that provides input into the business drivers and conduct risks of the FSP. Returns owned by business.
- How does the CO monitor and report on non-compliance with a principle? What indicators does it use to monitor the entity’s compliance with its culture & value commitments?
 - How to avoid the “race to rules” – for both industry and regulator to consider
- What is being done to ensure that COs have the skills to respond to the above shifts?
- Under COFI, shift away from sectoral to cross-cutting approach (no longer have a FAIS Act)

COFI Bill provisions

Clause 9(2) makes the governing body of a financial institution responsible for compliance with the requirements in the Bill, and **clause 10** requires institutions to have procedures in place to comply with the requirements of this Act on an ongoing basis and to identify any noncompliance with those requirements.

(31) The governing body of a financial institution must—

(a) endorse and be ultimately responsible for the establishment, implementation, subsequent reviews of, and continued internal compliance with, governance arrangements within the financial institution, to reasonably ensure the achievement of requirements in this Chapter; and

(b) ensure that these governance arrangements, including the governance policy contemplated in Part 2 where applicable, are appropriately embedded in the financial institution.

- 1st line of defense principle
- Where does conduct risk management fit into the overall risk management and governance frameworks, and what is the role of each of each of the control functions (including compliance) within that framework?
 - Financial institutions need to work out the respective roles of compliance, risk and audit functions
 - What indicators will be used by which functions to detect and measure conduct risk?
- Subordinate legislation: FSCA harmonization programme underway. Compliance framework will be specific area of focus. Consider how to move away from creating compliance requirements applicable to a specific sector (FAIS approach) to broad cross-cutting and activity-based approach

Issues in COFI Bill flagged for further consideration

- Scope of application – retail/non-retail; new types of companies
- Licensing approach – defined activities; dual license approach
- Application to financial market activities
- New approach to pension fund regulation – including state-owned funds; registering professional trustees
- Investment fund regulation – providing for alternative investment structures; where license should be held
- Medical schemes environment

Next steps

- COFI Bill forms part of the broader strengthening of market conduct in SA. Other initiatives underway include:
 - Reform of the ombuds system
 - Consumer financial education (new mandate of FSCA)
 - Retail banking diagnostic
- Working closely to align with other legislative processes underway:
 - NPS Act Review
 - FMA Review
 - Resolution Bill (see also annexure 5 of policy paper)
- It is anticipated that the Bill will be subject to revisions based on the public consultation process. Further focused engagements will be scheduled as necessary
- The revised Bill will be submitted to Cabinet and then tabled in Parliament. This is anticipated to occur in the latter half of 2019