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THE FINANCIAL SECTOR REGULATION BILL IN SOUTH AFRICA: LESSONS FROM AUSTRALIA

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I INTRODUCTION

The proposed reforms to financial regulation in South Africa, as embodied in the *Financial Sector Regulation Bill*, (second draft, 10 December, 2014) ('*FSR Bill*'), represent the most important reforms to South Africa's financial regulatory architecture since the 1987 de Kock Commission. The degree to which these reforms succeed will determine the extent to which South Africa can maintain financial stability, and manage the effects of a future financial crisis.

The de Kock Commission's findings led to the creation of the Financial Rand, and a dual exchange rate system for South Africa (Pieter Cornelis Smit, 'Economics: A Southern African Perspective', (1996), p 421). The current proposed reforms introduce two regulators for the Republic's financial sector – a so-called 'Twin Peaks' regulatory model: a Prudential Authority, which 'will supervise the safety and soundness of banks, insurance companies and other financial institutions', and a Financial Sector Conduct Authority, which 'will supervise how financial services firms conduct their business and treat customers.' (Republic of South Africa National Treasury, 'TWIN PEAKS: Second draft of Financial Sector Regulation Bill and draft Market Conduct Policy Framework discussion document published for comment', (11 December 2014), *Media Statement*). This a model first adopted by Australia, and the

South African authorities have drawn on the Australian experience (Republic of South Africa National Treasury, 'A safer financial sector to serve South Africa better', (23 February, 2011), *National Treasury Policy Document*, pp 28/29/40; Financial Regulatory Reform Steering Committee, 'Implementing a twin peaks model of financial regulation in South Africa', (1 February, 2013), pp 22/23; Bryane Michael, 'The "Twin Peaks" Regulatory Model: The Future of Financial Regulation?', (March-April, 2014), *Banking Today*, pp 3/4).

What follows is an analysis of the South African iteration of the model and where and how it differs from the Australian model in certain respects, including the inter-agency co-ordination arrangements, and the extent to which the *FSR Bill* adequately creates the conditions for such co-ordination.

Importantly, the *FSR Bill* expressly recognises that the purpose of the legislation is to 'maintain and enhance financial stability' and that its object is 'to achieve a financial system that works in the interests of financial customers, and supports balanced and sustainable economic growth in the Republic' (*FSR Bill*, Preamble and s 6, 'Object of this Act').

The impact of a financial crisis can be catastrophic, as the Global Financial Crisis so amply demonstrated. It led to the closure of venerated financial firms such as Lehman Brothers (Phillip Swagel, 'The Financial Crisis: An Inside View', (Spring, 2009), *Brookings Papers on Economic Activity*, pp 1/2/5/8) and disrupted financial markets (and relationships) around the world (Massimiliano Cali, Isabella Massa & Dirk Willem te Velde, 'The Global Financial Crisis: financial flows to developing countries set to fall by one quarter', (13 November, 2008), *Research Reports and Studies*, p 1; Claes Norgren, 'The Causes of the Global Financial Crisis and Their Implications for Supreme Audit Institutions', (October, 2010), p 8[49]; Guy Debelle, 'Some Effects of the Global Financial Crisis on Australian Financial Markets', (31 March, 2009), *Finance Professionals Forum*) — at one stage during the GFC, UK authorities activated anti-terrorism powers against Iceland's banks (invoking s 4, *Anti-terrorism, Crime and Security Act*, (2001). See further Timothy Edmonds, 'Icelandic Bank Default', (21 July, 2009), *Publications & Records, Briefing Papers*, p 13; FT reporters, 'Terror law used for Iceland deposits', (8 October, 2008 10:54 pm), *The Financial Times*). Iceland in turn faced either the loss of currency sovereignty or default on their foreign debt (Már Guðmundsson, 'Iceland's crisis and recovery and current challenges', (28 February, 2013), *Conference organised by the French-*

Icelandic Chamber of Commerce; Islande, La Renaissance). By comparison, Greece chose default (Richard M. Salsman, 'Greece's Disgraceful Debt Default -- and Calls to "Euthanize" Bondholders', (20 March, 2012, 11:58 am), *Forbes*, p 1).

The *Bill's* focus on financial stability is supported by a definition of 'financial stability'. Section 4 provides that 'there is said to be "financial stability"' if:

(a) financial institutions generally provide financial products and financial services without interruption and are capable of continuing to do so; and

(b) there is general confidence in their ability to continue to do so'.

Section 8 of the *Bill* contains provisions dealing with the functions of the South African Reserve Bank (SARB) in relation to financial stability, and the method by which financial stability should be restored or maintained in the event of a systemic event. A definition of 'systemic event' is provided in s 1 of the *Bill* and serves as a counterpart to the definition of 'financial stability' in so far as it relates to the inability of a financial institution or a group of financial institutions 'to provide financial products and financial services' or 'a general failure of confidence of financial customers in the ability of one or more financial institutions to continue to provide financial products or services'.

Central to the 'Twin Peaks' model in South Africa is the creation of two regulators; namely, the Prudential Authority (Chapter 3 of the *Bill*) and the Financial Sector Conduct Authority (Chapter 4 of the *Bill*). Each authority will be a juristic person; however, the Prudential Authority will be housed within the South African Reserve Bank ('SARB') and will operate 'within the administration of the Reserve Bank' (s 27(1)). Under s 46 of the *FSR Bill*:

'The Reserve Bank must provide the Prudential Authority with the personnel, accommodation, facilities, the use of assets and other services and resources that are determined in accordance with section 45(1).'

There are many elements that underpin the effectiveness of the 'Twin Peaks' system of financial regulation, under which there are separate regulators for prudential supervision and market conduct. These include a clear allocation of objectives and responsibilities between each regulator; effective co-ordination between the regulators; transparency and accountability on the part of each regulator; effective powers of supervision and enforcement; operational independence of each regulator (vis-à-vis the executive government); a sound governance system and adequate resources (Michael W. Taylor, '"Twin Peaks": A regulatory structure for the new century', (December, 1995), pp 1-3; Michael W. Taylor, 'The Road from "Twin Peaks" - and the Way Back', (2009-2010), Vol. 16, *Connecticut Insurance Law Journal*, pp 64/77; Michael W. Taylor, 'Regulatory reform after the financial crisis - Twin Peaks Revisited', (Wednesday 16 February, 2011)). Most (if not all) of these elements form part of the Basel Core Principles for Effective Banking Supervision (Basel Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision', (September, 2012)).

This note will focus on three fundamental questions by reference to the experience and current debate in Australia, which has recently undergone a comprehensive review of the financial system, known as the Financial System Inquiry (FSI) (Financial System Inquiry, 'Financial System Inquiry Final Report', (November, 2014)). The FSI has generated debate around a number of fundamental issues, including the nature and structure of the system of financial regulation in Australia. The questions that arise for South Africa are as follows: (1) what are the implications of housing the prudential regulator within the National Central Bank (NCB)?; (2) how should effective co-ordination between the regulators be achieved?; and (3) what substantive functions and powers should an inter-agency co-ordinating body have?

II WHAT ARE THE IMPLICATIONS OF HOUSING THE PRUDENTIAL REGULATOR WITHIN THE NATIONAL CENTRAL BANK?

It is noteworthy that in Australia the prudential regulator, the Australian Prudential Regulation Authority (APRA) (created pursuant to the *Australian Prudential Regulation Authority Act* (Cth), *(1998)*), is separate from the Reserve Bank of Australia, and is an independent statutory authority, as is the market conduct regulator, the Australian Securities and Investment Commission (ASIC) (created pursuant to the *Australian Securities and Investments Commission Act* (Cth), *(2001)*). In the United Kingdom, on the other hand, the Prudential Regulation Authority is part of the Bank of England, and is a limited liability company, wholly owned by the Bank of England. Its relationship with the Bank of England is regulated by Schedule 1ZB of the *Financial Services Act, (2012)*. Various arguments have been made for and against each approach. In our view, the weight of opinion (theoretically at least) is in favour of a stand-alone regulator that is independent of the NCB, provided that adequate co-ordination is achieved between the regulators (namely, the market conduct regulator and the prudential regulator) and also between each regulator and the NCB. (See for example: Carmine Di Noia & Giorgio Di Giorgio, 'Should banking supervision and monetary policy tasks be given to different agencies?', (November, 1999), Vol. 2, *International Finance*, pp 361/372-6; Basel Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision', (September, 2012), § 41, p 10; Charles Goodhart & Dirk Schoenmaker, 'Institutional separation between supervisory and monetary agencies', (October-December, 1992), Vol. 51, *Giornale degli economisti e annali di economia*, p 361; H. Robert Heller, 'Prudential supervision and monetary policy', (September, 1991), *International Financial Policy: Essays in Honour of Jacques J. Polak*, p 5; Vasso P. Ioannidou, 'Does monetary policy affect the central bank's role in bank supervision?', (January, 2005), Vol. 14, *Journal of Financial Intermediation*, p 60; José Tuya & Lorena Zamalloa, 'Issues on Placing Banking Supervision in the Central Bank', (December, 1994), *Frameworks for Monetary Stability: Policy Issues and Country Experiences. Papers presented at the sixth seminar on central banking, Washington, D.C., March 1-10, 1994*, p 680).

The arguments in favour of a stand-alone prudential regulator relate, principally, to conflicts of interest and operational independence. From an economics and finance perspective, Goodhart & Shoenmaker (Charles Goodhart & Dirk Schoenmaker, 'Institutional separation between supervisory and monetary agencies', (October-December, 1992), Vol. 51, *Giornale degli economisti e annali di economia*, p 361) have observed that a conflict of interest:

> 'may arise between the monetary authorities, who wish for higher rates … , and the regulatory authorities who are frightened about the adverse effects such higher rates may have upon the bad debts, profitability, capital adequacy and solvency of the banking system.'

Under the *FSR Bill*, the Reserve Bank must deal with similarly competing priorities. Section 12 provides that when the Reserve Bank acts to prevent or manage a systemic risk, it must have due regard to various needs, including the need to 'protect and maintain financial stability', which may involve the continuing provision of financial products and financial services by financial institutions, the need to 'protect, as appropriate, financial customers' and the need to 'contain the cost to the Republic of the systemic event and the measures taken to manage it.'

An assessment of these factors may involve competing priorities and give rise to potential conflicts of interest. For example, the costs of a systemic event could potentially be lower in the event that a bank is deemed to have failed, and should exit. However, a bank exit policy may conflict with the goal of protecting financial customers where the bank in question is designated as a systemically important financial institution, and should therefore continue to provide financial products and financial services. Such circumstances may create challenges in terms of determining which priority should prevail.

Along similar lines, Ioannidou (Vasso P. Ioannidou, 'Does monetary policy affect the central bank's role in bank supervision?', (January, 2005), Vol. 14, *Journal of Financial Intermediation*, p 60) has asserted that:

> 'when the Fed tightens monetary policy, it becomes less strict in bank supervision (i.e., an increase in interest rates or a decrease in reserves is associated with a lower probability of intervention). One possible explanation is that the Fed tends to be less strict on bank supervision in order to compensate banks for the extra pressure it puts on them when it tightens monetary policy. The Fed might be interested in compensating troubled banks either because it is concerned about possible adverse effects from bank failures on its reputation or because it is concerned about possible knock-on effects. After all, the Fed is responsible for maintaining the stability of the financial system and it is responsible for the supervision of some of the biggest banks in the United States.'

There is also evidence that an independent regulator leads to better macro-economic outcomes, such as lower average inflation (Carmine Di Noia & Giorgio Di Giorgio, 'Should banking supervision and monetary policy tasks be given to different agencies?', (November, 1999), Vol. 2, *International Finance*, p 361/372) and further, that an independent prudential regulatory authority correlates to a more competitive banking system (Carmine Di Noia & Giorgio Di Giorgio, 'Should banking supervision and monetary policy tasks be given to different agencies?', (November, 1999), Vol. 2, *International Finance*, ibid, p 373).

From a regulatory perspective, an independent regulator comports more closely with the Basel Committee Principles on Banking Supervision (Basel Committee on Banking Supervision, 'Core Principles for Effective Banking

Supervision', (September, 2012), § 41, p 10), in particular Principle 2, which states as follows:

> 'Independence, accountability, resourcing and legal protection for supervisors: The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.'

Conversely, and from a practical perspective, there are benefits in housing the prudential regulator within the NCB. These include the ability to achieve synergies in relation to resources and expertise, and to avoid the difficulties that arise in relation to information-sharing that do not present where the central bank and the prudential regulator are one organisation. In addition, in jurisdictions that do not have a tradition of independent regulatory agencies, but do have a tradition of a strongly independent central bank, housing the prudential regulator within the NCB may ensure that it operates independently of government. Anecdotal evidence suggests that this was a factor behind the proposed reforms in South Africa.

In Australia, the prudential regulator, the Australian Prudential Regulation Authority (APRA), was established as a stand-alone regulator on 1 July 1998 in response to the recommendations of the 1996 Financial System Inquiry, known as the Wallis Inquiry. This was established to examine the Australian financial system and led, ultimately, to the adoption of the 'Twin Peaks' model in Australia (Stan Wallis, Bill Beerworth, Professor Jeffrey Carmichael, Professor Ian Harper & Linda Nicholls, 'Financial System Inquiry', (31 March, 1997), p 20). Its ability to perform its role effectively from the outset was attributable, in part, to the movement of personnel to APRA from the Reserve Bank of Australia (RBA). This ensured that APRA had the necessary expertise for its functions, and also provided a firm basis for co-ordination and co-operation between APRA and the RBA. Empirical research suggests that there is general consensus among the regulators and the RBA in support of APRA's stand-alone status (interviews with ASIC, APRA and the RBA conducted by the authors in July 2014), and that such support is reflected in the business community more broadly. For example, the submission by KPMG to the FSI, commenced in Australia at the end of 2013, stated: 'KPMG is inclined to view the current model – with APRA remaining a separate authority focused on prudential supervision – [as] the better arrangement.' (Adrian Fisk & Ian Pollari, 'Financial System Inquiry, KPMG Submission', (31 March, 2014), *Financial Services*, p 6). This, KPMG suggested, was due to its 'cultural traits', knowledge and experience, as well as the risk of conflicts of interest that would arise if APRA were merged with the RBA (Adrian Fisk & Ian Pollari, 'Financial System Inquiry, KPMG Submission', (31 March, 2014), *Financial Services*, p 6).

The regulatory design in any country has to accommodate the specific circumstances and needs of that country. In South Africa's case, there are likely to be cogent reasons for housing the Prudential Authority within the SARB. To some extent, the *FSR Bill* overcomes some of the concerns identified above, by clearly stipulating the objectives and internal governance structures of the Prudential Authority. However, it will still be necessary to ensure that the PA achieves an appropriate level of operational independence in practice, and that the risks of conflicts of interest and competing priorities, as referred to above, are appropriately managed.

III HOW SHOULD EFFECTIVE CO-ORDINATION BETWEEN THE REGULATORS BE ACHIEVED?

a. Regulatory Co-ordination – soft law vs hard law

Much has been written about soft law in the context of regulation, and its relative merits, as compared with hard law. For example, it has been said that regulators turn to soft law in financial regulation because of the 'sociological pull of soft law venues', the fact that soft law is 'quicker, cheaper and more flexible' and also that it is non-binding in nature, all of which 'appeals to fast-moving regulators who need to try things out' (Claire R. Kelly, 'The Sociological Pull of Soft Law', (28-31 March, 2012), Vol. 106, *American Society of International Law Proceedings*, p 327). Soft law is often embodied in memoranda of understanding between the regulatory agencies. As Ferran and Alexander state (Ellis Ferran & Kern Alexander, 'Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board', (June, 2011), *Legal Studies Research Paper Series*, p 6):

> 'Hard law ordinarily gives rise to enforceable obligations and therefore has to be reasonably certain and predictable so that people can determine what is

> expected of them. Soft law, not being directly enforceable, can be more open-textured.'

In Australia, the legislative framework for regulatory co-ordination is high-level and outcomes-focused. Although there is a general reference to co-ordination in the legislation governing APRA, there are no detailed provisions as to the nature of co-ordination and how it should be achieved. Instead, s 10A of the *APRA Act* (*Australian Prudential Regulation Authority Act* (Cth), (1998)) provides in general terms as follows:

> '(1) The Parliament intends that APRA should, in performing and exercising its functions and powers, have regard to the desirability of APRA coordinating with other financial sector supervisory agencies, and with other agencies specified in regulations for the purposes of this subsection. (2) This section does not override any restrictions that would otherwise apply to APRA or confer any powers on APRA that it would not otherwise have.'

This provision was added to implement recommendations handed down by the HIH Royal Commission (The HIH Royal Commission, 'Report of the HIH Royal Commission', (16 April, 2003)) 'on liaison and co-ordination with both domestic and international regulators and other agencies'. (See the *Australian Prudential Regulation Authority Amendment Act* (Cth)*, (2003)*, Explanatory Memorandum).

This process relies substantially on 'soft law' mechanisms in the form of memoranda of understanding and informal protocols between the regulators, where the legislative framework is more facilitative, or enabling, than prescriptive. Overseeing the process is the Council of Financial Regulators (CFR), which 'operates as a high-level forum for co-operation and collaboration among its members.' (The Council of Financial Regulators, 'Memorandum of Understanding on Financial Distress Management between the Members of the Council of Financial Regulators', (18 September, 2008)). The soft law approach in Australia is reflected in the fact that neither the CFR, nor the form or content of the regulatory MOUs, is prescribed by statute.

The soft law approach was also underscored in the *Interim Report of the Australian Financial System Inquiry*, which drew on the submission of the RBA in stating that '[l]egislation cannot be relied on to promote a culture of cooperation, trust and mutual support between domestic regulatory agencies. These have been highlighted as essential elements of an effective financial stability framework, especially during a crisis.'

(*Financial System Inquiry, 'Financial System Inquiry Interim Report', (July, 2014),* p 3-119). Of greater importance to the regulators in Australia, the RBA has suggested, is cultivating a culture of co-ordination, under which the main focus is on regulatory performance, rather than regulatory structure. The Assistant Governor (Financial) of the RBA has attributed the efficacy of co-ordination between the regulators in Australia to a culture -

> 'where we regard cooperation with the other agencies as an important part of our job, and there is a strong expectation from the public and the government that we will continue to do so…Key aspects [of coordination] include an effective flow of information across staff in the market operations and macroeconomic departments of a central bank and those working in the areas of financial stability and bank supervision. Regular meetings among these groups to focus on risks and vulnerabilities and to highlight warning signs can be very valuable. A culture of coordination among these areas is very important in a crisis because, in many instances, a stress situation is first evident in liquidity strains visible to the central bank, and the first responses may be calls on central bank liquidity.' (Malcom Edey, 'Macroprudential Supervision and the Role of Central Banks', (28 September, 2012), *Regional Policy Forum on Financial Stability and Macroprudential Supervision Hosted by the Financial Stability Institute and the China Banking Regulatory Commission* 3).

The soft law approach to regulatory co-ordination in Australia can be contrasted with the more prescriptive 'hard law' approach to regulatory co-ordination adopted in the United Kingdom as set out below, and the proposed approach in South Africa, as set out in Chapter 6 of the *FSR Bill*, particularly ss 76 and 77. Indeed, the preamble to the Bill provides expressly that one of its objects is 'to provide for co-ordination, co-operation, collaboration, consultation and consistency' between the regulatory authorities. In particular, the South African model borrows from the UK model in terms of prescribing the nature of co-ordination between the regulators, and imposing a statutory duty on the regulators to co-operate or co-ordinate their activities (the *FSR Bill*, s 76). This can be contrasted with Australia, where, although co-operation is referred to in the legislation governing APRA, there are no detailed provisions as to the nature of co-operation and how it should be achieved (*Australian Prudential Regulation Authority Act* (Cth), *(1998)*, s 10A).

In the UK, s 3D of the *Financial Services Act*, (2012) provides as follows:

'(1) The regulators must co-ordinate the exercise of their respective functions conferred by or under this Act with a view to ensuring –

(a) that each regulator consults the other regulator (where not otherwise required to do so) in connection with any proposed exercise of a function in a way that may have a material adverse effect on the advancement by the other regulator of any of its objectives;

(b) that where appropriate each regulator obtains information and advice from the other regulator in connection with the exercise of its functions in relation to matters of common regulatory interest in cases where the other regulator may be expected to have relevant information or relevant expertise;…'

This duty is qualified under subsection (2):

'(2) The duty in subsection (1) applies only to the extent that compliance with the duty –

(a) is compatible with the advancement by each regulator of any of its objectives; and

(b) does not impose a burden on the regulators that is disproportionate to the benefits of compliance.'

This approach finds parallels in s 76(1) of the *FSR Bill*, which provides that -

'The financial sector regulators and the Reserve Bank must co-ordinate, co-operate, collaborate and consult with each other in relation to performing their functions in terms of this Act and the other financial sector laws.'

Under s 76(2*)(b)*, *(c)* and *(f)*, the duty to co-ordinate includes the requirement to 'inform each other about, and share information about, matters of common interest' (unlike the legislation in the UK (see *Financial Services Act, (2012)*, s 3D(3)), the *FSR Bill* does not expressly define 'matters of common interest', although various examples are provided in certain sections), 'coordinate their actions to the extent that is appropriate and practicable' and 'interact with each other in relation to strategic directions and understandings of national and international regulatory challenges.' There is no direct equivalent to s 3D(2) of the UK legislation.

b. Regulatory Memoranda of Understanding

The FSR Bill makes provision for a regulatory memorandum of understanding to be entered into by the regulatory authorities (see the *FSR Bill*, s 77). This will deal with various matters, including how the regulators and the Reserve Bank will comply with their duties to co-ordinate in practice, delegation of powers between the Prudential Authority and the Financial Sector Conduct Authority and how differences between them are to be resolved. In Australia, the understanding is that the memoranda of understanding between the regulators and between each regulator and the RBA are not legally binding. This would appear to be the case under the *FSR Bill*.

Arguably, the hard law nature of regulatory co-ordination in South Africa, involving a statutory duty to co-operate raises various concerns, including whether this approach will result in inflexibility (namely, an inability to adapt to circumstances as and when they arise), and a culture that is more concerned with compliance than in achieving appropriate outcomes. Our findings, derived from interviews conducted with the regulators in Australia, suggest that a flexible approach to co-ordination, able to adapt to the circumstances, enabled the Australian regulators to deal effectively with the challenges arising out of the Global Financial Crisis and the 2010 Sovereign Debt Crisis. It was evident that over-prescription, or formalisation, would have stifled this flexibility.

Some flexibility to managing crises or systemic events is achieved in s 12(3) of the *FSR Bill,* which provides that the Governor of the Reserve Bank 'may establish a management committee, consisting of senior representatives of the Reserve Bank, the financial sector regulators and other relevant organs of state, to assist with co-ordinating activities to manage a systemic event referred to in subsection 1*(b)* and its effects'.

Empirical evidence suggests that the experience in Australia is that the memoranda of understanding do not have any practical effect or utility in terms of achieving the relevant outcomes, and that neither ASIC nor APRA relies strictly on the letter of the memoranda of understanding. Instead, the main value of the memoranda is in signalling to the public how the regulators intend to achieve effective co-ordination, and also the process by which they are reviewed from time to time. (Interviews conducted with the regulators by the authors in July 2014). The *FSR Bill* provides in s 77(3) that '[t]he financial sector regulators and the Reserve Bank must review and update the memoranda of understanding as appropriate, but at least once every three years.' In the UK, the *Financial Services Act, (2012)*, s 3E(4) provides that the memorandum of understanding between the regulators must be reviewed at least once in each calendar year.

IV WHAT SUBSTANTIVE FUNCTIONS AND POWERS SHOULD AN INTER-AGENCY CO-ORDINATING BODY HAVE?

The South African model borrows from the Australian model in terms of establishing a Council of Financial Regulators (CFR), a body that has no equivalent in the UK. An interesting difference between South Africa and Australia, however, is that the Council of Financial Regulators will have a statutory basis under the *FSR Bill* whereas the CFR has no statutory basis in Australia, reflecting the soft law approach as noted above. In addition, the Council of Financial Regulators in Australia 'has no legal functions or powers separate from those of its individual member agencies.' (The Council of Financial Regulators, 'About the CFR', (2013–2014)). The question of whether the Council should have a statutory basis has been the subject of recent debate in Australia in the context of the FSI, including whether greater transparency and accountability should be introduced into the regulatory system in Australia.

As outlined by the RBA in its submission to the Financial System Inquiry (FSI) -

> 'The CFR is the coordinating body for Australia's main financial regulatory agencies. Its membership comprises APRA, ASIC, the RBA and the Treasury. The CFR was established in 1998 following the recommendations of the previous Financial System Inquiry (the Wallis Inquiry). It is a non-statutory interagency body, and has no regulatory functions separate from those of its four members.
>
> CFR meetings are chaired by the Reserve Bank Governor, with secretariat support provided by the RBA. They are typically held four times per year but can occur more frequently if required. As stated in the CFR Charter, the meetings provide a forum for:
>
> - identifying important issues and trends in the financial system, including those that may impinge upon overall financial stability;
> - ensuring the existence of appropriate coordination arrangements for responding to actual or potential instances of financial instability, and helping to resolve any issues where members' responsibilities overlap; and

- harmonising regulatory and reporting requirements, paying close attention to the need to keep regulatory costs to a minimum (CFR 2004).

Much of the input into CFR meetings is undertaken by interagency working groups, which has the additional benefit of promoting productive working relationships and an appreciation of cross-agency issues at the staff level.

The CFR has worked well since its establishment and, during the crisis in particular, it has proven to be an effective means of coordinating responses to potential threats to financial stability…

The experience since its establishment, and especially during the crisis, has highlighted the benefits of the existing non-statutory basis of the CFR.' (Reserve Bank of Australia, 'Submission to the Financial System Inquiry', (March, 2014), p 66).

By contrast, section 79(2) of the *FSR Bill* makes provision for the operation and responsibilities of the CFR, stating that its function is to 'facilitate co-ordination, co-operation, collaboration, consultation and consistency, by allowing senior officers of its constituent institutions to discuss and inform themselves about matters of common interest, including strategic directions to be adopted, and understanding and meeting international and domestic regulatory challenges.' Membership of the CFR includes representatives from the regulatory authorities and certain departments, and the heads of any organ of state or other organisation that the Minister determines. The open-ended nature of the membership of the proposed Council in South Africa raises some queries and provides an interesting contrast with the approach in Australia, where the membership is limited to APRA, ASIC, the RBA and the Treasury. It should be noted, however, that submissions to the FSI had called for the membership in Australia to be extended to other regulatory agencies. (See for example, the submissions of the Commonwealth Bank of Australia, 'Wellbeing, Resilience and Prosperity for Australia, Financial System Inquiry', (March, 2014), p 88 and Adrian Fisk & Ian Pollari, 'Financial System Inquiry, KPMG Submission', (31 March, 2014), *Financial Services*, p 4). However, this recommendation was not subsequently accepted in the FSI Final Report. The *FSR Bill* further provides that meetings of the Council must be held at least twice a year (*FSR Bill*, s 80(1). By contrast, the expectation in Australia is that the Council will meet at least four times each year), and that the Council will include working groups and subcommittees in areas such as enforcement, legislation, standard-setting and financial inclusion. (*FSR Bill* s 81).

As noted above, the *FSR Bill* makes a general provision for the Council of Financial Regulators. As yet, there is no indication as to what, if any, substantive powers and functions it will have. Two questions arise in this regard: (1) should the Council have substantive powers and functions that go beyond its consultative and co-ordinating role?; and (2) how should accountability and transparency be achieved?

Both of these questions were the subject of submissions to the FSI in Australia and various stakeholders suggested that the role and functions of the Council of Financial Regulators should be enshrined in statute. For example, KPMG submitted that the Council's 'role, transparency and accountability would be strengthened if it were given statutory recognition.' (Adrian Fisk & Ian Pollari, 'Financial System Inquiry, KPMG Submission', (31 March, 2014), *Financial Services*, p 5). In addition, the National Australia Bank recommended that 'the Council of Financial Regulators (CFR) should be given a more formal structure and be tasked by the Treasurer to coordinate the implementation of regulatory change by APRA and ASIC.' (National Australia Bank, 'NAB Submission to the Financial System Inquiry', (March, 2014), § 3.2.2, p 4).

One concern in having a statutory-based inter-agency co-ordinating body is that it might be treated as the only channel through which inter-agency co-ordination can be achieved. In this regard, it is relevant to note that s 79(4) of the *FSR Bill* provides that '[t]his section does not limit the powers or duties of the Council of Financial Regulators' constituent institutions, including other powers and duties in relation to consultation, co-operation and co-ordination.'

A further concern, which was expressed by the RBA in its submission to the FSI, is that 'formalising the CFR with explicit responsibilities and policy tools would involve transferring agency constituent powers to the CFR, with the risk of blurring lines of responsibility that to date have worked well.' (Reserve Bank of Australia, 'Submission to the Financial System Inquiry', (March, 2014), p 67). In other words, conferring explicit powers and responsibilities on the CFR that go beyond its consultative and co-ordinating role might cut across the powers and responsibilities of the member agencies. A better approach, it has been suggested, is for the Council of Financial Regulators to be 'seen as the collaborative dimension of the regulatory agencies' activities, rather than as a separate body with its own ability to make the regulatory agencies cooperate.' (*Financial System Inquiry, 'Financial System Inquiry Interim Report', (July, 2014),* p

3-119). This is consistent with the approach of one of the regulators, expressed during interviews conducted by the authors, that giving formal co-ordination powers to the CFR may confuse accountability and require a more intrusive infrastructure, and that the system in Australia works well without one body directing the process. Further, what is critical to regulatory co-ordination is, at a formal level, the regular meetings of the Council of Financial Regulators and its working committees and, at an informal level, the relationship between the people involved (interviews with the regulators in July 2014).

In its submission, the RBA noted that although formal structures for co-ordination between agencies might assist to mediate the resolution of differences between regulatory agencies, and thereby enforce outcomes, 'it is unclear how reassigning part of a regulatory agency's constituent powers to an overarching body will influence coordination and effectiveness of regulatory policies. Similarly, it remains to be seen if formality is the feature of institutional arrangements that ensures better outcomes.' (Reserve Bank of Australia, 'Submission to the Financial System Inquiry', (March, 2014), p 53).

Underlying this reservation, it is suggested, is a concern that formalising the role of the Council of Financial Regulators and the inter-agency co-ordinating arrangements might distract from the flexibility and robustness required to make co-ordination work; namely, it might result in a situation where the regulators involved are more concerned about complying – and being seen to comply – with the formal requirements, than they are about regulatory performance and achieving the desired outcomes. This may have been one of the reasons why the FSI Final Report did not recommend any fundamental change to the current institutional arrangements. The approach in Australia appears to be reflected in the approach in South Africa, where the Council of Financial Regulators has a facilitative function and is not granted express powers that might cut across the powers and responsibilities of its members.

One area in which there has been some development in Australia in relation to the Council of Financial Regulators, albeit somewhat limited, is increased transparency in the form of a webpage for the Council of Financial Regulators on the website of the Australian Commonwealth Treasury. (The Council of Financial Regulators, 'Welcome to the Council of Financial Regulators', (2013–2014)). The webpage contains information about the Council, media releases, publications and other resources. This is in line with the views expressed in the FSI Final Report that ‘there would be benefit in increasing the transparency of the CFR’s deliberations, including its assessment of financial stability risks and how these are being addressed.’ To date, however, the minutes of the meetings of the Council have not been published. By contrast, s 57(2)*(b)* of the first draft of the *FSR Bill* provided for a higher level of transparency, by stipulating that the meetings of the Council ‘must be published on the National Treasury’s website for public information, unless the decision involves confidential information.’ This provision was not carried over into the second draft of the *FSR Bill*.

V SOME CONCLUDING OBSERVATIONS

The move in South Africa towards a ‘Twin Peaks’ model of financial regulation is a significant reform that should promote financial stability and strengthen South Africa’s ability to manage and mitigate the effects of financial crises. The experience of Australia provides some insights into the challenges that this model presents, particularly in the area of regulatory co-ordination, and the various ways in which these challenges might be overcome. One of the key lessons suggested by the Australian experience is that the legislative and regulatory framework is a necessary – but, of itself, insufficient – element in terms of achieving the desired outcomes. Of equal importance is a ‘culture of co-ordination’ under which the main focus is on regulatory performance rather than regulatory structure. In this regard, the high-level, outcomes-focused and ‘soft law’ approach adopted in Australia offers an interesting contrast to the more prescriptive ‘hard law’ approach in the United Kingdom, and the proposed approach in South Africa. Of critical importance, this note suggests, is achieving an appropriate balance between formality and flexibility; namely, making clear provision for the nature and scope of regulatory co-ordination while at the same time ensuring that the system is sufficiently flexible to allow it to adapt to specific circumstances, as and when they arise.

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