

## **Peer Review of South Africa**

### Review Report

5 February 2013

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## Foreword

Financial Stability Board (FSB) member jurisdictions have committed, under the FSB Charter and in the *FSB Framework for Strengthening Adherence to International Standards*<sup>1</sup>, to undergo periodic peer reviews. To fulfil this responsibility, the FSB has established a regular programme of country and thematic peer reviews of its member jurisdictions.

Country reviews focus on the implementation and effectiveness of regulatory, supervisory or other financial sector standards and policies agreed within the FSB, as well as their effectiveness in achieving desired outcomes. They examine the steps taken or planned by national authorities to address International Monetary Fund-World Bank Financial Sector Assessment Program (FSAP) and Report on the Observance of Standards and Codes (ROSC) recommendations on financial regulation and supervision as well as on institutional and market infrastructure that are deemed most important and relevant to the FSB's core mandate of promoting financial stability. Country reviews can also focus on regulatory, supervisory or other financial sector policy issues not covered in the FSAP that are timely and topical for the jurisdiction itself and for the broader FSB membership. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, or its compliance with international financial standards.

FSB member jurisdictions have committed to undergo an FSAP assessment every 5 years; peer reviews taking place 2-3 years following an FSAP will complement that cycle. As part of this commitment, South Africa volunteered to undertake a country peer review in 2012.

This report describes the findings and conclusions of the South Africa peer review, including the key elements of the discussion in the FSB's Standing Committee on Standards Implementation (SCSI) on 6-7 December 2012. It is the seventh country peer review conducted by the FSB and the first using the revised objectives and guidelines for the conduct of peer reviews set forth in the December 2011 *Handbook for FSB Peer Reviews*.<sup>2</sup>

The analysis and conclusions of this peer review are based on the South African financial authorities' responses to a questionnaire and reflect information on the progress of relevant reforms as of January 2013. The review has also benefited from dialogue with the South African authorities as well as discussion in the FSB SCSI.

The draft report for discussion was prepared by a team chaired by Abdulrahman Al-Hamidy (Saudi Arabian Monetary Agency) and comprising Beate Frings (Deutsche Bundesbank) and Martin Joy (Australian Securities and Investments Commission). Jason George and Costas Stephanou (both FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

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<sup>1</sup> See [http://www.financialstabilityboard.org/publications/r\\_100109a.pdf](http://www.financialstabilityboard.org/publications/r_100109a.pdf).

<sup>2</sup> See [http://www.financialstabilityboard.org/publications/r\\_120201.pdf](http://www.financialstabilityboard.org/publications/r_120201.pdf).

## Abbreviations

BCBS	Basel Committee on Banking Supervision
BSD	Bank Supervision Department (of the South African Reserve Bank)
CCP	Central Counterparty
CIPC	Companies and Intellectual Property Commission
CMS	Council for Medical Schemes
CPSS	Committee on Payment and Settlement Systems
DTI	Department of Trade and Industry
EU	European Union
FIC	Financial Intelligence Centre
FICA	FIC Act
FMA	Financial Markets Act
FMI	Financial Markets Infrastructure
FRRSC	Financial Regulatory Reform Steering Committee
FRSC	Financial Reporting Standards Council
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSB-SA	Financial Services Board (South Africa)
FSLGAB	Financial Services Laws General Amendment Bill
FSC	Financial Stability Committee (of the South African Reserve Bank)
FSOC	Financial Stability Oversight Committee
GDP	Gross Domestic Product
IOSCO	International Organization of Securities Commissions
JSE	Johannesburg Stock Exchange
MoU	Memorandum of Understanding
NCC	National Consumer Commission
NCR	National Credit Regulator
ODWG-SA	Over-the-Counter Derivatives Working Group (South Africa)
OTC	Over-the-Counter
R	South African Rand (ZAR)
ROSC	Reports on the Observance of Standards and Codes
SAM	Solvency Assessment and Management
SARB	South African Reserve Bank
SCSI	Standing Committee on Standards Implementation
SRO	Self-Regulatory Organisation
TCF	Treating Customers Fairly
TR	Trade repository
TRP	Takeover Review Panel
US	United States
USD	United States Dollar

## **Executive summary**

### **Background and objectives**

This peer review examines two important financial reform topics in South Africa that are relevant for the broader FSB membership: interagency coordination and the regulatory structure; and regulation of over-the-counter (OTC) derivatives markets. Both topics were initially identified in South Africa's 2008 FSAP assessment update and 2010 ROSC assessments of banking, securities and insurance sector standards.

### **Main findings**

#### *Interagency coordination and the regulatory structure*

The institutional arrangements for financial regulation and supervision in South Africa are relatively complex, involving multiple government agencies as well as several advisory and oversight committees and self-regulatory organisations. The main agencies are the Bank Supervision Department (BSD) of the South African Reserve Bank (SARB), which prudentially regulates and supervises banks; the Financial Services Board of South Africa (FSB-SA), which regulates and supervises most non-bank financial institutions as well as securities markets activities; and the National Credit Regulator (NCR) under the Department of Trade and Industry (DTI), which regulates the market conduct aspects of granting of consumer credit by all credit providers. Lead responsibility for setting financial regulatory policy lies with the National Treasury.

In 2011, the South African Treasury issued a policy document for financial reform that includes changes in the institutional arrangements for financial regulation and supervision. These changes can be categorised under three headings: introduction of a Twin Peaks regulatory structure; strengthening financial stability oversight; and strengthening coordination and information exchange arrangements.

The authorities are of the view that moving to a Twin Peaks model of financial regulation will improve prudential and market conduct regulation and create a more resilient and stable financial system. Under such a structure, a prudential regulator and supervisor for most financial institutions and key financial markets infrastructures will be established within the SARB, while the FSB-SA will be transformed into a dedicated market conduct regulator with limited prudential regulation responsibilities. Implementation will take place in two phases, although an overall timeline for the completion of the reforms has not yet been set.

The FSB welcomes the planned reforms and agrees that a shift to a Twin Peaks model provides a good opportunity for South Africa to streamline responsibilities and elevate the importance of market conduct regulation, which has historically played a less prominent role in certain financial sub-sectors (e.g. banking). As prudential supervisory responsibilities will be concentrated in one agency, the Twin Peaks model will also help to improve oversight of financial conglomerates that dominate the South African financial system. While the reforms do not seem to reduce the overall complexity in terms of the number of agencies involved in regulation and supervision, they do provide more clarity in the assignment of responsibilities and the concentration of related expertise.

However, the introduction of a new regulatory structure is not an easy task and will require careful planning. Such planning should encompass steps to ensure effective supervision and management of risks during the transition to the new structure, but also the harmonisation and rationalisation of the various laws applicable to different types of financial institutions. It also involves dealing with practical integration issues such as differences in pay structures, information technology systems, premises and corporate cultures among the different authorities. The task is made more challenging by the fact that South Africa is simultaneously tightening rules for regulated firms and expanding the perimeter of regulation to comply with new international standards.

Like several other FSB member jurisdictions, South Africa is in the process of adopting a system-wide approach to financial oversight. The authorities have established an interim inter-agency Financial Stability Oversight Committee (FSOC) that, when legislated, will be responsible for the oversight of the financial system from a macroprudential perspective. The development and implementation of national macroprudential policy frameworks is at a fairly early stage at the international level, and there is no international standard that could act as a benchmark in this area. The experience of other countries will prove useful in designing the necessary framework for the FSOC in South Africa, including on issues such as the proper alignment of powers and responsibilities, the legal framework, disclosure arrangements, and membership requirements so that there is effective follow-up on any decisions made.

The authorities have taken a number of steps in recent years to address the FSAP and ROSC recommendations to enhance coordination and information exchange between the regulatory agencies. The BSD and FSB-SA have adopted a Memorandum of Understanding (MoU) on coordination, meet regularly to discuss systemic issues and have agreed on a division of responsibility with respect to group-wide supervision. Conversely, the cooperation of the SARB and the FSB-SA on the one hand, with the NCR on the other hand, has not changed fundamentally since the FSAP, despite regularly working together on specific projects to address issues of mutual concern. The authorities plan to formalise the relationship with the NCR by including the NCR in the MoU. There has also been discussion, but little progress, on the establishment of a Council of Financial Regulators as a mechanism for enhancing cooperation and information sharing.

#### *OTC derivative market reforms*

The 2008 FSAP noted that non-resident activity in the foreign exchange market is very significant and a potential source of vulnerability; accordingly, it recommended that surveillance of the OTC derivative markets be enhanced. South Africa, as a G20 member, has also committed to implement a number of regulatory requirements on these markets.

The South African authorities have adopted a phased and carefully planned approach to the implementation of OTC derivative regulatory reforms as follows:

- Phase I – a code of conduct for, and registration of, markets participants and implementing central reporting of OTC derivative transactions;
- Phase II – risk management, i.e. margin and capital requirements for non-centrally cleared derivatives (where appropriate); and
- Phase III – standardisation, central clearing and central trading (where appropriate).

The reforms will be implemented via a regulatory framework to be established by the Financial Markets Act (FMA), which has recently been passed by Parliament and will become operational once the final regulations have been approved. Under this framework, regulations and rules will be developed to address the details of the reforms. The authorities have begun to consider the details of all reform areas with the exception of the G20 commitments on trading, an issue that the authorities do not view as an immediate priority. The authorities intend to mandate reporting of all OTC derivatives during 2013 and will initially rely on incentives to fulfil the G20 commitment on central clearing. The authorities have also commissioned a report to better understand the specific characteristics of the OTC derivatives market since available information is limited.

Upon full implementation of the reforms, the FSB-SA (and then the successor market conduct authority) and the SARB (in its role as a prudential authority) will share supervisory responsibility for the OTC derivatives market. The SARB's powers in relation to this market, however, are not yet finalised and await the enactment of the Twin Peaks legislation. Until the implementation of that legislation, the FSB-SA will have sole regulatory responsibility for the OTC derivatives markets. The FSB-SA states that it will consult with the SARB in exercising this responsibility in the intervening period.

Despite the progress made, many details of the reforms are not yet resolved and await further understanding of the market and development of additional regulation. According to the South African authorities, the pace and sequencing of the reform package has been and continues to be driven by concerns about the potential adverse consequences that the reform measures may have on the OTC derivatives market; the previously largely unregulated nature of the market, which has slowed down the development of suitable regulatory measures; and the need to better understand the cross-border impact of OTC derivative reforms in other jurisdictions before finalising their own measures. FSB members acknowledged the importance of major jurisdictions addressing cross-border OTC derivatives issues, but noted the need for all jurisdictions to put in place national legislation and regulation promptly and in a form flexible enough to respond to any cross-border consistency issues that may arise.

These factors highlight already apparent lessons on the importance of effective post-trade transparency and on the need for jurisdictions to consult and cooperate with each other in order to promptly and adequately address cross-border issues. A key issue going forward is whether South African entities will be able to use mechanisms that allow compliance with domestic regulations to satisfy the requirements of other jurisdictions. Accordingly, the cross-border impact of the United States (US) and European Union (EU) OTC derivative regimes will continue to influence the form of South Africa's regulatory framework.

## **Recommendations**

### *Interagency coordination and the regulatory structure*

- As part of the Twin Peaks reform, the SARB and the transformed FSB-SA should revise their MoU to clearly delineate respective responsibilities and outline mechanisms for information sharing and cooperation as well as for resolving policy disagreements.
- To ensure effective market conduct regulation and to avoid regulatory overlaps or gaps, the authorities are encouraged to incorporate the NCR into the transformed FSB-SA.

This move would be in line with the underlying concept of regulation by objectives and it would contribute to the effective streamlining of the regulatory structure.

- The authorities should consider shifting legal authority for financial disclosure regulation of public companies from the DTI to the FSB-SA, which will remain the lead regulator of the exchanges under the Twin Peaks structure.
- In order to reduce regulatory uncertainty for market participants and other stakeholders as well as to give impetus to the reform process, the authorities are encouraged to establish clear implementation timelines for the Twin Peaks reform process.
- The ability of the interim FSOC to ensure effective macroprudential oversight may be hampered by the fact that it has no tools available and lacks legislative backing. To overcome these limitations, the South African authorities are encouraged to swiftly move forward with the adoption of the final FSOC and to clarify its mandate, powers and accountability arrangements.
- The authorities are encouraged to consider the establishment of a Council of Financial Regulators with broad membership, including of relevant agencies outside the Treasury's ambit, to share information and discuss financial sector policy issues.

#### *OTC derivatives market reforms*

To ensure the full and rapid implementation of the G20 commitments and follow-up to the FSAP/ROSC recommendations, the authorities may want to consider the following actions:

- Publicly announce a date on which the exclusive reliance on incentives to migrate contracts into central clearing arrangements will be reviewed. Announcing such a date would signal to the market a clear intent by the authorities to assess the effectiveness of incentives in encouraging central clearing. Armed with data from trade repositories (TRs), the authorities should then be able to determine on this date whether incentives are resulting in all standardised contracts being cleared.
- Give the FSB-SA (and SARB) the ability to levy fines on licensed FMIs for failure to comply with substantive standards of the FMA or their licence conditions. Fining powers could usefully supplement the FSB-SA's powers to revoke or vary the license of an FMI or direct an FMI to take specified action.
- Ensure that licensed FMIs are subject to adequate recovery and resolution requirements, drawing upon international guidance. While the FMA bestows adequate rule making and licensing powers on the FSB-SA to ensure this occurs, it does not impose these requirements clearly by its terms.
- Conduct follow-up work using data reported to TRs on whether the trading of appropriate contracts on exchanges or through electronic trading platforms can be encouraged or mandated in a timely fashion.
- Ensure that the FSB-SA is ready to supervise all facets of the OTC derivatives market in the event that the SARB lacks legal supervisory powers at the time the market is brought within the regulatory net via the FMA. To this end, the FSB-SA may want to enter into a cooperative arrangement with the SARB so that it can rely on the SARB's expertise and resources in this area.



## 1. Introduction

South Africa underwent an FSAP assessment update in 2008.<sup>3</sup> This was followed in 2010 by detailed assessments of the Basel Committee on Banking Supervision's (BCBS) *Core Principles for Effective Banking Supervision*, the International Association of Insurance Supervisors' *Insurance Core Principles*, and the International Organization of Securities Commissions' (IOSCO) *Principles and Objectives of Securities Regulation*.<sup>4</sup>

The FSAP team reported that South Africa's sophisticated financial system is fundamentally sound and that the regulatory framework is modern and generally effective. At the same time, the FSAP highlighted the increased macro-financial risks arising from a less benign global environment as well as the need to further strengthen contingency planning arrangements and improve supervisory cooperation given the extensive inter-linkages in the financial sector. It also made recommendations in other areas relating to financial stability, the functioning of financial markets, financial sector regulation and supervision, and financial inclusion and consumer protection. The ROSC assessment team noted that South Africa's regulatory system is substantially compliant with international standards and that progress was made in addressing identified gaps in the insurance and securities sectors. It also emphasised the importance of improving regulatory independence as well as coordination among regulators.

The main purpose of the peer review report is to examine two topics that are relevant for financial stability and currently represent areas of financial reform in South Africa: interagency coordination and the regulatory structure; and regulation of OTC derivatives markets. Both of these topics, which were initially identified in the FSAP, are important for South Africa and topical for the broader FSB membership. The peer review focuses on the steps taken to date by the South African authorities to implement reforms in these two areas, including by following up on relevant FSAP and ROSC recommendations. In particular, the review evaluates progress with the reforms in order to draw conclusions and policy implications that could be of benefit to South Africa and its FSB peers.

The report has two main sections, corresponding to the two topics being reviewed. Section 2 analyses the measures taken by the South African authorities to strengthen inter-agency coordination and the regulatory structure, including the introduction of a Twin Peaks regulatory model. Section 3 (and Annex 3) focuses on the priorities and policy choices made by the South African authorities in OTC derivatives market reforms. In addition to these two sections, Annex 1 provides background information on the structure of the South African financial system and on recent regulatory developments, while Annex 2 presents the follow-up actions reported by the South African authorities to other key FSAP and ROSC recommendations; these actions have not been analysed as part of the FSB peer review and are presented solely for purposes of transparency and completeness.

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<sup>3</sup> See "South Africa: Financial System Stability Assessment" (IMF Country Report No. 08/349, October 2008, available at <http://www.imf.org/external/pubs/ft/scr/2008/cr08349.pdf>).

<sup>4</sup> See "South Africa: Report on Observance of Standards and Codes - Banking Supervision, Insurance Supervision, and Securities Regulation" (IMF Country Report No. 10/352, December 2010, available at <http://www.imf.org/external/pubs/ft/scr/2010/cr10352.pdf>).

## 2. Interagency coordination and the regulatory structure

### Background

The institutional arrangements for financial regulation and supervision in South Africa are relatively complex, involving multiple government agencies as well as several advisory and oversight committees and self-regulatory organisations (see Box 1 and Figure 1). The main agencies are the SARB's BSD, which prudentially regulates and supervises banks; the FSB-SA, which regulates and supervises most non-bank financial institutions as well as securities markets activities (relying largely on the Johannesburg Stock Exchange or JSE as a self-regulatory organisation or SRO); and the NCR under the DTI, which regulates the market conduct aspect of granting of consumer credit by all credit providers.<sup>5</sup> Lead responsibility for setting financial regulatory policy lies with the National Treasury, which steers legislation through parliament and has final authority on regulations prepared by the FSB-SA and BSD.

While the 2008 FSAP recognised that the regulatory framework for the financial sector in South Africa is modern and generally effective, it noted that the financial system is concentrated and dominated by a number of financial conglomerates (see Annex 1), thereby underscoring the need for regulators to address risks that span across sectors. The FSAP recommended strengthening coordination and information exchange among regulators and policymakers, minimising gaps and overlaps as well as clearly delineating responsibilities among regulators; enhancing day-to-day collaboration among the staff of different sectoral regulators; and considering a mechanism for resolving policy disagreements among different regulators and departments and assessing trade-offs among differing policy objectives.

Following the FSAP and ROSC assessments, the South African Treasury issued a policy document for financial reform.<sup>6</sup> The policy document presents the government's vision of how to reshape the sector to address existing challenges and sets out the policy priorities over the next few years. These include changes in the institutional arrangements for financial regulation and supervision, which can be categorised according to the three headings described below: introduction of a Twin Peaks regulatory structure; strengthening financial stability oversight; and strengthening coordination and information exchange arrangements.

Since the publication of the policy document, two laws have been proposed that, while not directly related to it, affect certain proposals contained therein. The Financial Services Laws General Amendment Bill (FSLGAB) seeks to rationalise and align supervisory powers and functions by the various Registrars in the FSB-SA in terms of the various laws administered by it.<sup>7</sup> The FMA *inter alia* lays down the foundation for the exchange of information related

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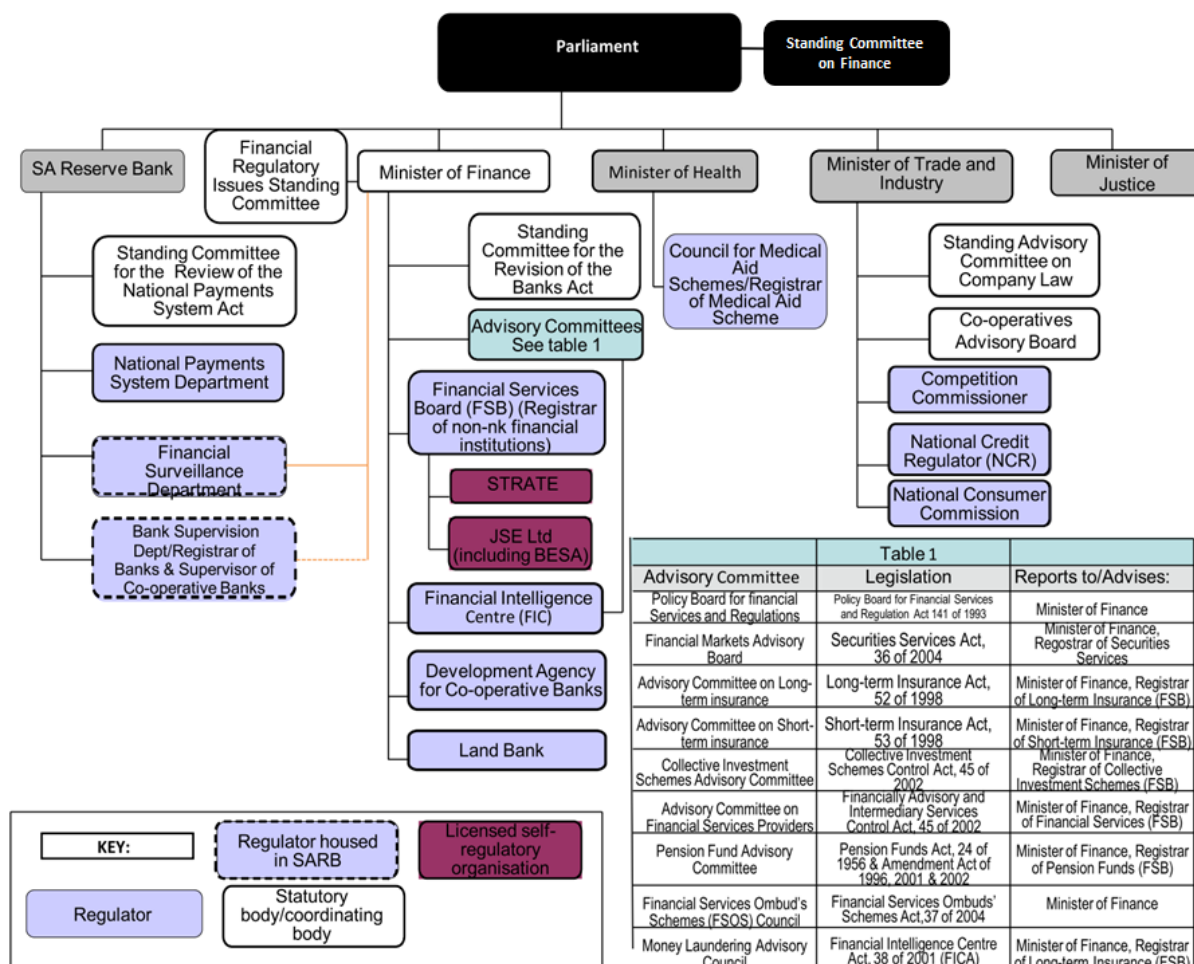
<sup>5</sup> Another relevant agency is the Council of Medical Schemes, which reports to the Department of Health and regulates medical insurances schemes.

<sup>6</sup> See "A safer financial sector to serve South Africa better" (23 February 2011, available at <http://www.treasury.gov.za/documents/national%20budget/2011/A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf>).

<sup>7</sup> The laws entrust regulatory functions to various Registrars in the FSB-SA: Registrar of Pension Funds, Registrar of Friendly Societies, Registrar of Long-Term Insurance, Registrar of Short-Term Insurance, Registrar of Securities Services, Registrar of Collective Investment Schemes and the Registrar of Financial Services Providers. These functions converge in the Office of the Executive Officer who is presiding over the FSB-SA.

to systemic risk between the FSB-SA, the SARB and the National Treasury. Moreover, the South African authorities are planning to strengthen market conduct regulation and expand the scope of prudential regulation to cover activities that are currently not regulated or are under-regulated but have the potential to be a source of systemic risk (see Annex 1).

**Figure 1: The current regulatory structure in South Africa**



### **Box 1: The current system of financial regulation in South Africa**

The various agencies involved in the regulation and supervision of the South African financial system are as follows:

- **SARB:** The Office for Banks (commonly referred to as the Bank Supervision Department, BSD) of the SARB has legislative authority to register and supervise banks in South Africa. Given its historical institutional dependence on the Treasury, and in spite of being a department of the SARB and as such reporting to the Governor, the BSD also has a direct reporting line to the Minister of Finance on certain legislative matters.
- **FSB-SA:** The FSB-SA regulates and supervises securities firms, the stock exchange, the central securities depository, clearing houses, financial advisors and intermediaries, collective investment scheme operators, pension funds, and insurance companies. Its current supervisory scope also includes banks in respect of advice and intermediary services. The FSB-SA is subject to the general authority of the Minister of Finance, who appoints board members and selects the senior officers, after consultation with the board.
- **JSE:** The JSE is a registered Self-Regulatory Organisation that has broad regulatory responsibilities as delegated by the FSB-SA. The JSE is the primary and secondary market for listed equity securities, financial derivatives, agricultural commodities, and the bond market. It has primary regulatory responsibility for licensing members (authorised users) and employees, and setting listing standards and disclosure obligations for listed companies. It also has lead responsibility for market surveillance and has the authority to take disciplinary action against member firms and their employees, listed companies, and company directors.
- **DTI:** The DTI oversees the NCR, the Takeover Review Panel (TRP), the Companies and Intellectual Property Commission (the CIPC), the National Consumer Commission (NCC) and the Financial Reporting Standards Council (FRSC). The NCR, which operates under the National Credit Act and is funded by the DTI, is responsible for regulating consumer credit provision. The TRP is responsible for reviewing all public company mergers and acquisitions. The CIPC is responsible for registering all corporations, intellectual property rights, and monitoring on-going public company disclosure obligations. The FRSC is the national financial accounting policy standard-setting body.
- **Council for Medical Schemes (CMS):** The CMS reports to the Department of Health and regulates medical insurance schemes. While sharing characteristics of insurance, these schemes are closer to social security funds since they do not underwrite individual risks.
- **Financial Intelligence Centre (FIC):** The FIC is a separate unit under the Ministry of Finance responsible for anti-money laundering regulation. Created by the FIC Act (FICA) of 2001, its principal objectives are to assist in the identification of the proceeds of unlawful activities and the combating of money laundering and financing of terrorist activities. To achieve its objectives, the FIC must cooperate with other authorities, including supervisory bodies. Each supervisory body remains responsible for supervising compliance with the FICA for the institutions it supervises.
- **Statutory advisory boards:** There are several statutory advisory boards and standing committees that provide strategic and policy input to the various financial regulatory authorities (see Figure 1).

## **Introduction of a Twin Peaks regulatory structure**

### *Steps taken and actions planned*

A Twin Peaks regulatory structure is characterised by separate prudential and market conduct regulators. In South Africa, a prudential regulator and supervisor for most financial institutions and key financial markets infrastructures will be established within the SARB, while the FSB-SA will be transformed into a dedicated market conduct regulator.<sup>8</sup>

The South African authorities consider the move to a Twin Peaks model of financial regulation as a means of strengthening regulation and creating a more resilient and stable financial system. The most important reasons cited by the authorities for moving to a Twin Peaks regulatory structure include:

- Facilitate the adoption of a system-wide approach to financial stability and streamline the regulatory system.
- Adopt a group-wide approach to prudential supervision, taking into account the importance of financial conglomerates to the South African financial system.
- Strengthen market conduct regulation by establishing a dedicated authority as one of the two peaks of the regulatory system and by acknowledging the different skill sets required for prudential and market conduct regulation.

This approach is similar to institutional arrangements for financial regulation in countries that South Africa is historically linked to, such as the UK, Australia and the Netherlands.

The feedback from the public consultation on the reform proposals reinforced the direction of the reforms. Market participants noted that the current regulatory architecture is perceived to be unclear, with overlapping responsibilities and potential duplication of work. Moreover, respondents stressed the importance of effective coordination and cooperation among financial regulators and voiced concerns about inadequate market conduct, insufficient consumer protection and disproportionate bank charges.

A Financial Regulatory Reform Steering Committee (FRRSC), comprised of and co-chaired by senior officials from the SARB, FSB-SA and National Treasury, was established in June 2011 to develop the Twin Peaks financial regulatory framework and subsequently implement the reforms. The FRRSC has organised several events to learn from South Africa's peers, including workshops with foreign central banks and international study tours of countries with similar regulatory architectures. It has established six working groups on specific aspects of the reforms.<sup>9</sup> The results of their efforts are set forth in a Roadmap Implementation document issued for public comments in early 2013.<sup>10</sup> Implementation of the Twin Peaks

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<sup>8</sup> It was decided to initially retain certain elements of prudential supervision in the FSB-SA (e.g. for entities such as micro insurers and friendly societies) after considering the relative importance of conduct versus prudential risk for different types of institutions and their customers, the social impact of failure, as well as the complexity of their activities and the related difficulty of supervising them.

<sup>9</sup> The working groups focus on: (i) the perimeter of the prudential regulatory authority; (ii) the enhanced role of the FSB-SA in oversight of consumer protection and market conduct; (iii) the economic impact of the regulatory reforms; (iv) the legislative framework; (v) institutional and organisational design; and (vi) enforcement of compliance at an administrative level.

<sup>10</sup> See "Implementing a twin peaks model of financial regulation in South Africa" (1 February 2013, <http://www.treasury.gov.za/>).

model will take place in two phases, the precise timing of which is dependent upon progress made by the working groups and the legislative timetable. During the first phase, supporting legislation will be developed to enable the SARB and the FSB-SA to assume their new responsibilities. Legislation applicable to steps in this phase is expected to be finalised in 2013. The second phase, consisting of the broader harmonisation process of regulatory and supervisory systems, will be implemented over the next several years. However, an overall timeline for the completion of the reforms has not been set.

The move to the Twin Peaks model will lead to important changes in operational procedures and governance structures of the various regulatory agencies and the SARB. According to the authorities, the prudential regulator will operate as a cluster of departments within the SARB and report to a deputy governor. In contrast, the authorities expect the future market conduct regulator to be governed by an executive group consisting of full-time members appointed by the Minister of Finance. The authorities also plan to review the reliance on SROs in the regulatory framework during 2013-14.

The South African authorities are aware that one particularly important issue that needs to be addressed under the Twin Peaks model is the future role of the NCR. As the FSB-SA is expected to become a market conduct regulator covering retail banking market activities, its responsibilities will overlap to a certain degree with the mandate of the NCR as set forth in the National Credit Act. The NCR, *inter alia*, is mandated with the monitoring of and reporting on market conduct within the consumer credit industry, including banks. To avoid uncertainty about the division of responsibilities between the future FSB-SA and the NCR, the DTI and Treasury are engaged in discussions about how the NCR should fit into the Twin Peaks model, taking into account the decision made by the Cabinet when approving that model. One option is to merge the NCR with the transformed FSB-SA. Another option is to carve-out systemically important financial institutions from the NCR's mandate.

The policy document also proposed rationalising the various advisory boards and technical committees to streamline the regulatory structure. While progress on this front is slow, the FMA and FSLGAB are removing provisions on the establishment of mandatory advisory committees. The authorities intend to move from the currently rigid structure of sector-specific committees to a more flexible structure of stakeholder engagement. Details have yet to be worked out, but the Minister of Finance will be given a leading role in that respect.

#### *Lessons learned and issues going forward*

The Twin Peaks approach to financial regulation separates regulatory functions by objectives, thereby allowing each regulator to focus on a single core mandate.<sup>11</sup> In the case of South Africa, the shift to this model provides a good opportunity to streamline responsibilities and develop specialised expertise, including by transforming the FSB-SA into a dedicated market conduct authority and providing it with adequate resources to strengthen its technical capacity. This will elevate the importance of market conduct regulation, which has historically played a less prominent role in South Africa for certain financial sub-sectors (e.g. banking). The dedicated market conduct authority will also have the ability to hire, train and

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<sup>11</sup> See "The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace" by the Group of Thirty (6 October 2008, available at <http://www.group30.org/images/PDF/The%20Structure%20of%20Financial%20Supervision.pdf>).

retain personnel with specialised expertise. Furthermore, as prudential supervisory responsibilities for financial institutions will be concentrated in one agency (SARB), the Twin Peaks model will help to improve regulatory oversight of financial conglomerates that dominate the South African financial system. Given that most entities will be supervised by and report to both peaks, coordination and cooperation between them is crucial to minimise potential regulatory overlaps or gaps. As part of the reform, the SARB and the FSB-SA should therefore revise the current MoU in order to clearly delineate the respective responsibilities of the two agencies and outline mechanisms for information sharing and cooperation as well as for resolving policy disagreements.

The introduction of the Twin Peaks regulatory structure is not an easy task and will require careful planning. Such planning should encompass steps to ensure effective supervision and management of risks during the transition to the new structure, but also the harmonisation and rationalisation of the various laws currently applicable to different types of financial institutions. It also involves dealing with practical integration issues such as differences in pay structures, information technology systems, premises and corporate cultures among the different authorities. The task is made more difficult by the fact that South Africa is simultaneously tightening rules for regulated financial institutions and expanding the perimeter of regulation by bringing different types of entities (e.g. hedge funds and credit rating agencies) and markets (e.g. OTC derivatives) under the regulatory net.

Notwithstanding the benefits of a Twin Peaks model, the reforms do not seem to reduce the overall complexity of the South African regulatory structure, at least in terms of the number of agencies involved in regulation and supervision. More importantly however, is the need for greater clarity in the assignment of responsibilities and the concentration of related expertise. In this respect, agreement on the future role of the NCR will be crucial. To ensure effective financial market conduct regulation and to avoid regulatory overlaps or gaps, the authorities are encouraged to incorporate the NCR into the transformed FSB-SA. This move would be in line with the underlying concept of regulation by objectives and it would contribute to the effective streamlining of the regulatory structure.

The South African authorities are also encouraged to continue progress with the phasing-out or rationalising of the various advisory bodies and technical committees. At the same time, to ensure continued consultation with stakeholders, the authorities should start designing future stakeholder engagement mechanisms to ensure that they remain flexible and well-targeted.

While the overall Twin Peaks reform initiative is comprehensive and will strengthen market conduct regulation, it does not address the related issue of financial disclosure regulation, particularly for unlisted public companies. The 2010 ROSC identified a substantial void in the regulation of companies' public disclosures and noted that the DTI had broad legal authority in that area but had largely delegated to the JSE the regulation of listed company disclosure. Although the JSE, as a SRO, reports to the FSB-SA, the FSB-SA lacks regulatory authority to set disclosure requirements for public companies. So far, no changes to that arrangement are planned in moving to the Twin Peaks model. As the transformed FSB-SA will remain the lead regulator of the exchanges under the future Twin Peaks structure, authorities should consider shifting legal authority for financial disclosure regulation of public companies from the DTI to the FSB-SA.

In order to reduce regulatory uncertainty for market participants and other stakeholders as well as to give impetus to the reform process, the South African authorities are encouraged to establish clear implementation timelines for the Twin Peaks reform process. These timelines could be established once there is greater clarity concerning the future role of the NCR and the legal authority for financial disclosure regulation. In particular, while the Roadmap Implementation document is an important step forward in terms of clarifying the overall direction of the reforms, it would be desirable to disclose additional implementation details, such as interim milestones and provisional deadlines on the reforms as well as information on the broader harmonisation process of regulatory and supervisory systems.

### **Strengthening financial stability oversight**

#### *Steps taken and actions planned*

Like several other FSB-member jurisdictions, South Africa is in the process of adopting a system-wide approach to financial stability oversight. In this context, SARB has been given an explicit mandate for financial system stability and it intends to establish an institutional and governance framework for macroprudential surveillance and formulate a financial stability policy. In 2011, SARB merged its Financial Stability Department with the BSD in an effort to enhance information sharing between microprudential banking supervision and macroprudential oversight. Macroprudential analyses are currently being conducted by the BSD's Financial Stability Unit. The authorities are considering reversing this arrangement, while retaining information sharing between the micro- and macroprudential functions, once SARB assumes prudential supervisory functions for other sectors and key FMIs in addition to banking.

While there is general consensus in South Africa that SARB is best placed to perform the macroprudential analysis function, it is also clear that it cannot be the sole custodian of financial system stability and that all other financial regulators must take into account the financial stability implications of their actions. To ensure the engagement and cooperation of all financial regulatory authorities in systemic oversight, the FRRSC proposes that the SARB be given the mandate to establish and lead an inter-agency FSOC. The FSOC will be responsible for the oversight of the financial system from a macroprudential perspective and will play an advisory role in crisis management and resolution.

The FSOC has met three times in a preliminary form, co-chaired by the Governor of SARB and the Minister of Finance. Senior officials from the Treasury, the SARB and the FSB-SA participated in the meetings and discussed global economic and financial developments, potential vulnerabilities and their implications for South Africa as well as systemic issues in the banking and insurance sectors. The interim FSOC requested its members to develop a risk matrix, indicating the possible impact and probability of major risks to financial stability, as well as possible tools for the introduction of contingency measures.

Acknowledging the leading role of the SARB in financial stability, the South African authorities have decided to replace the interim FSOC by expanding the SARB's FSC with external members to form the FSOC. The main function of the FSOC will be to share information on financial stability issues and analyse and address emerging and imminent threats to financial stability. It will attempt to limit the social cost of system-wide distress and ensure financial system stability through information sharing, proactive and corrective



decision-making, and issuing and monitoring of recommendations to mitigate risks. According to the authorities, the FSOC will be given the power to make recommendations to relevant financial authorities on a “comply-or-explain” basis.

#### *Lessons learned and issues going forward*

The development and implementation of national macroprudential policy frameworks is at a fairly early stage at the international level, and there is no international standard that could act as a benchmark in this area.<sup>12</sup> In South Africa, like in other FSB jurisdictions, the central bank will play a leading role in macroprudential policy making due to its experience and expertise in the assessment of financial and macroeconomic developments as well as its role in payment systems and as a lender of last resort. The experience of other countries will prove useful in designing the necessary framework for an effective FSOC in South Africa.

The ability of the interim FSOC to ensure effective macroprudential oversight may be hampered by the fact that it has no tools available and lacks legislative backing. To overcome these limitations, the South African authorities are encouraged to swiftly move forward with the adoption of the final FSOC and to clarify its mandate, powers and accountability arrangements.

### **Strengthening coordination and information exchange**

#### *Steps taken and actions planned*

The authorities have taken a number of steps in recent years to address the FSAP and ROSC recommendations to strengthen coordination and information exchange between the regulatory agencies. In this regard, the BSD and the FSB-SA have adopted a MoU on coordination and meet quarterly to discuss systemic issues, interrelated regulatory matters and supervisory activities, including joint enforcement issues and financial results of the major domestic financial conglomerates. The two agencies have also agreed on a clear distinction regarding their respective responsibilities for group-wide supervision. In 2010, the FSB-SA and BSD established frequent supervisory meetings for the five largest banking and insurance groups in order to enhance supervisory information sharing, eliminate gaps in group supervision and help identify the potential for regulatory arbitrage. In 2012, the FSB-SA and BSD started to conduct joint on-site reviews of selected insurance groups’ activities related to unsecured lending. In contrast, the cooperation of the SARB and the FSB-SA with the NCR has not changed fundamentally since the FSAP, except in those cases where they work together on specific projects to address issues of mutual concern.

The 2008 FSAP also encouraged authorities to consider a mechanism for resolving policy disagreements among different regulators and departments and for assessing trade-offs among differing policy objectives. In response, quarterly meetings between the FSB-SA and the BSD are now being held. To date, no other formal mechanism has been established even though planning on a Council of Financial Regulators had already begun at the time of the ROSC assessments in 2010. The policy document repeated the idea of establishing a Council of Financial Regulators to enhance coordination and cooperation between the different

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<sup>12</sup> See “Macprudential Policy Tools and Frameworks: Progress Report to G20” by the FSB, IMF and BIS (27 October 2011, available at [http://www.financialstabilityboard.org/publications/r\\_111027b.pdf](http://www.financialstabilityboard.org/publications/r_111027b.pdf)).

regulatory authorities. The FRRSC, however, did not progress with this project as it was considered less urgent because it expects the FSOC to play a role in enhancing cooperation and contribute to resolving potential policy disputes. According to the authorities, a Council of Financial Regulators might be established in the future in order to deal with non-prudential, non-stability-related issues and primarily act as a forum for information exchange between a larger group of financial authorities.

#### *Lessons learned and issues going forward*

The BSD and FSB-SA have taken important steps to enhance cooperation and information exchange that are expected to contribute to more effective oversight of financial conglomerates. Details on how conglomerate supervision, based on the recently-revised Joint Forum principles<sup>13</sup>, will be developed as a financial stability function of the SARB will be a crucial further step in that respect.

With several agencies involved in supervision and regulation, there is a need for clear delineation of responsibilities and a mechanism to resolve potential policy disagreements. The Twin Peaks regulatory reform, once implemented, will help to streamline responsibilities and may partly address some coordination issues. The FSOC might also be able to resolve diverging policy views between the two peaks, although this mechanism is not sufficient since it focuses only on financial stability issues. The authorities are therefore encouraged to consider the establishment of a Council of Financial Regulators with broad membership, including of relevant agencies outside the Treasury's ambit (see Box 1), in order to share information and discuss financial sector policy issues. The establishment of such a Council should not be dependent on the timing of other regulatory reforms, and could be launched with a preliminary membership that would be revised once the Twin Peaks model is enacted.

### **3. OTC derivatives market reforms**

#### **Background**

The 2008 FSAP noted that non-resident activity in the foreign exchange market is very significant and a potential source of vulnerability, and it recommended that surveillance of the OTC foreign exchange derivative markets be enhanced. The IOSCO assessment also flagged the significant OTC derivatives activity (including for equity-linked derivatives), little regulatory oversight, and limited available information on the size and characteristics of that market. It noted the systemic risk in the OTC derivatives market, and encouraged the authorities to examine all aspects of the market in detail and to strengthen its surveillance.

In November 2009, the G20 Leaders agreed that “*all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.*” In 2011, the G20 Leaders further agreed to add margin

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<sup>13</sup> See <http://www.bis.org/publ/joint29.pdf>.

requirements on non-centrally cleared derivatives. As a member of the G20, South Africa has committed to implement these reforms.

Currently, the South African OTC derivatives market is largely unregulated:

- The *Securities Services Act* (No 36 of 2004) does not provide for the proactive regulation, monitoring or surveillance of the South African OTC derivatives market;
- The *Financial Advisory and Intermediary Services Act* (No 37 of 2002) does not regulate the activities of counterparties to a bilateral derivative transaction where they are acting in a principal capacity;
- Derivatives are only regulated under the *Banks Act* (No. 94 of 1990) to the extent the derivative activity is covered by the Basel II.5 requirements; and
- South African banks have high-level monthly derivative reporting obligations to the SARB. Non-bank financial institutions report their OTC derivative exposures to the FSB-SA on a monthly/quarterly basis.

Currently available information on the size and structure of the South African OTC derivatives market is limited. According to preliminary estimates of a consultant report commissioned by the authorities (see below), the market had a notional value of South African Rand (R) 27.7 trillion at 30 June 2012. Approximately R24 trillion (85% of the total) was in interest rate contracts, while approximately R3.3 trillion was in foreign exchange-related contracts; smaller amounts were reported in equities (R41.5 billion), credit (R23.1 billion) and commodities (R18.79 billion). Interbank interest rate transactions constituted 59% of the outstanding OTC derivatives market (about R16 trillion); of these transactions, 61% involved a South African bank and a foreign bank as counterparties.

There is little physical financial markets infrastructure (FMI) in South Africa for the clearing of OTC derivatives, and there is no domestic TR or trading platform. However, the JSE's subsidiary (SAFCOM) operates a licensed clearing house for the JSE's listed derivative contracts and has recently been certified as a qualifying central counterparty (CCP) for exchange-traded contracts.<sup>14</sup>

### **Approach to reforms**

The National Treasury, SARB and the FSB-SA have initiated their response to the G20 commitments and FSAP/ROSC recommendations on OTC derivatives. The FSB-SA commissioned a report in 2010 from an OTC Derivatives Working Group (ODWG-SA), comprising industry and government representatives, to investigate the structure, operation, functionality and risks of the OTC derivatives market.<sup>15</sup> The report recommended comprehensive reporting of OTC derivatives transactions, clearing of standardised trades and

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<sup>14</sup> According to the BCBS document on *Capital requirements for bank exposures to central counterparties* (July 2012, <http://www.bis.org/publ/bcbs227.pdf>), CCPs need to be in compliance with CPSS/IOSCO's *Principles for Financial Market Infrastructure* in order to be a qualifying CCP.

<sup>15</sup> See "An Examination of the South African OTC Derivatives Markets to Recommend Measures for Strengthening their Regulatory Oversight" by the OTC Derivatives Working Group (2010, available at [http://www.treasury.gov.za/legislation/bills/2012/FMA/Annexure%20C%20An%20examination%20of%20the%20OTC%20derivatives%20market%20\(Skerrit\).pdf](http://www.treasury.gov.za/legislation/bills/2012/FMA/Annexure%20C%20An%20examination%20of%20the%20OTC%20derivatives%20market%20(Skerrit).pdf)).

additional risk management requirements for non-centrally cleared trades. It further recommended a code of conduct for professional participants in the OTC derivative markets, providing legal certainty for OTC derivative contractual arrangements and monitoring of, and timely response to, international developments concerning OTC derivative regulations.

The South African authorities have adopted a phased and carefully planned approach to the implementation of OTC derivative regulatory reforms as follows:

- Phase I – a code of conduct for, and registration of, markets participants and implementing central reporting of OTC derivative transactions;
- Phase II – risk management, i.e. margin and capital requirements for non-centrally cleared derivatives (where appropriate); and
- Phase III – standardisation, central clearing and central trading (where appropriate).

This phased approach was adopted because of concerns about the potential consequences of implementing these reforms on a previously unregulated market. The concerns stemmed from the fact that the authorities lacked a detailed understanding of the OTC derivative market's functioning. The phased approach was seen as allowing the authorities to develop this understanding, including through adequate consultation with industry. The order of the phases has been informed by the perceived natural sequence of implementing each reform (i.e. mandating reporting can be implemented without detailed market information, while central clearing would require information that would be delivered by mandated reporting).

To advise on the most appropriate regulatory framework for meeting the G20 commitments, the National Treasury has established an OTC Derivatives Sub-Committee as part of its Financial Stability Policy Advisory Group. The FSB-SA and SARB are members of this sub-committee and have participated in the policy development process. Under this sub-committee, there are three broad-based working groups:<sup>16</sup>

- Registration and Code of Conduct Working Group, covering participants in the market, and some elements of the broader framework;
- Central Reporting Working Group, covering reporting; and
- Central Clearing Working Group, covering clearing and standardisation.

The authorities have commissioned a consulting firm to prepare a sizing and scoping report to help them better understand the specific characteristics of the South African OTC derivatives market. The findings from this report, which will be completed in early 2013, are expected to assist the authorities to determine the viability and estimated costs of implementation of domestic or international CCPs and TRs.

The authorities broadly accepted the ODWG-SA report's recommendations and have incorporated them into the FMA, which has recently been passed by Parliament and will become operational once the final regulations have been approved.<sup>17</sup> The FMA establishes

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<sup>16</sup> The working groups have representatives from financial trade associations, government authorities, banks and commercial firms.

<sup>17</sup> The FMA addresses South Africa's securities markets in general and replaces the *Securities Services Act* (No 36 of 2004) – see <http://www.treasury.gov.za/legislation/bills/2012/FMB/> for details. OTC derivatives are 'unlisted securities' under the FMA.

the broad framework that will allow the authorities to implement each area of the reforms (with the exception of trading, which the authorities do not view as an immediate priority) and, in so doing, to respond to the G20 commitments and the FSAP/ROSC recommendations. The main elements of the FMA are set out below by main area of reform, while additional details on the status of progress are set out in Annex 3.<sup>18</sup>

A substantial amount of the reforms' details are left to regulations to be prepared by the Minister of Finance and the FSB-SA's rule-making powers (collectively referred to in this report as 'rules').<sup>19</sup> Upon full implementation of OTC derivative market reforms, the FSB-SA (and then the successor market conduct authority) and the SARB (in its role as a prudential authority) will share supervisory responsibility for the market; the FSB-SA will regulate market conduct, while SARB will regulate capital and risk requirements (see section 2). At this stage, the SARB is not given any powers under the FMA; the authorities state that powers relating to the OTC derivative markets will be granted to the SARB under the forthcoming Twin Peaks legislation. As a result, the FSB-SA will have sole regulatory responsibility for the OTC derivative markets prior to the implementation of that legislation. The FSB-SA states, however, that it will consult with the SARB in exercising this responsibility until the implementation of the Twin Peaks legislation.

### **Status of progress in main areas of reform**

*Trade reporting:* The South African authorities have taken steps towards the mandated reporting of OTC derivative transactions to TRs. Section 58 of the FMA enables the Registrar of Securities Services to prescribe what trades need to be reported, which entity must do the reporting and the manner and frequency of the reporting. In March 2012, the authorities consulted on the form and content of the mandatory reporting obligation, with the Working Group on Central Reporting subsequently determining that the reporting of all OTC derivatives will be mandatory.

Based on current drafts of the relevant rules, 'OTC derivatives providers' will need to report all of their OTC derivative transactions.<sup>20</sup> Corporate end users would not need to report their transactions on the current working assumption that most of these users transact with OTC derivative providers. 'OTC derivatives' will be identified via a taxonomy of products set out in rules to be issued. The authorities expect this reporting obligation to be effective by the end of June 2013, although the obligation may be implemented across contract types in a phased manner.<sup>21</sup>

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<sup>18</sup> See also the FSB's *OTC Derivatives Market Reforms: Fourth Progress Report on Implementation* (November 2012, [http://www.financialstabilityboard.org/publications/r\\_121031a.pdf](http://www.financialstabilityboard.org/publications/r_121031a.pdf)), which describes the status of progress in this area by its member jurisdictions, including South Africa.

<sup>19</sup> The rule-making powers are manifested in powers vested in the 'Registrar' (defined in the FMA as the executive officer of the FSB-SA) to 'prescribe', or issue directives and notices on, relevant matters.

<sup>20</sup> OTC derivatives providers are defined as those who, as regular feature of their business and for their own account, originate OTC derivatives or make a market in those derivatives. There is no quantitative transaction threshold proposed for the definition of an OTC derivative provider. This is because the purpose of the definition is to bring all primary OTC market participants within the regulatory net. In this sense, the regulatory framework will have an investor protection, as well as systemic stability, objective.

<sup>21</sup> The authorities, together with the Central Reporting Working Group, are currently in the process of identifying the data they will require OTC providers to submit to a trade repository.

*Standardisation of contracts:* The FMA does not address standardisation of OTC derivative contracts explicitly. The authorities are waiting on the final results of the scoping exercise (mentioned above) to better understand the capacity for standardisation in the market. There is scope under the FMA for rules to be made on standardisation.

*Clearing:* Rather than mandate the clearing of standardised contracts, the authorities intend to initially rely on incentives to fulfil this G20 commitment.<sup>22</sup> These incentives are the netting benefits of clearing and the Basel III credit valuation adjustment, which allows banks to hold less capital for contracts cleared through a qualifying CCP. Margining requirements may also play a role if and when they are implemented. The authorities have no deadline by which central clearing will be implemented, although they state that they will review the effectiveness of incentives in meeting this commitment over time. The FMA would enable rules to mandate central clearing.

Preliminary research commissioned by the authorities as part of the scoping exercise on the South African OTC derivatives market indicates that interest rate derivatives transactions would be the main candidate for central clearing; in other asset classes, the research suggests that the scale of business does not seem large enough to make a domestic CCP viable. The actual amount to be cleared will depend on the instruments and counterparties (e.g. large corporates or only banks) subject to any domestic clearing requirements; it is expected that many of the transactions involving both a domestic and a foreign counterparty may clear offshore pursuant to foreign clearing mandates.<sup>23</sup>

*Financial market infrastructure (as part of the reporting and clearing commitments):* The FMA establishes a licensing and recognition regime that would permit domestic and external (i.e. offshore) TRs and CCPs to provide services to South African entities.<sup>24</sup> Clearing and reporting obligations, when applicable, will only be met when carried out through licensed (i.e. domestic) or recognised (i.e. external) FMIs.

The FMA sets out a range of standards applicable to domestic FMI licensees. These standards concern how certain aspects of an FMI's business should be run. Some standards that might be expected of FMIs, however, are not articulated in the FMA. For example, the FMA does not make clear how it will ensure that CCPs mitigate risks applicable to their business or make provision for their recovery and resolution. These details will need to be completed through as yet unmade rules, licensing requirements and, potentially, the forthcoming Twin Peaks legislation.

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<sup>22</sup> According to the summary of "Jurisdictions' declared approaches to central clearing of OTC derivatives" by the FSB (November 2012, [http://www.financialstabilityboard.org/publications/r\\_121105a.pdf](http://www.financialstabilityboard.org/publications/r_121105a.pdf)), a majority of FSB member jurisdictions intend to adopt mandatory clearing requirements or a combination of mandatory clearing requirements and incentives to meet the G20 commitment to have all standardised OTC derivative contracts centrally cleared.

<sup>23</sup> In January 2013, the first South African cross-border OTC derivatives transaction was cleared via an offshore CCP (LCH.Clearnet in the United Kingdom).

<sup>24</sup> There are two types of domestic 'clearing houses' (i.e. CCPs) contemplated by the FMA: those associated with an exchange and those that are independent from an exchange (and accordingly, supervise their own members).

Under the FMA, the Registrar of Securities Services must conduct annual assessments of FMIs against the provision of information.<sup>25</sup> The Registrar may also revoke or attach conditions to a license (and may transfer the business of an FMI if its license is cancelled). The Registrar may attend meetings of the controlling body of an FMI. FMIs must report annually to the Registrar. The Registrar may transfer the business of an FMI to another licensed FMI, although only after the FMI has ceased operating, which may be too late in time to avoid market disruption. Related to this, a court may grant a business rescue order in respect of a FMI.<sup>26</sup>

Despite these considerable regulatory powers, it is not clear that financial sanctions could apply to an FMI for failure to comply with the substantive standards applicable to them under the FMA or their license conditions.<sup>27</sup> Although fines are available against external FMIs for contravening rules of the Registrar (see below), no equivalent fines could be levied against a licensed FMI for failing to comply with the standards enumerated under FMA or its license conditions. Licensed, but not external, FMIs may also avoid financial liability under South African law for failures in their operations because section 72 of the FMA grants FMIs the benefit of a limitation of liability against losses resulting from the performance of the functions mandated by the FMA.

External TRs and clearing houses would not need to be licensed to provide services to South African entities. They would, however, need to be established under the laws of a foreign country that are recognised as equivalent by the FSB-SA. The authorities are currently working on the issue of how to assess such equivalence, and have stated that resolving this issue has been made more difficult by the absence of clear international standards on how jurisdictions should or could recognise equivalent regulatory regimes. Both the Minister of Finance and the Registrar have rule-making power over the services that may be offered by external FMIs.

The authorities state that they are open to either domestic or external FMIs providing services to South African entities and intend to be agnostic as to where transactions are cleared, provided the CCP is either licensed or is an external CCP subject to laws recognised as equivalent to those of South Africa. The authorities, however, are alert to the possibility that the commercial viability of domestic clearing of relevant contracts could be impaired by rules of other jurisdictions that mandate the clearing of those contracts through offshore CCPs.

Moreover, use of external CCPs would likely require South African entities to post collateral to offshore accounts. Exchange controls, known as macro-prudential limits, currently place a limit on the ability of South African entities to expatriate funds to meet collateral (and

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<sup>25</sup> Section 94 of the FMA gives the Registrar powers to compel the production of information and require attendance before the Registrar by persons providing security services, including CCPs. This section would not, however, apply to TRs.

<sup>26</sup> A business rescue order is a mechanism under the *Companies Act 2008* that facilitates a temporary supervision of, and moratorium on claims against, a distressed company while it seeks to restructure itself to facilitate its continued existence.

<sup>27</sup> Fining powers exist for certain procedural breaches, such as failing to submit information that FMIs are required to provide under section 97 of the FMA.

margin) requirements.<sup>28</sup> The authorities recognise that these limits will need to be reconsidered.

The FMA empowers the Registrar to enter into agreements with other supervisory authorities to exchange information on either domestic or external FMIs. The SARB will also need to enter into such agreements given its anticipated prudential supervisory role concerning FMIs. However, neither the FSB-SA nor the SARB have started negotiating any such agreements with their external counterparts.

*Trading:* Trading is not addressed in the FMA. The authorities do not see mandated trading as an immediate priority. They contemplate, however, establishing a trading working group in 2013 to commence considering the issues associated with this aspect of the G20 reforms.

*Margining:* The ODWG-SA report recommended that, where central clearing is not used, there should be adequate risk management arrangements in place to mitigate counterparty credit and other risks. The authorities state that they are awaiting the final joint report from the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions on margin requirements for non-centrally-cleared derivatives before finalising their position on margining. Under the FMA, the Minister for Finance could make regulations on margining requirements for non-cleared trades.

*Regulation of market participants:* While not part of the G20 commitments, South Africa is also addressing the regulation of previously unregulated participants in the OTC derivative markets. All OTC derivative providers will need to be registered with the FSB-SA, regardless of whether they are registered under the Financial Advisory and Intermediary Services Act (see Annex 3 for further details). A code of conduct established under the FMA and subject to further detail to be prescribed by the Registrar will apply to OTC derivative providers.

*FSAP and ROSC recommendations:* The FSAP and ROSC recommendations in this area are expected to be largely addressed through the imposition of the trade reporting obligations. These obligations will enhance the ability of the authorities to carry out surveillance of all OTC derivative market activity, with the exception of transactions between corporates.

## **Lessons learned and issues going forward**

The South African authorities have advanced their reforms of the OTC derivative markets in response to the G20 commitments and the relevant FSAP and ROSC recommendations. The enactment of the FMA leaves the authorities well-positioned to implement the details of the reforms on reporting, clearing of standardised contracts and margining of non-cleared contracts. Trading is, however, currently unaddressed.

Despite the progress made, many details of the reforms are not yet resolved and await further understanding of the market and the development of additional rules.<sup>29</sup> The pace and sequencing of the authorities' reform package is driven by three factors:

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<sup>28</sup> The macro-prudential limits imposed by the SARB prohibit South African entities from expatriating more than 25% of their liabilities for investment in offshore assets.

<sup>29</sup> Even when these reforms are finalised, it will take time to migrate OTC derivative contracts onto reporting and clearing platforms. For example, in the FSB's fourth progress report on the implementation of OTC



- First, there was (and continues to be) concern about the potential adverse consequences that the reform measures may have on the OTC derivatives market;
- Second, the previously largely unregulated nature of the market has hampered a comprehensive understanding of its characteristics and thereby slowed down the development of suitable regulatory measures; and
- Third, the South African authorities, like those in other jurisdictions,<sup>30</sup> would like to better understand the cross-border impact of OTC derivative reforms in the US and EU before finalising their own measures.

These factors highlight already apparent lessons on the importance of effective post-trade transparency (to ensure market regulators have good visibility into the OTC derivative markets) and on the need for jurisdictions consulting and cooperating with each other (either informally or through multilateral fora) to promptly and adequately address cross-border issues. This is particularly relevant for jurisdictions with dominant OTC derivatives markets whose reforms carry implications for other jurisdictions reliant on access to those markets.

A key issue going forward is whether South African entities will be able to use mechanisms that allow compliance with domestic regulations to satisfy the requirements of other jurisdictions. Accordingly, the cross-border impact of the US and EU OTC derivative regimes will continue to influence the form of South Africa's regulatory framework.

To ensure the full and rapid implementation of the G20 commitments and follow-up to the FSAP/ROSC recommendations, the National Treasury, in cooperation with the FSB-SA and SARB, may want to consider the following actions:

- Publicly announce a date on which the exclusive reliance on incentives to migrate contracts into central clearing arrangements will be reviewed. Announcing such a date would signal to the market a clear intent on the part of the authorities to assess the effectiveness of incentives in encouraging central clearing. Armed with data from trade repositories, the authorities should then be able to determine on this date whether incentives are resulting in all standardised contracts being cleared.
- Give the FSB-SA (and SARB) the ability to levy fines on licensed FMIs for failure to comply with substantive standards of the FMA or their licence conditions. Fining powers could usefully supplement the FSB-SA's powers to revoke or vary the license of an FMI or direct an FMI to take specified action.
- Ensure that licensed FMIs are subject to adequate recovery and resolution requirements, drawing upon international guidance.<sup>31</sup> While the FMA bestows adequate rule making and licensing powers on the FSB-SA to ensure this occurs, it does not impose these requirements clearly by its terms.

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derivatives market reforms (ibid), trade repositories are stated as needing approximately six months on average to launch new services.

<sup>30</sup> See, for example, the third progress report by the FSB on the implementation of OTC derivatives reforms (June 2012, [http://www.financialstabilityboard.org/publications/r\\_120615.pdf](http://www.financialstabilityboard.org/publications/r_120615.pdf)).

<sup>31</sup> See the CPSS-IOSCO consultative report on *Recovery and Resolution of Financial Market Infrastructures* (July 2012, <http://iosco.org/library/pubdocs/pdf/IOSCOPD388.pdf>).

- Conduct follow-up work using data reported to trade repositories on whether the trading of appropriate contracts on exchange or through electronic trading platforms can be encouraged or mandated in a timely fashion.
- Ensure that the FSB-SA is ready to supervise all facets of the OTC derivatives market in the event that the SARB lacks legal supervisory powers at the time the market is brought within the regulatory net via the FMA. To this end, the FSB-SA may want to enter into a cooperative arrangement with the SARB so that it can rely on the SARB's expertise and resources in this area.

## Annex 1: Structure of the financial system and regulatory developments

### Financial system structure

The financial system in South Africa totalled approximately R7 trillion in assets as of year-end 2011 (United States Dollar (USD) equivalent of 855 billion) and financial services contributed almost 10% to South Africa's gross domestic product (GDP). The banking sector constitutes almost 50% of the financial system assets, with pension funds and long-term insurers each contributing roughly 25% (see Table 1).

**Table 1: Snapshot of the financial system in South Africa**

	Dec-00	Dec-11	Relative size 2011
<b>Size*</b>	R 68.6 bn	R 204.2 bn	9.7 % of GDP
<b>Assets</b>	R 1.89 tn	R 6.99 tn	236% of GDP
Of which:			
Banks	0.73	3.41	
Long term insurers	0.63	1.71	
Short term insurers	0.05	0.09	
Pension funds (public and private)	0.47	1.79	
<b>Tax contribution<sup>+</sup></b>	n/a	R 22.1 bn	26.9% of corporate taxes

Source: SARB, StatsSA, SARS; Tax contribution is for the 2010/11 tax year.

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

<sup>+</sup> Excludes VAT and other taxes

The banking sector in South Africa is dominated by five major financial conglomerates. These groups have extensive interest in primarily banking, asset management, insurance and securities sectors. The insurance industry is also dominated by four large conglomerates with the same characteristics. These internationally active conglomerates are listed on either the Johannesburg Stock Exchange, the London Stock Exchange or have a dual listing. The banking operations of the conglomerates are structured under a bank controlling company. Interests in the other sectors such as insurance, asset management and securities are also structured under the bank controlling company, but legislation provides that the activities of the bank controlling company should be predominantly in the business of banking.

The banking sector comprises 17 banks (down from 30 at year-end 2002), 14 branches of international banks, 2 mutual banks and 43 representative offices, with foreign shareholders owning 43% of shares outstanding. The sector is characterised by a high degree of concentration with four banks (ABSA, Standard Bank, First Rand, and Nedbank), two of which are foreign-owned, accounting for 84% of total sector assets as of year-end 2011.

The sector has been relatively stable since mid-2011 and has improved since 2010, although overall conditions remain somewhat challenging. Profitability, as measured by return on equity and return on assets, has increased from 14.6% and 1.0% at year-end 2010 to 16.4% and 1.2% at year-end 2011 respectively. Capital adequacy ratios have also improved, with the

Tier 1 capital ratio standing at 11.7% in June 2012. Deposits from corporate customers (including financial institutions) constituted the largest portion of total banking sector deposits (46%). Lending amongst South African banks is concentrated in the residential mortgage market, with such loans comprising 33% of all loans as of year-end 2011. This share is slowly decreasing as banks are witnessing a marked increase in term loans. The ratio of impaired advances to gross loans and advances amounted to 4.7% in December 2011.

The insurance sector in South Africa, while smaller than the banking sector, plays an important role in credit intermediation. The life insurance sector reported overall premium growth of 5% in 2011. The strength of the long-term (mainly life) insurance industry is due in large part to its well-capitalised nature. The short-term (non-life) insurance sector also posted positive results in 2010 and 2011, after sharp declines in 2008 and 2009. Premiums and underwriting profits have increased over the past two years with the latter being positively impacted by a reduction in claims.

The number of companies with shares listed on the JSE totalled 399 in 2012. Liquidity, measured on the basis of equity turnover as a percentage of market capitalisation, amounted to 46% for the year ended on 31 March 2012. The market capitalisation of all listed securities amounted to R7,261 billion (approximately US\$907 billion) at 31 March 2012. This ranks the JSE as the 20th largest stock exchange in the world in terms of market capitalisation. In addition, 128 issuers were listed on the JSE bond market at 31 March 2012. The nominal value amounted to R1,387 billion, while the nominal turnover amounted to R21,239 billion.

The retirement fund sector covers most employees in the formal sector through occupational retirement fund arrangements (“quasi-mandatory”), pension funds, provident funds, umbrella funds, retirement annuity funds and preservation funds. Voluntary retirement savings are supported by tax incentives, largely limited to middle and upper income workers and cover about 60% of workers in the formal sector. During the 2010 financial year, retirement funds had approximately 12.2 million members and total assets exceeding R2 trillion.

### **The global financial crisis and South Africa**

Although South Africa did not itself experience a financial crisis, its economy, and to a lesser degree the financial sector, were impacted by the resultant global credit squeeze and recession. Significant capital outflows, a decline in external demand and a slump in major export commodity prices caused South Africa’s economy to contract for three consecutive quarters beginning in the fourth quarter of 2008, inflation to rise to almost 10% in 2008, and the domestic stock market to drop by 36% from May-December 2008, resulting in the loss of almost 1 million jobs in the formal sector of the economy. These events made South Africa one of the more affected countries among emerging markets to the global financial crisis.

The financial system weathered the global financial crisis reasonably well; importantly, there was no need for public support. Owing to a generally sound framework for prudential regulation, a conservative selection of risks by banking institutions, modest exposure to foreign risks and a subsidiary structure for foreign banks operating in South Africa, bank capital levels were able to remain above regulatory minima during the crisis and profitability, while suffering, remained positive. Nevertheless, with unemployment rising to almost 25%

during the crisis, private sector credit growth declined sharply and banks experienced a concomitant decrease in bank balance sheets and an increase in impaired loans.<sup>32</sup>

The global financial crisis highlighted for the South African authorities the importance of the financial sector in terms of its direct role in economic growth and development, as well as its role as an intermediary for all other sectors. According to the authorities, key policy lessons from the crisis included the following:

- A stronger regulatory framework needs to be developed;
- The effectiveness, governance and domestic and international coordination of regulators needs to be strengthened;
- The crisis resolution framework needs to be improved to ensure that the costs of a financial institution's failure are as small as possible, and that such a failure does not affect the broader financial system;
- Regularly benchmark principles and practices of the regulatory system against international norms; and
- The importance of good communication channels and information sharing arrangements between home and host regulators, particularly given that two of South Africa's four big banks are foreign owned.

In the 2011 Budget, the Minister of Finance announced substantial reforms to the system of financial regulation. The identified reforms are contained in the National Treasury Policy Document *A safer financial sector to serve South Africa better*. The policy document defines four key policy objectives: (1) financial stability; (2) consumer protection and market conduct; (3) expanding access through financial inclusion; and (4) combating financial crime.

### **Major regulatory reforms**

Following the crisis, South Africa embarked on a number of reforms to its domestic financial infrastructure and regulatory framework that in most cases are still underway. Most notable is the implementation of a Twin Peaks model of financial regulation (see section 2).

Other major regulatory reforms that are underway are as follows:

- *Insurance sector*: Continuation of the Solvency Assessment and Management (SAM) project to overhaul the solvency regime for insurers: SAM encompasses quantitative (Pillar 1) requirements and qualitative (Pillar 2) requirements, as well as enhanced reporting and public disclosure (Pillar 3). SAM is based on Solvency II in the European Union but adapted as necessary to local conditions.<sup>33</sup> The SAM project aims to deliver changes in 2013 in the form of enhanced governance, risk management and internal control requirements for both life and non-life insurers, and a formal insurance groups supervisory framework. SAM final implementation is targeted for 1 January 2015.

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<sup>32</sup> See the recent IMF Article IV reports (<http://www.imf.org/external/country/ZAF/index.htm>) for details.

<sup>33</sup> South Africa is one of the jurisdictions currently being reviewed by the European Commission for deemed third country equivalence to Solvency II once it is implemented.

- *Market conduct*: Continuation of a regulatory reform initiative designed to introduce an outcomes-based approach to treating customers fairly: the Treating Customers Fairly (TCF) initiative is similar to the TCF approach adopted by the UK Financial Services Authority. TCF will encompass a revised regulatory framework consisting of principles and rules to guide the delivery of core consumer outcomes, including an enhanced focus on governance, risk management and internal control requirements with respect to conduct of business risks; a more intensive and intrusive market conduct supervisory framework; and more stringent enforcement tools. The FSB-SA has already undertaken a pilot TCF self-assessment exercise and will be shortly undertaking a benchmarking exercise. Full TCF implementation is planned for 2015. TCF will apply to all entities supervised by the market conduct regulator, including insurers, collective investment scheme management companies, and financial services providers. By 2015, it will also be extended to all aspects of retail banking activities.<sup>34</sup>
- *Securities market*: The Credit Rating Services Act has been adopted. The envisaged regulation responds to G20 and IOSCO recommendations on the regulation of credit rating agencies. In addition, the FMA, which replaces the Securities Services Act 2004, has recently been passed by Parliament. The Act introduces new powers to regulate OTC derivatives instruments and establishes new infrastructure (see section 3).
- *Collective investment schemes*: One major reform underway is the proposal to include hedge funds in regulation, also in response to the G20 recommendation. The National Treasury is currently in the process of finalising a policy on this.
- *Financial advisory and intermediary services*: A new code on Conflict of Interest and Prohibitions on receiving of financial interest was introduced in 2010. These provisions restrict the receiving and giving of certain financial interest such as “soft commission” and incentives. It also brought in principles relating to the management of conflict of interest. In addition, the new code is also introducing compulsory regulatory examinations to test the knowledge of service providers of both the regulatory environment and, as the next phase, technical product related competency.
- *Pension funds*: Since the FSAP, the prudent investment guidelines have been amended significantly in revised regulation. National Treasury has also identified compulsory preservation and compulsory annuitisation as immediate term policy changes.<sup>35</sup>

The South African authorities are also working on a number of other areas related to the G20/FSB reform agenda, such as higher and better capital and liquidity standards for banks; measures to better regulate and supervise as well as effectively resolve systemically important financial institutions; the development of a suitable macro-prudential policy framework; strengthening regulation and oversight of shadow banking activities specifically in the money-market and hedge fund industries; improving market integrity and efficiency; and enhancing consumer protection and education.

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<sup>34</sup> See <ftp://ftp.fsb.co.za/public/TCF/TCFRoadmapFinal31Mar2011.pdf>.

<sup>35</sup> The government has released several policy papers on this issue, which are available on its website.

## Annex 2: Other key FSAP and ROSC recommendations

This Annex presents the follow-up actions reported by the South African authorities to other key FSAP and ROSC recommendations that are not covered in sections 2 and 3. The actions mentioned below have not been evaluated as part of the FSB peer review and are presented solely for purposes of transparency and completeness.

<i>FSAP/ROSC recommendations</i>	<i>Steps taken to date and actions planned (including timeframes)</i>
<b>Financial stability</b>	
<ul style="list-style-type: none"> <li>• <b>Closely monitor emerging risks and conduct early warning analysis. Enhanced focus on banking system risks, including household credit and bank liquidity and funding risks, should be a priority. Proactively use the scope available under Basel II to ensure adequate buffers in banks to cope with risks associated with lending to highly leveraged borrowers, including for residential mortgages.</b></li> </ul>	<p>The SARB closely monitors trends in specific products (e.g. unsecured lending, residential mortgage underwriting and provisioning) which could potentially impact household indebtedness and result in banking system risk. This is an on-going process.</p> <p>SARB conducts early warning analysis of qualitative and /or quantitative information collected by way of questionnaires, requesting reports done by the banks based on ‘deep dive’ analysis/research performed internally or discussion with the banks during Credit prudential meetings.</p> <p>An investigation was conducted during 2009 to determine the appropriateness of a 35% risk weighting for residential mortgage exposures. Based on results of the survey conducted a sliding scale for risk weights in respect of mortgages had been included in the amended Regulations which became effective 1 January 2012.</p> <p>As part of Basel III to be implemented in South Africa in 2013, banks with approval to use their own internal estimates for credit risk should ensure that their ratings and risk measurement systems are sufficiently robust.</p>
<ul style="list-style-type: none"> <li>• <b>Undertake a crisis simulation exercise to evaluate response capabilities to systemic stress in the financial sector. Further strengthen procedures for addressing banking problems and work towards the implementation of a well-designed deposit insurance system.</b></li> </ul>	<p>Since the previous FSAP there have been substantial developments in the area of international standards for financial crisis resolution. South Africa’s priority focus was to strengthen its resolution framework in line with these standards. This strengthening forms an integral part of the redesign of the regulatory framework. It was reasoned that a full simulated crisis management test would not have its full value if conducted in a resolution framework that is likely to change significantly during the course of 2012/13. It would make more sense to postpone it until there is clarity about the envisaged resolution powers, responsibilities and coordination arrangements, even if it still has to follow the legislative process. The intention is to conduct a simulation by mid-2013 when the revised resolution framework has been finalised between the SARB (as resolution authority), the relevant regulators and the National</p>

	<p>Treasury. In order to achieve that target, preparatory work with one of the large auditing firms to possibly design such a test has already commenced.</p> <p>The SARB hosted the second regional crisis management workshop for SADC from 20 to 24 August 2012, in collaboration with the Toronto Centre. This programme is a combination of lectures and a simulated crisis management exercise. As hosts, the SARB has a relatively large delegation attending this workshop and participating in the programme as participants, role-players, moderators, presenters or panellists.</p> <p>During the past two years, the SARB also participated in simulated liquidity crisis management exercises at each of the four largest banks. Various departments were actively involved in these simulations, namely Bank Supervision, the National Payment Systems Department and the Financial Markets Department. SARB participants acted out their particular roles in the simulations, thereby also gaining first-hand experience of how a liquidity crisis in a large bank could evolve.</p>
<p><b>Money, foreign exchange, and capital markets</b></p>	
<ul style="list-style-type: none"> <li>• <b>Facilitate further development of the stock and bond markets, including by continued measured liberalization of exchange controls calibrated to take account of the macroeconomic situation.</b></li> </ul>	<p>South Africa has followed a gradual process in the liberalisation of exchange controls and significant reforms have been carried out since 1994. The strategy for exchange control reform has aimed gradually to remove restrictions on cross-border transactions and associated market distortions, while maintaining or introducing alternative policies and regulations for managing the macroeconomic benefits and risks associated with cross-border investment and foreign exposures. Some of the reforms in the exchange controls have contributed to the development of the capital markets.</p> <p>During the 2011 Medium-Term Budget Policy Statement (“MTBPS”), Treasury announced that all inward listed shares traded and settled in Rand on the Johannesburg Stock Exchange (“JSE”) would be regarded as ‘domestic’ assets, for the purposes of trading on the JSE and its indices. The policy change on the inward listing policy created capacity within the institutional investors’ foreign investments limits who are only allowed to invest a portion of their assets offshore. The reclassification of some of the inward listed shares which were previously classified as ‘foreign’ assets and had institutional investors restricted to them meant that they could easily invest into these shares without any restrictions. The policy reform was aimed at promoting capital market development by allowing institutional investors to invest into inward listed companies, something that was restricted in the past. Allowing domestic fund managers access to the inward listed shares without</p>



	<p>restriction also provided an incentive for foreign companies to list on the JSE.</p> <p>In addition to the above-mentioned reform, in August 2012 Treasury allowed the JSE to extend the trading of Zambian grain referenced derivative contracts in foreign currency to non-resident participants and qualifying South African corporate entities in foreign exchange. This move was aimed at increasing the liquidity of the JSE's commodity market.</p> <p>The focus for exchange control reforms continues to be that of further improving efficiencies; promoting investments from South Africa; and capital markets development, while managing potential risks from volatile international environment.</p> <p>In September 2011, the National Treasury and the Financial Services Board drafted the National Treasury/Financial Services Board Interest Rate Strategy Policy and Principles Document which was released for comment to the Bond Advisory Committee. The purpose of the paper was to bring forth to the surface the policy objectives and principle considerations underlying the National Treasury/Financial Services Board proposed interest rate strategy, and to provide both the policy-makers' and the regulator's perspective of what constitutes an efficient and transparent bond market. A number of responses were received from some of the interest groups. In March 2012, the National Treasury's Policy Unit convened and chaired a meeting to chart the way forward. Members expressed the need to urgently bring this matter to a conclusion, but conceded that, due to the possible significant impact changes may have on the market, broad consultation with all market participants was essential. It is expected to conclude this matter mid-2013.</p>
<p><b>Financial sector supervision and regulation</b></p>	
<ul style="list-style-type: none"> <li>• <b>The FSB should develop standards for corporate governance, risk management, and internal controls and harmonize its risk-based models for the different sectors.</b></li> </ul>	<p>The Financial Services Board issued a Directive on 12 April 2012 containing requirements that insurers must comply with when outsourcing any activity. This includes a requirement that any outsourcing must take place in accordance with a Board-approved outsourcing policy that must meet certain conditions provided for in the Directive, and that any outsourcing of a material, management or control function must be reported to the Registrar prior to the outsourcing arrangement being entered into.</p> <p>The Financial Services Board has proposed legislative amendments to the National Treasury to provide for enhanced governance, risk management and internal control requirements through the Insurance Laws Amendment Bill (to be promoted in 2013), pending the finalisation of the broader review of the Insurance Laws and the Solvency Assessment and Management Project (SAM).</p>

The Insurance Laws Amendment Bill requires insurers to –

- adopt, implement and document an effective governance framework. In addition to the requirements pertaining to transparent organisational structures, these requirements also provide for risk management and internal control systems, control functions, outsourcing controls, and written policies;
- meet requirements pertaining to fit and proper requirements for directors, senior management and heads of control functions. These provisions extend to “significant owners” as well as to situations where control functions are outsourced;
- establish and maintain an effective risk management system, comprising the totality of strategies, policies and procedures for identifying, measuring, monitoring, managing, and reporting of all material risks to which the insurer may be exposed;
- establish and maintain control functions (including an internal audit function, a risk management function, a compliance function and an actuarial control function), the heads of which will be required to act independently and regularly report to the board of directors or designated committees; and
- to establish, maintain and operate within an effective internal control system. The minimum requirements for the internal control system include, among others, appropriate controls to ensure the availability and reliability of financial and non-financial information, and would also include sound written administrative and accounting procedures.

These provisions either add to or enhance existing provisions in the current Long-term and Short-term Insurance Acts.

These provisions will be further enhanced in the Insurance Bill (to be applied from 2015) that will give effect to the Solvency Assessment and Management (SAM) project. In addition to further enhancing the measures listed above, the Insurance Bill will also require each insurer to complete an Own Risk and Solvency Assessment (ORSA).

#### **Pension funds**

Guidance in this regard is provided in Circular PF 130, which sets good governance standards for pension funds and the FSB-SA is currently working on converting this guidance to subordinate legislation.<sup>36</sup>

#### **Financial Services Board Treating Customers Fairly (TCF)**

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<sup>36</sup> Financial Services Board – PF Circular 130 on good governance of retirement funds, available at: <ftp://ftp.fsb.co.za/public/pension/circular/PF1302.pdf>

	<p><u><i>initiative</i></u></p> <p>The proposed TCF consumer protection regulatory framework will require regulated financial firms to develop appropriate governance, management information and risk management processes to enable them to monitor, assess, and report on their delivery of the TCF fairness outcomes to their customers.</p> <p><b><u><i>Financial Services Board Risk Based Supervisory Framework</i></u></b></p> <p>In 2005 the Financial Services Board changed its supervisory framework from compliance-based supervision to risk-based supervision, known as RiBS. Under a risk-based approach, the supervisory effort is focused on identifying important risks to an institution and to incentivise a financial institution to manage its own risk. The framework promotes the early identification and ongoing management of systemic and organisational risks allowing the Financial Services Board to focus its supervisory attention based on the risk profile of financial institutions. The framework sets out high level minimum standards.</p> <p>Since the adoption of the framework each Division within the Financial Services Board has developed its own approach to implementing RiBS within these overall principles.</p> <p>There are major differences in the approaches due to the uniqueness of each industry and inherent differences between prudential and market conduct regulation. However the objectives of each of the different approaches, the supervisory cycle that is followed and the end result of assigning a risk rating to each institution that is supervised, are similar.</p> <p>A revised Financial Services Board Policy Framework for Risk-based supervision was adopted in November 2011.</p>
<ul style="list-style-type: none"> <li>• <b>Enhance supervision of insurance groups and review adequacy of solvency buffers for life insurers ahead of the impending new international standards.</b></li> </ul>	<p>Since 2010, the Financial Services Board-South Africa has enhanced its approach to insurance group supervision through informal means in the absence of a formal insurance group supervisory framework provided for in legislation. Group supervision of the major insurance groups, including the completion of regular group returns, occurs with the voluntary participation of the insurance groups concerned. The focus on insurance group supervision was further enhanced in 2011 with the restructuring of the Insurance Division within the Financial Services Board to form a dedicated Insurance Group Supervision Department with dedicated responsibility for the supervision of the twenty or so largest insurance groups in South Africa.</p> <p>The Financial Services Board has proposed legislative amendments to the National Treasury to provide for a formal framework for insurance groups supervision through the Insurance Laws Amendment Bill (to be promoted in 2013), pending the finalisation of the broader review</p>

of the Insurance Laws and the Solvency Assessment and Management Project (SAM).

The Insurance Laws Amendment Bill includes a clear definition of an insurance group. A group is considered to be an insurance group for the purpose of group-wide supervision if there are two or more entities of which at least one is an insurer and one has significant influence on the insurer. The significance of influence is determined based on criteria such as participation, influence and/or other contractual obligations, interconnectedness, risk exposure, risk concentration, risk transfer and/or intra-group transactions.

The Bill further provides -

- that the Registrar, in respect of each insurance group (after consultation with other relevant regulatory authorities in the case of a financial conglomerate) must determine the scope of the insurance group that is subject group wide supervision;
- in respect of the South African context relating to cross-sector financial activities within an insurance group (i.e. financial conglomerates), that the Registrar will be the default group-wide supervisor for all insurance groups. The exception is for financial conglomerates where a bank controlling company is the head of the group. In this case the Bank Supervision Department of the SARB will serve as the group-wide supervisor;
- for transparent group structures and the ability of the Registrar to direct a change in the structure of the insurance group (after consultation with other relevant regulatory authorities in the case of a financial conglomerate) if the structure impedes the financial stability and financial soundness of any insurer that is part of the insurance group, or the ability of the Registrar effectively supervise the insurance group;
- for certain sections in the current Insurance Acts that apply to solo undertakings, to apply with the necessary changes to a controlling (holding) company of an insurance group, such as notification of the appointment, resignation or termination of appointments of directors and managing executives, removal of appointees that are not fit and proper, changes in capital structures and changes in shareholding;
- for governance, risk management and internal controls requirement for insurance groups;
- for the approval of material acquisitions or disposals and prior notification of other acquisitions or disposals;
- for fit and proper requirements for directors, senior managers and heads of control functions of the controlling company;

	<ul style="list-style-type: none"> <li>• for capital add-ons;</li> <li>• for returns by the controlling company;</li> <li>• for regulatory and enforcement mechanisms;</li> <li>• for resolution powers;</li> <li>• for processes and procedures relating to the group supervisors; and</li> <li>• for the powers and functions of the group supervisor where the Registrar is the group supervisor.</li> </ul> <p>These measures will be further enhanced by the Insurance Bill (to be applied from 2015) that will give effect to the SAM. Such enhancements will include the establishment of a framework for crisis management and group internal models.</p> <p>Since 2010, the review of the adequacy of the solvency buffers of insurers has been enhanced through the introduction of regular stress-testing exercises. The largest insurance groups in South Africa are required to submit bi-annual results for standardised stress tests of market risk. In addition, all insurers are required to submit the results of standardised stress tests of market, credit and insurance risk as part of their annual statutory returns.</p> <p>In addition, to assess insurer's readiness to implement SAM and to better understand the impact of the SAM on the industry, quantitative impact studies have been conducted. Insurers are in the process of completing the second study, with a submission date of mid-October 2012. The first quantitative impact study was undertaken in 2011 and the results showed, at a high-level, that capital requirements increased by R58bn in total across both the life and non-life sectors, against an increase in available capital of R51bn (the report on the results is publicly available).</p>
<ul style="list-style-type: none"> <li>• <b>Consider imposing fit and proper requirements for pension fund trustees and ensure that pension reform proposals preserve pension savings until retirement and that the drawdown of living annuities is appropriately aligned with life expectancy.</b></li> </ul>	<p>Currently fit and proper requirements are in place for principal officers of pension funds.</p> <p>National Treasury is currently considering appropriate policies regarding fit and proper requirements for pension fund trustees as well as preservation of pension savings.</p>

<b>Financial sector inclusion and consumer protection</b>	
<ul style="list-style-type: none"> <li>• <b>Preserve the Financial Sector Charter and enhance its inclusion targets with due regard to financial soundness and stability.</b></li> </ul>	<p>In March 2012 the draft Financial Sector Code was published for public comment. The draft code balances financial; inclusion (with the inclusion of additional targets for (i) empowerment financing and (ii) access to financial services in the scorecard of the Broad-based Black Economic Empowerment Act (“Act”) and financial stability (by allowing dilutions with respect to ownership as a result of (i) a requirement to increase regulatory capital and (ii) black participants electing to sell their shares to non-blacks to realise the net-value attributable to those shares).</p> <p>The draft code must still be gazetted as a legally-binding sector code in terms of the Act.</p>
<ul style="list-style-type: none"> <li>• <b>Review the mandates, products, and governance of development finance institutions (DFIs) to maximize their catalytic role, and consider sound mechanisms for promoting affordable housing finance.</b></li> </ul>	<p>The Department of Human Settlements and the National Housing Finance Corporation is proposing the introduction of Mortgage Default Insurance to promote affordable housing finance in the low- to middle-income households. Discussions are underway regarding around, inter alia, the capitalisation of the insurance entity.</p>
<ul style="list-style-type: none"> <li>• <b>Review the resources, staffing, and institutional arrangements of the NCR to ensure they are adequate.</b></li> </ul>	<p>The National Credit Regulator, which falls under the Department of Trade and Industry and not National Treasury, is the market conduct regulator of the retail credit industry. As such its role in the future twin peaks regulatory framework is under consideration.</p>

### Annex 3: Overview of South Africa's reforms to its OTC derivatives markets

Element of OTC derivative reform	Work phase and organisational responsibility	Work to date	Relevant provisions of Financial Markets Act (FMA)	Further licensing, regulations or rules required?	Expected implementation date
Market participant conduct	Phase I Registration and Code of Conduct Working Group	<ul style="list-style-type: none"> <li>• ODWG-SA Report recommended licensing of, and code of conduct for, professional participants</li> <li>• Consultation paper issued in March 2012</li> <li>• Introduction of FMA</li> <li>• The Working Group has proposed a definition of 'OTC derivative provider' as: <i>A person who, as a regular feature of its business and for its own account:</i> (a) originates OTC derivatives; or (b) makes a market in those OTC derivatives.</li> </ul>	<ul style="list-style-type: none"> <li>• Section 5 of the FMA allows the Minister of Finance to declare a category of regulated persons</li> <li>• Chapter VIII – allows the Registrar of Securities Services to prescribe a code of conduct that addresses an enumerated list of topics</li> </ul>	<p>Yes</p> <ul style="list-style-type: none"> <li>• Minister of Finance needs to declare 'OTC derivative providers' a category of regulated person under section 5 of the FMA</li> <li>• Registrar of Securities Services needs to prescribe code of conduct</li> <li>• OTC derivative providers will need to be 'authorised' by the Registrar</li> </ul>	During 2013
Reporting	Phase I Central Reporting Working Group	<ul style="list-style-type: none"> <li>• 2010 report of South African OTC Derivatives Working Group (ODWG-SA Report) recommended reporting</li> <li>• Consultation paper issued in March 2012 on reporting obligation and architecture</li> <li>• Introduction of FMA</li> <li>• Central Reporting Working Group has agreed that all OTC derivatives should be reported and that derivative originator will be responsible for reporting</li> <li>• Obligation would apply 'OTC derivative', which the Registration and Code of Conduct Working Group</li> </ul>	<ul style="list-style-type: none"> <li>• Sections 5 and 6 grant the Minister of Finance and the Registrar of Securities Services rule making power</li> <li>• Chapters VI – addresses the licensing of trade repositories and gives the Registrar power to require trade reporting</li> <li>• Chapter VII – establishes standards that must be adhered to by financial market infrastructure (including trade repositories)</li> </ul>	<p>Yes</p> <ul style="list-style-type: none"> <li>• Trade repositories need to be licensed, or foreign trade repositories recognised as being subject to laws equivalent to South Africa's</li> <li>• Registrar of Securities Services needs to prescribe reporting obligations (subject to regulations made by Minister of Finance)</li> </ul>	<p>End June 2013</p> <p>Reporting obligation could be phased in across asset classes</p> <p>As of January 2013, the five largest South African banks had not registered with CFTC in the US as 'swap dealers'. They are unlikely to register in the near future, as their transactions are below the prescribed thresholds.</p>

Element of OTC derivative reform	Work phase and organisational responsibility	Work to date	Relevant provisions of Financial Markets Act (FMA)	Further licensing, regulations or rules required?	Expected implementation date
		has proposed be such derivative instruments as categorised and prescribed as such by the Registrar			
Margin	Phase II Central Clearing Working Group	<ul style="list-style-type: none"> <li>• ODWG-SA Report recommended that where central clearing is not used, there should be adequate risk management systems in place to mitigate counterparty credit and other risks</li> <li>• Introduction of FMA</li> </ul>	<ul style="list-style-type: none"> <li>• Section 5 of the FMA allows the Minister of Finance to make regulations concerning the conduct of market participants</li> </ul>	<p>Yes</p> <ul style="list-style-type: none"> <li>• Minister of Finance needs to make regulations concerning margining requirements</li> <li>• This will require further consultation</li> </ul>	The authorities are awaiting the completion of the CPSS/IOSCO workstream on margining before taking their regulations any further
Clearing of standardised contracts	Phase III Central Clearing Working Group	<ul style="list-style-type: none"> <li>• ODWG-SA Report recommended clearing</li> <li>• Introduction of FMA</li> </ul>	<ul style="list-style-type: none"> <li>• Sections 5 and 6 grant the Minister of Finance and the Registrar of Securities Services rule making power</li> <li>• Chapter V – addresses the licensing of clearing houses</li> <li>• Chapter VII – establishes standards that must be adhered to by financial market infrastructure (including clearing houses)</li> </ul>	<p>Yes</p> <ul style="list-style-type: none"> <li>• Clearing houses need to be licensed, or external clearing houses recognised as being subject to laws equivalent to South Africa's</li> <li>• Registrar of Securities Services may prescribe clearing obligations (subject to regulations made by Minister of Finance)</li> <li>• This would require further consultation</li> </ul>	Implementation will be initially via incentives, including Basel III capital requirements that came into effect on 1 January 2013, the netting benefits of clearing and, potentially, any margin requirements for non-cleared trades
Trading	Phase III No working group as yet	<ul style="list-style-type: none"> <li>• N/A</li> </ul>	<ul style="list-style-type: none"> <li>• N/A</li> </ul>	If trading is mandated in South Africa, further legislation and regulations would be required.	N/A