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Financial Regulatory Governance in South Africa: The Move towards Twin Peaks

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Abstract

The Twin Peaks model of financial system regulation calls for the establishment of two, independent, peak regulatory bodies, one charged with ensuring safety and soundness in the financial system, the other with preventing market misconduct and the abuse of consumers in the financial sector. For reasons discussed elsewhere,¹ of the four models of financial system regulation,² Twin Peaks is regarded as best suited to this task. The Twin Peaks model in general-and elements of the Australian version of Twin Peaks in particular-is currently undergoing implementation in South Africa. This article explores issues related to that implementation from the perspective of governance as it is employed in Australia. The article commences with a discussion and an analysis of the historical development of Twin Peaks, followed by a discussion of governance. Next is an analysis of key differences between Twin Peaks in Australia and Twin Peaks as it is to be deployed in South Africa. Finally there are concluding observations.

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FINANCIAL REGULATORY GOVERNANCE IN SOUTH AFRICA: THE MOVE TOWARDS TWIN PEAKS

ANDREW SCHMULOW*

I INTRODUCTION

The Twin Peaks model of financial system regulation calls for the establishment of two, independent, peak regulatory bodies. One charged with ensuring safety and soundness in the financial system, the other with preventing market misconduct and the abuse of consumers in the financial sector.

For reasons discussed elsewhere,¹ of the four models of financial system regulation,² Twin Peaks is regarded as best suited to this task.

The Twin Peaks model in general, and the Australian version of Twin Peaks in particular, is currently undergoing implementation in South Africa. This article

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¹ A. D. Schmulow, 'Twin Peaks: A Theoretical Analysis', in *The Centre For International Finance and Regulation (CIFR) Research Working Paper Series*, no. 064/2015 / Project No. E018, The Centre For International Finance and Regulation (CIFR), (1 July, 2015).

² See: A.D Schmulow, 'Approaches to Financial System Regulation: An International Comparative Survey', in *The Centre For International Finance and Regulation (CIFR) Research Working Paper Series*, no. 053/2015 / Project No. E018, The Centre For International Finance and Regulation (CIFR), (January, 2015).

explores issues related to that implementation from the perspective of governance, as it is employed in Australia. The article commences with a discussion and an analysis of the historical development of Twin Peaks, followed by a discussion of governance. Next is an analysis of key differences between Twin Peaks in Australia and Twin Peaks as it is to be employed in South Africa. Finally there are concluding observations.

The article does not canvass the regulatory architecture of Twin Peaks, as this has been done elsewhere,³ as have discussions on the need for, and importance of, inter-agency co-operation⁴ in Twin Peaks.

II HISTORICAL DEVELOPMENT

The historical development of Twin Peaks provides an insight into its aims, which were principally a response to the phenomenon of the ‘blurring of the boundaries’ taking place between traditional financial firms in the United Kingdom. The model, which was first proposed by Michael Taylor in a pamphlet published by Centre for the Study of Financial Innovation in 1994,⁵ was aimed, primarily, at the Bank of England. Australia was, however, the first country to adopt this model – a model which is now increasingly being emulated across the globe.

A. The UK

Prior to the advent of Twin Peaks, the UK’s different overseers for conduct and systemic issues in the financial sector were so numerous, that it was described as an

³ A. D. Schmulow, *supra* note 2; A. D. Schmulow, ‘The four methods of financial system regulation: An international comparative survey’, 26 (3) *Journal of Banking and Finance Law and Practice* (November, 2015).

⁴ A. J. Godwin & A. D. Schmulow, ‘The Financial Sector Regulation Bill In South Africa: Lessons From Australia’, 132 (4) *South African Law Journal* (2015).

⁵ A. Hilton, ‘UK financial supervision: a blueprint for change’, in *Centre for the Study of Financial Innovation Working Paper*, no. 6, Centre for the Study of Financial Innovation, (May, 1994).

‘alphabet soup’⁶ of regulators. Taylor argued at the time that those arrangements led to conflicts of interest, ‘confusion and damage’.⁷

*Britain’s system for regulating financial services, as was once said of its Empire, has been acquired in a fit of absence of mind.*⁸

The UK had a Byzantine system of disparate regulators, with each being assigned a jurisdiction defined by the type of entity being regulated. Contemporaneously, the financial system was increasingly experiencing a ‘blurring of the boundaries’ between different kinds of financial institutions. Banks were combining with insurers, and investment banks with stockbroking firms. Added to this was the presence of large, systemically important building societies.⁹

The combination of these factors was identified as necessitating an overarching financial services regulator, the purpose of which would be to ensure the stability of the financial system.¹⁰

This idea – one, combined financial services regulator - became the first half of a more substantial proposal – ‘Twin Peaks’. Taylor¹¹ argued for a fusion of the multiple regulators then in existence - regulators charged with banking, securities, insurance, and investment management. These regulators included the Bank of England, the Building Societies Commission,¹² and the Securities and Investments Board (SIB).¹³

Under Taylor’s plan, a new financial services regulator would henceforth assume authority for all deposit-taking institutions¹⁴ and, crucially, would no longer simply enforce bank regulations against individual transactions. It would be charged with ensuring the overall stability of the financial system, by regulating bank capital and the control of risk.¹⁵

⁶ M. W. Taylor, “‘Twin Peaks’: A regulatory structure for the new century”, no. 20, *Centre for the Study of Financial Innovation*, (December, 1995), 7.

⁷ *Ibid.*, 1/3.

⁸ *Ibid.*, 2.

⁹ *Ibid.*, 4.

¹⁰ *Ibid.*, 1.

¹¹ A. Hilton, *supra* note 5.

¹² M. W. Taylor, *supra* note 6, 3.

¹³ A. Hilton, *supra* note 5, 2.

¹⁴ M. W. Taylor, *supra* note 6, 4.

¹⁵ *Ibid.*, 1.

Specifically, Taylor envisaged that the bank regulator would address ‘financial soundness of institutions – including capital adequacy and large exposure requirements, measures relating to systems, controls and provisioning policies, and the vetting of senior managers to ensure that they possessed an appropriate level of experience and skill.’¹⁶ The collapse of Barings Bank¹⁷ in 1995 provided further impetus¹⁸ for the adoption of a single bank regulator.

Under Taylor’s proposal a second regulator would then be created, charged with protecting consumers from unscrupulous operators: a market conduct and consumer protection regulator,¹⁹ the remit of which would be to ensure that consumers were treated fairly and honestly,²⁰ by protecting them against ‘fraud, incompetence, or the abuse of market power.’²¹ Measures would include restrictions on the advertising, marketing and sale of financial products, as well as minimum fit and proper standards for salespeople.²² In the event of conflict between the two regulators, the Chancellor of the Exchequer would provide a resolution.

According to Taylor,²³ this would address four issues simultaneously:

- i. that henceforth a wide range of financial firms would have to be regarded as systemically important;
- ii. that sprawling and disparate regulatory agencies be regarded as presenting opportunities for regulatory arbitrage,²⁴ and turf battles over jurisdiction;²⁵

¹⁶ *Ibid.*, 3.

¹⁷ For more on this see: S. Fay, *The Collapse of Barings*, W. W. Norton & Co, (1997); A. Tickell, ‘Making a melodrama out of a crisis: reinterpreting the collapse of Barings Bank’, 14 (1) *Environment and Planning D: Society and Space* (1996); and for a critical theory analysis: A. D. Brown, ‘Making sense of the collapse of Barings Bank’, 58 (12) *Human Relations* (2005).

¹⁸ M. W. Taylor, *supra* note 6, 2.

¹⁹ *Ibid.*, 1.

²⁰ *Ibid.*, 1.

²¹ *Ibid.*, 3.

²² *Ibid.*, 3.

²³ *Ibid.*, 4.

²⁴ And *ibid.*, 7: ‘[the same phenomenon that creates the potential for regulatory arbitrage also creates the possibility for] important issues to ‘disappear down the gaps’, and ... among consumers [confusion is created] by an “alphabet soup” of regulatory bodies’. See also: D. T. Llewellyn, ‘Institutional Structure of Financial Regulation and Supervision: The Basic Issues’, *Paper presented at the World*

- iii. that in the ever increasing cases of financial conglomerates, a group-wide perspective on financial soundness would be addressed;²⁶ and
- iv. that rare and specialist expertise and limited supervisory resources would be pooled, instead of duplicated by overlapping.

*The benefits of Twin Peaks are clear. The proposed structure would eliminate regulatory duplication and overlap; it would create regulatory bodies with a clear and precise remit; it would establish mechanisms for resolving conflicts between the objectives of financial services regulation; and it would encourage a regulatory process which is open, transparent and publically accountable.*²⁷

*These examples show why structure does, and should matter, if we wish to create an efficient, effective system of financial services regulation.*²⁸

While Llewellyn²⁹ takes a contrary view, arguing that specialist agencies are easier to hold to their objectives, in Australia the failures that have occurred under each of the two, integrated regulators, have not been due to confusion over objectives.³⁰ Rather, they have been due to a weak enforcement culture which has

Bank seminar Aligning Supervisory Structures with Country Needs, Washington, DC, (6th and 7th June 2006), 10, (§ 1).

²⁵ M. W. Taylor, *supra* note 6, 11.

²⁶ *Ibid.*, 5, Taylor discusses the issue of psychological contagion, that is to say a collapse in depositor confidence, not because an entity is directly involved in a loss, but because another entity – a subsidiary – another part of the same conglomerate, is involved in a loss. This possibility - that retail depositor panic can set-off a bank run across all associated entities - underscores the importance of a whole-of entity approach to regulation. See also: D. T. Llewellyn, *supra* note 24, 9.

²⁷ M. W. Taylor, *supra* note 6, 1. See also D. T. Llewellyn, *supra* note 24, 28.

²⁸ M. W. Taylor, 'Peak Practice: How to reform the UK's regulatory system', no. 23, *Centre for the Study of Financial Innovation*, (October, 1996), 17.

²⁹ D. T. Llewellyn, *supra* note 24, 26.

³⁰ See further, P. McConnell, 'War on banking's rotten culture must include regulators', *The Conversation*, (4 June, 2015 2.14pm AEST), <http://theconversation.com/war-on-bankings-rotten-culture-must-include-regulators-42767>; M. Williams, 'APRA and ASIC need cultural shift', *Asia-Pacific Banking and Finance*, (9 March, 2015), <https://www.australianbankingfinance.com/banking/apra-and-asic-need-cultural-shift/>; A. Schmulow, 'To clean up the financial system we need to watch the watchers', *The Conversation*, (4 March, 2015 2.11 pm AEDT), <http://theconversation.com/to-clean-up-the-financial-system-we-need-to-watch-the->

bedevilled especially the market conduct and consumer protection peak, and to which this article will return.

Similarly, Llewellyn argues that integrated agencies are more likely to suffer reputational harm, due to the failures of one particular division within the agency and, as a result, consumer confidence in the regulator may be weakened.³¹ This argument does comport with the Australian experience, in relation to the manner in which the market conduct and consumer protection agency has handled an on-going series of financial advice scandals.³²

B. Australia³³

The ‘Twin Peaks’ model was proposed by, and implemented on, the conclusion of the Wallis Commission of Inquiry in 1997.³⁴ In the case of the prudential regulator (PA), this replaced eleven separate regulators.³⁵ To wit, Australia separated the market conduct and consumer protection authority – the Australian Securities and Investment Commission (ASIC) – from the bank regulator – the Australian Prudential Regulation Authority (APRA) – and the National Central Bank (NCB) – the Reserve Bank of Australia (RBA).³⁶ Crucially, APRA is not a division of the RBA, whereas in other

[watchers-38359](#); A. Ferguson, ‘Hearing into ASIC’s failure to investigate CBA’s Financial Wisdom’, *The Sydney Morning Herald*, (3 June, 2014), <http://www.smh.com.au/business/hearing-into-asics-failure-to-investigate-cbas-financial-wisdom-20140602-39ept.html>; P. McConnell, ‘ASIC’s Fashion Faux-Pas’, *The Conversation*, (13 July, 2015 4.25pm AEST), <https://theconversation.com/asics-fashion-faux-pas-44590>.

³¹ See for example his remarks at: D. T. Llewellyn, *supra* note 24, 28.

³² For more on this see: A. D. Schmulow, *supra* note 1, 43ff.

³³ Elements of this section appeared in substantial part in a previous article, published as a working paper by the Centre for International Finance and Regulation: A. D. Schmulow, *supra* note 2, 40ff.

³⁴ S. Wallis, B. Beerworth, J. Carmichael, I. Harper & L. Nicholls, *Financial System Inquiry*, The Treasury, (31 March, 1997). See also: J. Black, ‘Managing Regulatory Risks and Defining the Parameters of Blame: A Focus on the Australian Prudential Regulation Authority’, 28 (1) *Law & Policy* (January, 2006), 4/5.

³⁵ J. Black, *ibid.*, 5.

³⁶ Also created was the Australian Competition and Consumer Commission (ACCC). If the ACCC is to be included, then the Australian model is in fact a ‘quad peak’ model. D. T. Llewellyn, *supra* note 24, 17.

jurisdictions that have adopted Twin Peaks, the PA has been incorporated as a division of the NCB, and this is the arrangement envisaged for South Africa.³⁷

Under Twin Peaks, the RBA is tasked with, *inter alia*, overall responsibility for the financial system, and as lender of last resort (LLR).³⁸ The Australian model could, therefore, reasonably have been described as a three-peak model, with each peak created as an independent, statutory body.³⁹

In respect of governance, in 1999 APRA moved to a risk-based approach to supervision.⁴⁰ In 2002⁴¹ APRA codified its risk-based approach to financial regulation with the introduction of the ‘probability and impact rating system’ (PAIRS),⁴² and the ‘supervisory oversight and response system’ (SOARS).⁴³

PAIRS is a framework for assessing how ‘risky’ an institution is vis-à-vis APRA’s objectives; SOARS determines how officials respond to that risk.⁴⁴ While PAIRS examines a number of internal risk indices,⁴⁵ a glaring omission is its failure to provide a formal assessment of industry-wide risks,⁴⁶ which are particularly germane in an industry susceptible to contagion.

³⁷ A. J. Godwin & A. D. Schmulow, *supra* note 4, 758.

³⁸ John Trowbridge, ‘The Regulatory Environment - A Brief Tour’, *Paper presented at the National Insurance Brokers Association (NIBA) Conference*, Sydney, NSW, (22 September 2009), Table, 2.

³⁹ *Australian Securities and Investments Commission Act (Cth)*, No. 51 of 2001, (Australia); *Australian Prudential Regulation Authority Act (Cth)*, No. 50 of 1998, (Australia); *Reserve Bank Act (Cth)*, No. 4 of 1959, (Australia). Independence in this context is a term of art describing the relationship between the two peaks. It is not meant to describe the relationship between the peaks and government; in that respect their independence is heavily limited. APRA, for example, is subject to limited direction from the Minister: s 12, *Australian Prudential Regulation Authority Act (Cth)*, No. 50 of 1998.

⁴⁰ J. Black, *supra* note 34, 5/6.

⁴¹ Australian Prudential Regulation Authority, *Probability and Impact Rating System*, Australian Prudential Regulation Authority, (June, 2012), <http://www.apra.gov.au/CrossIndustry/Documents/PAIRS-062012-External-version.pdf>, 5.

⁴² For more, see: Australian Prudential Regulation Authority, ‘Supervision’, in *About APRA*, published by Australian Prudential Regulation Authority, (undated), accessed: 31 July, 2015, <http://www.apra.gov.au/AboutApra/Pages/Supervision.aspx>; J. Black, *supra* note 34, 10ff.

⁴³ J. Black, *supra* note 34, 8ff.

⁴⁴ *Ibid.*, 8.

⁴⁵ See: *ibid.*, 11.

⁴⁶ *Ibid.*

PAIRS differentiates the risk profile of regulated institutions into five categories: low, lower medium, upper medium, high, and extreme.⁴⁷ A similar system was used in the UK prior to the global financial crisis (GFC) and the ensuing collapse of Royal Bank of Scotland. As a result the efficacy of this ratings matrix is questionable. In evaluating the ratings system used to assess the riskiness of Royal Bank of Scotland, Hosking states:

The report is a blizzard of acronyms and bogus science: RBS was scored as a “medium high minus”^[48] risk, whatever that is ...⁴⁹

A key aspect of PAIRS is that it works on a multiplier not a linear scale.⁵⁰ This results in a higher SOARS scale, which in turn, it is argued, compels a more aggressive supervisory response.⁵¹

In terms of the potential impact that a regulated entity might have on the financial system, these is divided into four categories: low, medium, high and extreme.⁵² This rating is determined relative to the regulated entity’s total Australian resident assets, ‘subject to a management override that can raise or lower the impact depending on senior management’s assessment’.⁵³ In this regard Black asserts that:

⁴⁷ Australian Prudential Regulation Authority, ‘Probability and Impact Rating System, Chapter 8 - Probability of failure’, in *About APRA, Probability and Impact Rating System*, published by Australian Prudential Regulation Authority, (June 2012), accessed: 5 August, 2015, <http://www.apra.gov.au/AboutAPRA/Pages/PAIRS-1206-HTML.aspx>.

⁴⁸ For details on this rating, see: Financial Services Authority, ‘The failure of the Royal Bank of Scotland’, in *Financial Services Authority Board Report*, Part 2, Chap. 3, Financial Services Authority, (December, 2011), 260, (§ 683).

⁴⁹ P. Hosking, ‘More lever-arch files wouldn’t have saved RBS’, *The Times*, (Morning ed., Tuesday, 13 December, 2013).

⁵⁰ J. Black, *supra* note 34, 12.

⁵¹ *Ibid.*

⁵² Australian Prudential Regulation Authority, ‘Probability and Impact Rating System, Chapter 9 - Impact of failure’, in *About APRA, Probability and Impact Rating System*, published by Australian Prudential Regulation Authority, (June 2012), accessed: 5 August, 2015, <http://www.apra.gov.au/AboutAPRA/Pages/PAIRS-1206-HTML.aspx>.

⁵³ J. Black, *supra* note 34, 13.

*There was little science involved in determining the dividing lines between the ratings, it was more a question of whether the overall result seemed to make sense ...*⁵⁴

What this flexibility belies, however, is a lack of coherent methodology. Rather, reliance is made on intuition and supposition. There is, however, a wealth of evidence from psychology that ‘gut instincts’ are frequently unreliable.⁵⁵ Evidence of the failure of this approach is to be found in the rogue trading scandal at National Australia Bank, which resulted in losses of \$360 million to the bank, and which APRA ascribed to ‘cultural issues’.⁵⁶

C. The Netherlands⁵⁷

The Kingdom of the Netherlands was second to adopt a Twin Peaks approach in 2002,⁵⁸ retaining prudential supervision within De Nederlandsche Bank NV⁵⁹ (‘The Dutch Bank’ (DNB)). This is similar to the arrangement in the UK, but distinct from Australia, where, as mentioned previously, the prudential regulator (APRA) is separate from the NCB.

⁵⁴ *Ibid.*

⁵⁵ See for example the work of Kahneman, 2002 Nobel Laureate in Economic Sciences, in: D. Kahneman, *Thinking, Fast and Slow*, 1st ed., Farrar, Straus and Giroux, (2011).

⁵⁶ Australian Prudential Regulation Authority, ‘Report into Irregular Currency Options Trading at the National Australia Bank’, *Australian Prudential Regulation Authority*, (23 March, 2004), 6.

⁵⁷ Elements of this section appeared in a previous article, published as a working paper by the Centre for International Finance and Regulation: A. D. Schmulow, *supra* note 2, 33ff.

⁵⁸ International Monetary Fund, ‘Kingdom of the Netherlands-Netherlands: Publication of Financial Sector Assessment Program Documentation—Technical Note on Financial Sector Supervision: The Twin Peaks Model’, in *Financial Sector Assessment Program Update*, IMF Country Report No. 11/208, International Monetary Fund, (July, 2011), Table 1, 6. See also: H. Prast & I. van Lelyveld, ‘New Architectures in the Regulation and Supervision of Financial Markets and Institutions: The Netherlands’, in *DNB Working Paper*, no. 021/2004, De Nederlandsche Bank, (21 December, 2004).

⁵⁹ De Nederlandsche Bank, ‘DNB Supervisory Strategy 2010 – 2014’, in *Supra-institutional perspective, strategy and culture*, De Nederlandsche Bank, (April, 2010), 21; E. Wymeersch, ‘The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors’, 8 (2) *European Business Organization Law Review (EBOR)* (June, 2007), 16.

The Dutch copied the Australian approach, particularly as it applied to supervisory strategy - PAIRS and SOARS - both of which the Dutch regulator, the DNB, adopted.⁶⁰

While the Netherlands, under a Twin Peaks regime, managed to stave-off the worst of the GFC, success for the Dutch authorities in an economy with such an important financial sector was not achieved without ‘drastic’⁶¹ government intervention.⁶²

*Total foreign claims of Dutch banks amounted to over 300% of GDP. The Dutch financial system therefore depended heavily on external developments. Only the Belgian and Irish banking sectors were in a similar position. The European average was less than half the Dutch figure at 135% of GDP ... exposure of Dutch banks to the United States also was the highest in Europe, at 66% of GDP ... whereas the average of European banks had kept limited exposure of less than 30% of GDP. By contrast, the exposure of Dutch banks to hard-hit Eastern European countries was at 11% of GDP just above the European average of 8% of GDP.*⁶³

Intervention during the crisis took the form of measures to stimulate employment through construction and housing (€ 6 billion); capital injections for banks and insurers (€ 20 billion); state guarantees for banks (€ 200 billion); a guarantee on all deposits up to €100,000;⁶⁴ the nationalisation of Fortis/ABN AMRO (€ 16.8 billion) and ING banking group (€ 10 billion) (comprising eighty-five per cent

⁶⁰ J. Black, ‘Regulatory Styles and Supervisory Strategies’, Chap. 8, in *The Oxford Handbook of Financial Regulation*, edited by N. Moloney, E. Ferran & J. Payne, Oxford University Press, (August, 2015), p 262.

⁶¹ De Nederlandsche Bank, ‘Annual Report 2009’, *De Nederlandsche Bank NV*, (24 March, 2010), 37, and Chart, 45.

⁶² See further: J. Black, *supra* note 60, 47, (fn 128).

⁶³ M. Masselink & P. van den Noord, ‘The Global Financial Crisis and its effects on the Netherlands’, 6 (10) *ECFIN (Economic analysis from the European Commission’s Directorate-General for Economic and Financial Affairs) Country Focus* (4 December, 2009), 3.

⁶⁴ Ministry of Finance, Government of the Netherlands, ‘The Netherlands and the credit crisis’, in *Financial Policy*, published by Ministry of General Affairs, (undated), accessed: 11 January, 2015.

of the Dutch banking sector⁶⁵), and the SNS REAAL insurance and banking group (€ 3.7 billion);⁶⁶ and a reform of the financial system and the capital levels that had been enforced to date. Thereafter the Dutch government was compelled to drastically reduce spending in order to reduce its deficit.⁶⁷

In the aftermath of the crisis, the conclusions reached about the performance of the Dutch regulators were less than positive:

*Both in the run-up to and during the credit crisis, supervisory instruments fell short in several areas. These deficiencies emerged in both the scope and the substance of supervision. The trend towards lighter supervision, reflecting developments within the financial sector as well as changed social attitudes, [had] gone too far.*⁶⁸

This finding supports the conclusions reached in the analysis of the performance of the UK regulatory authorities during the GFC, namely that regulatory architecture alone is not a panacea against financial crises. Doubtless regulatory architecture is part of the solution, but no more so than the capacity of the regulators to foresee, at times, the unforeseeable,⁶⁹ and regulate accordingly; and the willingness of the regulators to enforce their regulations.

D. South Africa

For South Africa the problem of the current regulatory structure was highlighted, with a degree of disapproval, by the Financial Sector Assessment Program (FSAP) Report,

⁶⁵ M. Van Oyen, 'Ringfencing or Splitting Banks: A Case Study on The Netherlands', 19 (1) *The Columbia Journal of European Law Online* (Summer 2012), 6.

⁶⁶ T. Escritt & A. Deutsch, 'Netherlands nationalizes SNS Reaal at cost of \$5 billion', *Reuters*, United States ed., (Friday, 1 February, 2013, 6:30 am).

⁶⁷ Ministry of Finance, Government of the Netherlands, *supra* note 64.

⁶⁸ De Nederlandsche Bank, 'DNB Supervisory Strategy 2010 - 2014 and Themes 2010', *De Nederlandsche Bank*, (April, 2010), 5.

⁶⁹ See for example: M. Douglas & A. Wildavsky, *Risk and Culture: An Essay on the Selection of Technological and Environmental Dangers*, revised ed., University of California Press, (1983), p 1, where the authors state: 'Can we know the risks we face, now or in the future? No, we cannot; but yes, we must act as if we do.'

conducted by the International Monetary Fund (IMF) and the World Bank (WB) in 2008.⁷⁰ As a result, the National Treasury of the Republic of South Africa, in its 2011 Report,⁷¹ identified financial regulatory reform as a necessity, and committed the Republic to adopting a Twin Peaks model of financial regulation,⁷² modelled broadly on that currently in use in Australia.

Historically South Africa had adopted an institutional approach in which banks, insurers and capital markets were regarded as separate species.⁷³ Regulation was typified by a lack of co-ordination.⁷⁴

The 1987 de Kock Commission Report, chaired by Dr Gerhardus de Kock, later Governor of the South African Reserve Bank, reformed the regulatory system in South Africa, and implemented a functional financial regulatory approach.⁷⁵

While the 1993 the Melamet Commission, chaired by Judge David Melamet, recommended a single regulator, the regulatory system has remained functional and partially integrated.⁷⁶ Currently the financial system is regulated by the South African Reserve Bank (SARB)⁷⁷ and the Financial Services Board (FSB).⁷⁸ The FSB is a statutory body charged with the task of overseeing the non-bank financial industry (NBFIs),⁷⁹ which in turn is currently covered by twelve separate pieces of legislation plus its own enabling Act.⁸⁰ In respect of NBFIs, the FSB has a market abuse remit,

⁷⁰ S. Kal Wajid, 'South Africa: Financial System Stability Assessment, Including Report on the Observance of Standards and Codes on the following topic: Securities Regulation', in *Financial System Stability Assessment*, no. 08/349, International Monetary Fund, (October, 2008).

⁷¹ Republic of South Africa National Treasury, 'A safer financial sector to serve South Africa better', in *National Treasury Policy Document*, National Treasury, Republic of South Africa, (23 February, 2011).

⁷² *Ibid.*, 5.

⁷³ D. Rajendaran, 'Approaches to Financial Regulation and the case of South Africa', *IFMR Finance Foundation* (6 March, 2012).

⁷⁴ *Ibid.*

⁷⁵ *Ibid.*

⁷⁶ *Ibid.*

⁷⁷ *South African Reserve Bank Act*, No. 90 of 1989, (Republic of South Africa).

⁷⁸ *Financial Services Board Act*, No. 97 of 1990, (Republic of South Africa).

⁷⁹ Financial Services Board, 'Welcome to the FSB', in *About Us*, published by Financial Services Board, (1996-2013), accessed: 17 August, 2014, <https://www.fsb.co.za/aboutUs/Pages/default.aspx>.

⁸⁰ *Collective Investment Schemes Control Act*, No. 45 of 2002, (Republic of South Africa); *Credit Rating Services Act*, No. 24 of 2002, (Republic of South Africa); *Financial Advisory and*

carried out by the Directorate of Market Abuse (DMA).⁸¹ Market abuse in terms of the Financial Markets Act consists of insider trading,⁸² market manipulation,⁸³ and false reporting.⁸⁴

The prohibitions against market abuse, the Directorate's powers to investigate, and the administrative sanctions and penalties which the Directorate may bring to bear are set out in Chapter X⁸⁵ of the *Financial Markets Act*,⁸⁶ for offences committed after 3 June 2013. For offences alleged to have taken place prior to 3 June 2013, the provisions of Chapter VIII⁸⁷ of the *Securities Services Act*⁸⁸ will apply.

Currently, the *Financial Advisory and Intermediary Services Act*⁸⁹ is in force, and has as one of its principal aims the protection of consumers.⁹⁰

Intermediaries Services Act (FAIS Act), No. 37 of 2002, (Republic of South Africa); *Financial Institutions (Protection of Funds) Act*, No. 28 of 2001, (Republic of South Africa); *Financial Markets Act*, No. 19 of 2012, (enacted: 1 February, 2013), (Republic of South Africa); *Financial Services Board Act*, No. 97 of 1990; *Financial Services Ombud Schemes Act*, No. 37 of 2004, (enacted: 9 February, 2005), (Republic of South Africa); *Financial Supervision of the Road Accident Fund Act*, No. 8 of 1993, (Republic of South Africa); *Friendly Societies Act*, No. 25 of 1956, (Republic of South Africa); *Inspection of Financial Institutions Act*, No. 80 of 1988, (Republic of South Africa); *Long-term Insurance Act*, No. 52 of 1998, (Republic of South Africa); *Pension Funds Act*, No. 24 of 1956, (Republic of South Africa); *Short-term Insurance Act*, No. 53 of 1998, (Republic of South Africa).

⁸¹ Financial Services Board, 'Market Abuse', in *About Us*, published by Financial Services Board, (1996-2013), accessed: 17 August, 2014, <https://www.fsb.co.za/departments/marketAbuse/Pages/Home.aspx>, and created pursuant to s 85 of the *Financial Markets Act*, No. 19 of 2012.

⁸² Prohibited by s 78, *Financial Markets Act*, No. 19 of 2012.

⁸³ Prohibited by s 80, *ibid*.

⁸⁴ Prohibited by s 81, *ibid*.

⁸⁵ Sections 77 to 89, *ibid*.

⁸⁶ *Ibid*.

⁸⁷ Sections 72 to 87, *Securities Services Act*, No. 36 of 2004, (Republic of South Africa).

⁸⁸ *Ibid*.

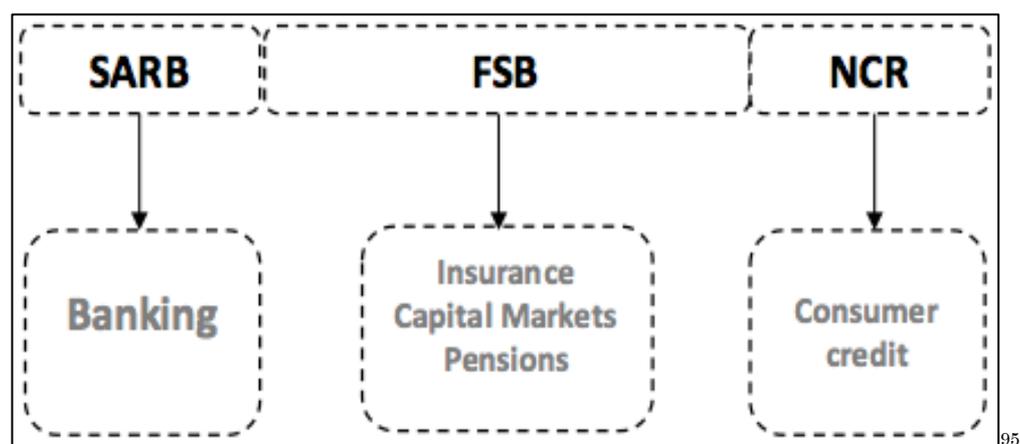
⁸⁹ *Financial Advisory and Intermediary Services Act*, No. 37 of 2002, (Republic of South Africa).

⁹⁰ Financial Services Board, 'Financial Advisory and Intermediary Services', in *Regulatory Examinations*, published by Financial Services Board, (1996-2013), accessed: 17 August, 2014, <https://www.fsb.co.za/Departments/fais/Pages/Regulatory-Examinations.aspx>. 'Undesirable Practices', s 34 (1), *Financial Advisory and Intermediary Services Act*, No. 37 of 2002, which states: 'Subject to subsections (2) and (3), the registrar may by notice in the Gazette declare a particular business practice to be undesirable for all or a category of authorised services providers, or any such provider',

(subsequently replaced by s 196 (a), *Financial Services Laws General Amendment Act*, No. 45 of 2013, (Republic of South Africa), which states: ‘(1) Subject to subsections (2) and (3), the registrar may by notice in the Gazette declare a particular business practice to be undesirable for all or a category of authorised services providers, or any such provider.’). S 34 (2), *Financial Advisory and Intermediary Services Act*, No. 37 of 2002, which states: ‘(2) The following principles must guide the registrar in considering whether or not a declaration contemplated in subsection (1) should be made: (a) That the practice concerned, directly or indirectly, has or is likely to have the effect of – (i) harming the relations between authorised financial services providers or any category of such providers, or any such provider, and clients or the general public; (ii) unreasonably prejudicing any client; (iii) deceiving any client; or (iv) unfairly affecting any client; and (b) that if the practice is allowed to continue, one or more objects of this Act will or is likely to, be defeated. (3) The registrar may not make such a declaration unless the registrar has by notice in the Gazette published an intention to make the declaration, giving reasons therefor [sic], and invited interested persons to make written representations thereanent so as to reach the registrar within 21 days after the date of publication of that notice. (4) An authorised financial services provider or representative may not, on or after the date of the publication of a notice referred to in subsection (1), carry on the business practice concerned.’ (Subsequently replaced by s 196 (b), *Financial Services Laws General Amendment Act*, No. 45 of 2013, which states: ‘(4) An authorised financial services provider or representative may not, on or after the date of the publication of a notice referred to in subsection (1), carry on the business practice concerned.’). S 34 (5), *Financial Advisory and Intermediary Services Act*, No. 37 of 2002, states: ‘The registrar may direct an authorised financial services provider who, on or after the date of the publication of a notice referred to in subsection (1), carries on the business practice concerned in contravention of that notice, to rectify to the satisfaction of the registrar anything which was caused by or arose out of the carrying on of the business practice concerned: Provided that the registrar may not make an order contemplated in section 6D (2)(b) of the Financial Institutions (Protection of Funds) Act, (sic) 2001 (Act No. 28 of 2001).’ (Subsequently replaced by s 60 (a), *Financial Services Laws General Amendment Act*, No. 22 of 2008, (Republic of South Africa), which states: ‘by the substitution for subsection (5) of the following subsection: “(5) The registrar may direct an authorised financial services provider who, on or after the date of the publication of a notice referred to in subsection (1), carries on the business practice concerned in contravention of that notice, to rectify [or reinstate] to the satisfaction of the registrar [any loss or damage] anything which was caused by or arose out of the carrying on of the business practice concerned: Provided that the registrar may not make an order contemplated in section 6D (2)(b) of the Financial Institutions (Protection of Funds) Act, 2001 (Act No. 28 of 2001).”’;’). S 34 (6), *Financial Advisory and Intermediary Services Act*, No. 37 of 2002, which states: ‘An authorised financial services provider concerned who is under subsection (5) directed to rectify anything, must do so within 60 days after such direction is issued.’ (Subsequently replaced by s 60 (b), *Financial Services Laws General Amendment Act*, No. 22 of 2008, which states: ‘by the substitution for subsection (6) of the following subsection: “(6) An authorised financial services provider concerned who is under subsection (5) directed to rectify [or reinstate] anything, must do so within 60 days after such direction is issued.”’).

In addition, there are consumer protection provisions which are enforced by the Office of the Ombud for Financial Services Providers (FAIS Ombud).⁹¹ The Ombud is a statutory body⁹² empowered to deal with complaints against financial institutions which do not fall within the jurisdiction of any other ombud scheme, or where there is uncertainty over jurisdiction.

Currently, deposit-taking banks are regulated by the Banking Supervision Department (BSD) of the SARB.⁹³ In addition, the National Credit Regulator⁹⁴ has as its' objective to promote fairness in accessing consumer credit, consumer protection and competitiveness in the credit industry.



⁹¹ The Office of the Ombud for Financial Services Providers, 'Welcome to FAIS Ombud', published by The Office of the Ombud for Financial Services Providers, (2012-2014), accessed: 17 August, 2014, <http://www.faisombud.co.za>.

⁹² Established by the *Financial Advisory and Intermediary Services Act*, No. 37 of 2002. From the 1st of April 2005, the FAIS Ombud was created as a Statutory Ombud under the *Financial Services Ombud Schemes Act*, No. 37 of 2004, giving the entity original jurisdiction.

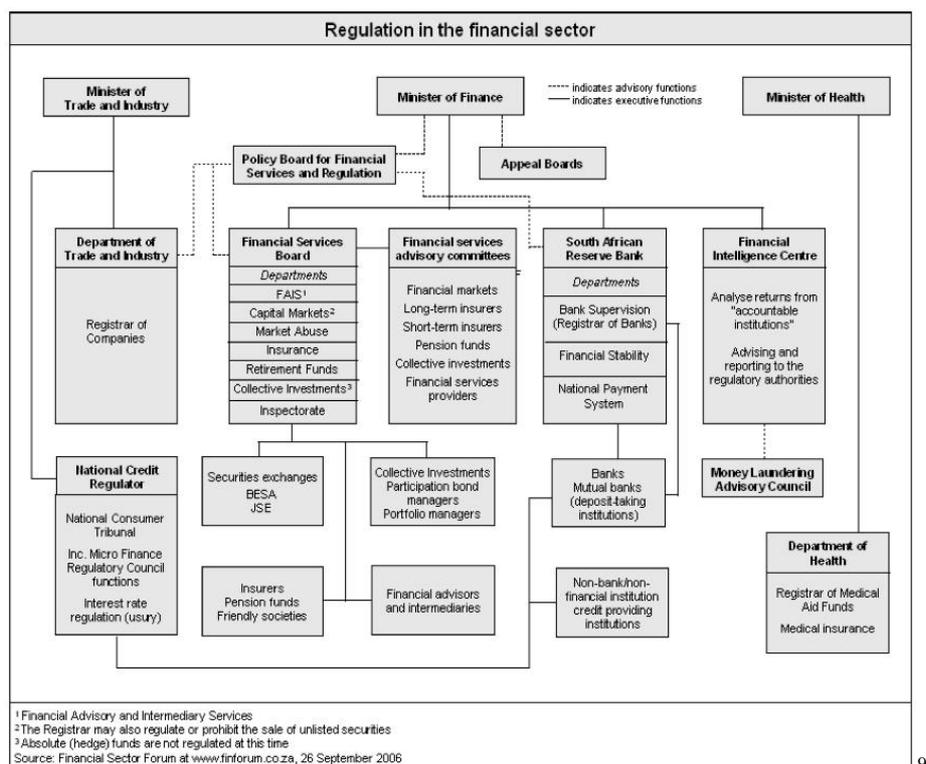
⁹³ South African Reserve Bank, 'Bank Supervision', in *Regulation and supervision*, published by the South African Reserve Bank, (undated), accessed: 17 August, 2014, <https://www.resbank.co.za/RegulationAndSupervision/BankSupervision/Pages/BankSupervision-Home.aspx>.

⁹⁴ National Credit Regulator, 'About the NCR', published by National Credit Regulator, (2014), accessed: 17 August, 2014, <http://www.ncr.org.za>. A statutory body created by the *National Credit Act*, No. 34 of 2005, (Republic of South Africa).

⁹⁵ D. Rajendaran, *supra* note 73.

Against this backdrop the IMF issued its 2008 Financial Sector Assessment Program (FSAP) Report.⁹⁶ In respect of financial system regulation, the Report stated as follows:

*'The financial sector regulatory framework is modern and generally effective. There is a need to strengthen supervision of conglomerates with a focus on risks that span more than one sector, and to further promote cooperation, consistency, and effectiveness among regulators.'*⁹⁷



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As a result the South African Treasury issued a report on financial sector regulation,⁹⁹ aimed at addressing the shortcomings identified by the IMF Report.¹⁰⁰ Principally the South African Treasury Report proposed the adoption of a Twin Peaks model of financial system regulation.¹⁰¹ The Treasury Report stated:

⁹⁶ S. Kal Wajid, *supra* note 70.

⁹⁷ S. Kal Wajid, *supra* note 70, 1.

⁹⁸ *Ibid.*, 24.

⁹⁹ Republic of South Africa National Treasury, *supra* note 71.

¹⁰⁰ S. Kal Wajid, *supra* note 70.

¹⁰¹ Republic of South Africa National Treasury, *supra* note 71, 28.

The twin peaks approach is regarded as the optimal means of ensuring that transparency, market integrity, and consumer protection receive sufficient priority, and given South Africa's historical neglect of market conduct regulation, a dedicated regulator responsible for consumer protection, and not automatically presumed to be subservient to prudential concerns, is probably the most appropriate way to address this issue... the existence of separate prudential and market conduct regulators may be a way of creating a system of checks and balances, thereby avoiding the vesting of too much power in the hands of a single agency... the flip side of creating checks and balances is the need to carefully define roles and responsibilities to avoid duplication of work and jurisdictional overlap... separation of prudential and market conduct regulation does not eliminate the possibility of conflict between them... consultation between the two bodies would lead to an acceptable compromise. But if not, some external means would need to be found to reconcile objectives. In South Africa, the formal way of resolving conflict will be through the Council of Financial Regulators.¹⁰²

As a result, the South African Treasury has put forward a draft Financial Sector Regulation Bill which, as at time of writing, had recently been tabled in South Africa's National Parliament.¹⁰³ The Bill makes provisions for the establishment of a Twin Peaks system in South Africa, and envisages the creation of a Financial System Council of Regulators,¹⁰⁴ which will co-ordinate financial regulation; and the

¹⁰² *Ibid.*, 28. Pursuant to advice provided by the writer to the South African Treasury in 2015, this has now be renamed the 'Financial System, Council of Regulators'. National Treasury, Republic of South Africa, 'Financial Sector Regulation Bill, Comments Received on the Second Draft Bill Published by National Treasury for Comments on 11 December 2014 (Comment Period from 11 December 2014 - 02 March 2015)', National Treasury, Republic of South Africa, (2015), 120. See also Chap. 5, Part 2, s 79 (1), *Financial Sector Regulation Bill (2nd Draft)*, (21 August 2015), (Republic of South Africa).

¹⁰³ Tabled Bill no. B34-2015, (27 October, 2015). National Treasury, Republic of South Africa, 'Media statement: Tabling of Financial Sector Regulation Bill to give effect to Twin Peaks reform', published by National Treasury, Republic of South Africa, Pretoria, ZA, (27 October, 2015).

¹⁰⁴ S 79, *Financial Sector Regulation Bill (2nd Draft)*, (21 August 2015), which states: 'The Financial System Council of Regulators is hereby established. (2) The objective of the Financial System Council of Regulators is to facilitate co-operation and collaboration, and, where appropriate, consistency of action, between the institutions represented on the Financial System Council of Regulators by

Financial Stability Oversight Committee,¹⁰⁵ which will co-ordinate financial stability issues, and endeavour to mitigate risks to the financial system.

III AN ANALYSIS OF THE REGULATORY ENFORCEMENT METHODOLOGY IN AUSTRALIA

This part provides an analysis of risk-based financial regulation, and its close cousins,¹⁰⁶ principles-based and outcomes-focused regulation. Because these are terms of art, not science, they cannot be defined, or indeed even separated, precisely. They do, however, share methodological and philosophical characteristics, which bear investigating.

*What lies under the labels is an agglomeration of regulatory styles and approaches, some of which are exhibited by some regulators, but not all of which are exhibited by all. ... a rough guide to a roughly drawn regulatory world and how it has evolved.*¹⁰⁷

Put simply, the hierarchy may be understood as follows: Risk-based regulations are the tactics for addressing the strategy provided by outcomes-focused regulation: risk-based regulation is focused on outcomes, and has, therefore, a natural affinity with, and folds into, an outcomes-focused paradigm.¹⁰⁸ Outcomes-focused strategies, in turn, address the grand strategy outlined by principles-based regulation.

A. Risk-based approach

providing a forum for senior representatives of those institutions to discuss, and inform themselves about, matters of common interest.’

¹⁰⁵ S 5, *Financial Sector Regulation Bill*, (11 December, 2013), (Republic of South Africa).

¹⁰⁶ J. Black, ‘OFR: the historical context’, Chap. 2, in *Outcomes-Focused Regulation, A Practical Guide*, edited by A. Hopper QC & G. Treverton-Jones QC, in ‘Legal Handbooks’, Law Society Publishing, (2011), 7/8.

¹⁰⁷ *Ibid.*, 8.

¹⁰⁸ *Ibid.*, 15.

If in Australia Twin Peaks is the regulatory architecture, then the risk-based model¹⁰⁹ as used by APRA is the plumbing.

*... at APRA, we have always been strong proponents of risk-based supervision. It's inherent in our mission and values, and it's ingrained in our supervisory approach. It's in our DNA. For us, risk-based supervision is religion.*¹¹⁰

While risk-based models of enforcement are not exclusive to Twin Peaks, some would argue that a risk-based model of enforcement is a natural adjunct to Twin Peaks. Put differently, you need not have Twin Peaks to use a risk-based model, but you may need a risk-based model to use Twin Peaks. This due to the fact that the safety and soundness regulator is, by its nature, concerned with combatting systemic risk.

Risk-based prudential regulation focuses on activities that pose the greatest risk to the regulators' statutory obligations, as well as other, key goals.¹¹¹ This approach has been adopted in the UK, the Netherlands, Canada, the United States, Hong Kong, Ireland, is recommended by the 2012 standards of the OECD's Financial Action Task Force, and is proposed for adoption by the Joint Committee of European Supervisory Authorities.¹¹² It is the method preferred by the World Bank, the IMF and the Basel Committee.¹¹³

As such, [this risk-based] approach is predicated on outcomes and thus has a natural affinity to [Outcomes Focused Regulation]: where conduct breaches a rule but does not have a substantive impact on, for example, consumer

¹⁰⁹ *Ibid.*, 9. For a history of risk-based financial regulation, see: J. Black, *supra* note 60, 261. For a history of the development of different philosophical approaches to regulation, see: J. Black, *supra* note 106, 8ff.

¹¹⁰ D. Lewis, 'Risk-Based Supervision: How Can We Do Better? An Australian Supervisory Perspective', *Paper presented at the Toronto Centre Program on Supervisory Experiences in Implementing Global Banking Reforms, Toronto, Toronto, CA*, edited by Toronto Centre, Global Leadership in Financial Supervision, (19 June 2013), 1.

¹¹¹ J. Black, *supra* note 106, 9.

¹¹² J. Black, *supra* note 60, 261ff.

¹¹³ J. Black, *supra* note 60, 265.

protection, the regulator will not act, or at least will not treat the issue as a matter of priority... a focus [therefore] on risks not rules.¹¹⁴

Risk-based supervision is now seen as the hallmark of good regulation at the global level. ... IOSCO ... recommends to supervisors that they take a 'risk-based approach'[¹¹⁵]. The revised Basel Core Principles for Banking Supervision issued in 2012 require supervisors to adopt effective risk-based systems[¹¹⁶] ... The Financial Stability Board (FSB)'s recommendations[¹¹⁷] for the supervision of globally systemic financial institutions (GSIFIs) echoes the call for a risk-based approach.¹¹⁸

There are a number of advantages to a risk-based approach.¹¹⁹ Most notably there is an acknowledgement that in a rules-based paradigm of financial system regulation, regulators are often over-burdened by rules – rules which cannot be enforced in every firm, for every transaction, on every occasion. Selecting what to prioritise is, therefore, necessary and, according to Black¹²⁰ '[t]hese selections have always been made, but risk-based frameworks both render the fact of selection explicit and provide a framework of analysis in which they can be made.'

¹¹⁴ J. Black, *supra* note 106, 9.

¹¹⁵ See: The International Organization of Securities Commissions (IOSCO), 'Guidelines to Emerging Market Regulators Regarding Requirements for Minimum Entry and Continuous Risk-Based Supervision of Market Intermediaries, Final Report', The International Organization of Securities Commissions (IOSCO), (December, 2009), 9ff.

¹¹⁶ See: Basel Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision', Bank for International Settlements, (September, 2012), 4, (§ 12).

¹¹⁷ See: Financial Stability Board, 'Increasing the Intensity and Effectiveness of SIFI Supervision', in *Progress Report to the G20 Ministers and Governors*, Financial Stability Board, (1 November, 2012), 7.

¹¹⁸ J. Black, *supra* note 60, 264.

¹¹⁹ See: B. Carruthers, "'Objectives Based Regulation:' buzzword du jour?", *Out of the Crooked Timber of Humanity, No Straight Thing Was Ever Made*, Blog, (2 April, 2008), accessed: 22 July, 2015, [http://crookedtimber.org/2008/04/02/"objective-based-regulation"-buzzword-du-jour/](http://crookedtimber.org/2008/04/02/).

¹²⁰ J. Black, *supra* note 106, 9.

*... pick important problems and fix them.*¹²¹

But pragmatic as this approach may sound, it leads to several unintended consequences which, in turn, undermine the overall efficacy of this regulatory paradigm. These include:

- the assumption that regulators are smart enough to ‘foresee the unforeseeable’.¹²² Put differently, there is an assumption that regulators will know from where the next financial crisis will come and, consequently, correctly identify which types of risks and what forms of conduct to prioritise. But, as was seen during the GFC, this assumption is not always correct:

*... indeed with respect to the global financial crisis more broadly, assumptions that had been made as to how markets would react in particular scenarios proved significantly misplaced, with risk events that had been anticipated to occur once in several lives of the universe ... occurring every day.*¹²³

- the model itself may incorrectly prioritise which risks to avoid, as distinct from a failure to identify the risk at all, and this was evident from the conclusions reached in the aftermath of the failure of HIH;¹²⁴
- there exists the potential for process-induced myopia. That is to say, a focus on the process upon which risk-based regulation relies, without paying sufficient attention to issues that are outside the scope of what is covered by the process.

*If little scope is given in practice for those engaged in working within the framework to work outside it where they see the need, the framework will always be prey to events that those working within it were not given the room to say they had seen.*¹²⁵

¹²¹ M. K. Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance*, Council for Excellence in Government, (2000), Brookings Institution Press, 9.

¹²² What Black refers to as ‘blind spots’. J. Black, *supra* note 34, 23.

¹²³ J. Black, ‘Learning from Regulatory Disasters’, in *LSE Law, Society and Economy Working Papers*, no. 24/2014, London School of Economics and Political Science, (2014), 14.

¹²⁴ J. Black, *supra* note 34, 23.

¹²⁵ *Ibid.*, 23.

To this end anecdotal evidence suggests that criticism of APRA, and challenges to the organisation's prevailing orthodoxies, are in danger of being met with hostility;¹²⁶

- there is, as a consequence, a lack of predictive certainty for the regulatees, as to what forms of conduct will be sanctioned and what forms not;
- this in turn encourages a capricious regulatory environment, particularly where different individuals in the regulators take different approaches, or have different priorities;
- an unpredictable regulatory environment, brought about by changes in the prevailing political climate;¹²⁷
- the potential for regulatees to encourage regulatory forbearance, by either arguing that the proposed sanctions pose a greater risk to the regulated entity, and therefore the entire financial system, than the misconduct itself;¹²⁸ or
- the potential for regulatees to encourage forbearance by arguing that similar conduct was expressly authorised by the regulator in the past, (constituting, as it did then, an acceptable risk);
- what Llewellyn¹²⁹ refers to as the 'Christmas tree effect',¹³⁰ in which the regulator's remit steadily increases – as perceptions of risk increase - with a wide array of ancillary functions, both to the point of over-burden and to the point of distraction from what should be core activities;
- perceptions of risk are exactly that: perceptions. While APRA has attempted to create a methodology around the assessment of risk, and to lessen the

¹²⁶ This anecdotal evidence is based upon the writer's tenure at APRA in late 2013, and informal discussions with colleagues.

¹²⁷ See: J. Black, *supra* note 106, 10. See also: J. Black, *supra* note 34, 24ff, where she asserts that politically, a failing bank, which may be acceptable to the regulator, may be unacceptable to those in the community who stand to lose their deposits. To this can be added political pressure from bank owners for the bank to be rescued, despite the regulator's willingness to allow the bank to fail.

¹²⁸ C. Binham & J. Guthrie, 'FCA: On the wrong side of the argument?', *Financial Times*, (2 July, 2015, 7:29 pm).

¹²⁹ D. T. Llewellyn, *supra* note 24, 23.

¹³⁰ Citing M. Taylor & A. Fleming, 'Integrated Financial Supervision: Lessons from Northern European Experience,' in *Policy Research Working Paper*, no. 2223, The World Bank, (September, 1999), 13, (§ 2.24).

impact upon the assessment of risk of individual perceptions, risk assessment is not and never will be as “rational” [or] as consistent in substance as its form suggests.’¹³¹

B. Outcomes-focused regulation

The risk-based approach followed by the Australian prudential regulator falls easily within a ‘regulation by objective’¹³² paradigm; that is to say a paradigm the purpose of which is to ‘[achieve] particular and concrete outcomes’.¹³³ This paradigm enjoys a number of advantages. These include:

- regulators can be more effective, with each having clear objectives (outcomes) that do not overlap;
- regulators can, as a result, be more accountable and more focused¹³⁴ on achieving those outcomes;
- it creates checks and balances between agencies, and their objectives;¹³⁵
- it allows each regulator to create its own culture that best suits its objectives; and
- it allows each regulator to acquire expertise specifically required to meet its objectives.¹³⁶

¹³¹ J. Black, *supra* note 34, 24.

¹³² G. D. Killoren, ‘Comparative Analysis of Non-U.S. Bank Regulatory Reform and Banking Structure’, *Law & Business*, edited by CCH Incorporated, Wolters Kluwer, (2009), 10. See also: H. M. Paulson Jr., R. K. Steel, D. G. Nason, K. Ayers, H. Etner, J. Foley III, G. Hughes, T. Hunt, K. Jaconi, C. Klingman, C. C. Ledoux, P. Nickoloff, J. Norton, P. Quinn, H. Schultheiss, M. Scott, J. Stoltzfoos, M. Ugoletti & R. Woodall, ‘The Department of The Treasury Blueprint For A Modernized Financial Regulatory Structure’, The Department of The Treasury, (March, 2008).

¹³³ B. Michael, S. Hak Goo & D. Wojcik, ‘Does Objectives-Based Financial Regulation Imply a Rethink of Legislatively Mandated Economic Regulation? The Case of Hong Kong and Twin Peaks Financial Regulation’, *Social Science Research Network* (12 November, 2014), 1/4ff.

¹³⁴ See also: D. T. Llewellyn, *supra* note 24, 26.

¹³⁵ R. K. Abrams & M. W. Taylor, ‘Issues in the Unification of Financial Sector Supervision’, in *IMF Working Paper*, no. WP/00/213, International Monetary Fund, (December, 2000), 17.

¹³⁶ C. Goodhart, P. Hartmann, D.T. Llewellyn, L. Rojas-Suarez & S. Weisbrod, ‘The institutional structure of financial regulation’, Chap. 8, in *Financial Regulation: Why, How and Where Now?*, Taylor & Francis, (2013), pp 156/7.

As with a risk-based paradigm, so too an outcomes-focused approach has its shortcomings. These relate to the manner in which objectives are identified and prioritised. As with a risk-based approach the danger remains that the regulator may identify the wrong objectives; or may initially identify the correct objectives, but fail to adjust those in light of changed circumstances; or may find itself captured by industry with a concomitant contamination of its objectives; or become suborned by political masters, in which the regulator's objectives are once again contaminated. Put differently, with flexibility in priorities come opportunities for a more nuanced approach to combatting whatever problem the regulator is charged with preventing; but so too with flexibility come the pitfalls that arise wherever regulator's are invested with discretion.¹³⁷

C. Principles-based regulation

Both these approaches - objectives-based regulation and risk-based regulation – have as their over-arching paradigm principles-based regulation, in that neither focus on systems and processes, but on principles-based outcomes. Principles-based regulation, as an over-arching paradigm too, has its deficiencies. A principles based model sets forth broad principles to be followed, as opposed to prescriptive, inflexible rules governing specific activities, and requiring minimum standards of conduct.

*...means moving away from reliance on detailed, prescriptive rules and relying more on high-level, broadly stated rules or principles to set the standards by which regulated firms must conduct business. The term 'principles' can be used simply to refer to general rules, or also to suggest that these rules are implicitly higher in the implicit or explicit hierarchy of norms than more detailed rules: they express the fundamental obligations that all should observe.*¹³⁸

¹³⁷ Indeed A. Demirgüç-Kunt & E. Detragiache, 'Basel Core Principles and Bank Soundness, Does Compliance Matter?', in *Policy Research Working Paper*, no. WPS5129, The World Bank, (November, 2009), 5, find in certain circumstances, an inverse correlation between regulator power and bank soundness: '... power of supervisors to license banks and regulate market structure are associated with riskier banks.'

¹³⁸ J. Black, 'Principles Based Regulation: Risks, Challenges and Opportunities', *Presentation by Julia Black on Principles Based Regulation to be followed by a Conversation with the Regulators*, Sydney

So regulators, instead of focussing on prescribing the processes or actions that firms must take, should step back and define the outcomes that they require firms to achieve. Firms and their management will then be free to find the most efficient way of achieving the outcome required.¹³⁹

In 2008 the Australian Law Reform Commission Report into privacy put forth the following statement by Curtis to explain the advantages of a principles based regulatory regime:

By encouraging organisations to recognise the business advantages of [compliance] and regulating their behaviour accordingly ... regulatory approach where a legislative framework is balanced by an emphasis on ... self-regulation ... inculcate the values and objectives ... rather than just the superficial rules. ... organisations ... will understand the ideas behind the laws—the principles—and will not become as confused by detailed ... regulations.¹⁴⁰

These sentiments, expressed in respect of privacy regulations, have been expressed in similar vein to support the supposed advantages of a principles based regulatory regime, for the financial system.¹⁴¹ There is, however, a difference between information privacy regulations and financial system regulations, and one so crucial that it undermines the supposed advantages of the principles based model: financial

Supreme Courthouse (Banco Court), Sydney, NSW, Faculty of Economics and Business, University of Sydney, (Wednesday 28th March 2007), 3.

¹³⁹ J. Black, *supra* note 138, 5.

¹⁴⁰ Curtis, quoted in D. Weisbrot (President), L. McCrimmon (Commissioner in charge), R. Croucher (Commissioner), Justice B. Collier (part-time Commissioner), Justice R. French (part-time Commissioner), Justice S. Kenny (part-time Commissioner) & Justice S. Kiefel (part-time Commissioner), 'For Your Information: Australian Privacy Law and Practice (ALRC Report 108)', no. 108, 1, Part A, Chapter 4, *Regulating Privacy*, Australian Law Reform Commission, (12 August, 2008), (§ 4.16). See further: The Treasury, Australian Government, 'Statement of Expectations — Australian Prudential Regulation Authority', in *Statements of Expectations*, published by The Treasury, Australian Government, (undated), accessed: 9 October, 2015, http://www.treasury.gov.au/~media/Treasury/Policy%20Topics/Public%20Policy%20and%20Government/Statements%20of%20Expectations/Downloads/PDF/APRA_Statement_of_expectations.ashx, 2.

¹⁴¹ J. Black, *supra* note 138, 2/7ff.

system regulations almost always contain an opportunity cost to the regulatee, in addition to the mere compliance cost.¹⁴² Put differently, in the financial system the costs of full regulatory compliance are potentially significantly higher,¹⁴³ and the degree of convenience to the bank for non-compliance significantly greater.¹⁴⁴ In this regard it is questionable whether Black is correct when she asserts that: '[r]egulatees have to take more responsibility for ensuring that they are achieving the right outcomes, not just going through the right processes'¹⁴⁵ as this does not adequately take account of the compulsions, inherent in financial regulation, for regulatees to constantly look for ways to lessen the impact of the regulations to which they ought to adhere; not just including, but especially in respect of outcomes.

Add to this the heady mixture created by a regulatory paradigm that is more one of managing conduct than enforcing discipline,¹⁴⁶ located within an overall strategy that seeks, at least initially, to be co-operative and collegial, as opposed to confrontational,¹⁴⁷ and seeks by negotiated settlement to define outcomes more

¹⁴² For more on the special nature of financial services regulation, and in particular the distinction that such services are incomplete contracts, relational rather than transactional, see: D. T. Llewellyn, 'Trust and confidence in financial services: a strategic challenge', 13 (4) *Journal of Financial Regulation and Compliance* (2005), 334/339/340/341; S. Bhati, 'An Analysis of the Financial Services Regulations of Australia', 4 (2) *International Review of Business Research Papers* (March, 2008), 14ff. Cf. D. T. Llewellyn, *supra* note 24, 5, who argues that compliance has a cost, but not a price. As a result consumers will, he argues, regard regulation as a free good, and over demand it, thus creating an inexorable tendency towards over regulation. This view, however, fails to adequately account for instances where industry pressure has succeeded in rolling-back regulation. See: A. E. Wilmarth Jr., 'Turning a Blind Eye: Why Washington Keeps Giving In to Wall Street', 81 (4/4) *University of Cincinnati Law Review* (2013).

¹⁴³ For more on this from the perspective of risk methodology and game theory, and the so-called 'prisoner's dilemma', or what in economics is referred to as the 'tragedy of the commons', see: P. McConnell, *Systemic Operational Risk: Theory, Case Studies and Regulation*, Risk Books, (2015), pp 404/5.

¹⁴⁴ See S. L. Schwarcz, 'Systemic Risk', 97 (1) *The Georgetown Law Journal* (2008), 206, quoted in P. McConnell, *supra* note 143, pp 50/1.

¹⁴⁵ J. Black, *supra* note 106, 11.

¹⁴⁶ J. Black, *supra* note 138, 19/20.

¹⁴⁷ I. MacNeil, 'Enforcement and Sanctioning', Chap. 10, in *The Oxford Handbook of Financial Regulation*, edited by N. Moloney, E. Ferran & J. Payne, in 'Part III, Delivering Outcomes and Regulatory Techniques', 1st ed., Oxford University Press, (August, 2015), p 285; A. D. Schmulow, *supra* note 2, 21ff.

general than specific, and it is no wonder that goals shift and outcomes become malleable.

*A principles-based approach does not work with individuals who have no principles.*¹⁴⁸

Indeed, one could argue that if it is outcomes that are set as benchmarks, as opposed to processes,¹⁴⁹ then all that is required in order to encourage regulators to forebear, is to re-negotiate the outcomes. A clearer and more straightforward objective than re-negotiating a myriad of complex processes.

A further important factor determining the efficacy of regulators is the political climate in which they operate.¹⁵⁰ This will affect the robustness of enforcement, and it may extend to the vigour with which principles are at first determined, and later adjusted. The degree to which the United States' Congress is beholden to Wall Street,¹⁵¹ and the pushback against the FSA¹⁵² in the UK are instructive in this respect.

¹⁴⁸ Hector Sants, Chief Executive Officer, Financial Services Authority. Quoted in L. Elliott & J. Treanor, "Revealed: Bank of England disarray in the face of financial crisis", *The Guardian*, (7 January, 2015).

¹⁴⁹ D. Weisbrot (President), L. McCrimmon (Commissioner in charge), R. Croucher (Commissioner), Justice B. Collier (part-time Commissioner), Justice R. French (part-time Commissioner), Justice S. Kenny (part-time Commissioner) & Justice S. Kiefel (part-time Commissioner), *supra* note 140, (§ 4.6).

¹⁵⁰ The very decision to regulate is political, and the form and extent thereof, ideological. B. Sheehy & D. Feaver, 'Designing Effective Regulation: A Normative Theory', 38 (1) *University of New South Wales Law Journal* (1 January, 2015), 394, and at 418: 'Although the decision is ultimately made by a political body, such as the executive or legislature, the selection choice is frequently subverted at much earlier stages in the policy-making process. Ideology, political influence and even an adherence to intellectual fashion by advisers and experts all influence the decision.'

¹⁵¹ A. E. Wilmarth Jr., *supra* note 142; L. R. Wray, 'Setting the Record Straight One More Time: BofA's Rebecca Mairone Fined \$1Million; BofA Must Pay \$1.3Billion', *New Economic Perspectives*, (2 August, 2014), accessed: 26 June, 2015, <http://neweconomicperspectives.org/2014/08/setting-record-straight-one-time-bofas-rebecca-mairone-fined-1million-bofa-must-pay-1-3billion.html>; E. Wyatt, 'Promises Made, Then Broken, By Firms in S.E.C. Fraud Cases', *New York Times*, New York ed., (8 November, 2011).

And fashions, even in regulation, change. In the UK, Antony Jenkins, the patron saint of conduct risk, has just been unceremoniously dumped as CEO of Barclays Bank, ostensibly for concentrating on managing the bank's toxic conduct rather than making profits. The conduct risk pendulum may already be beginning to swing back and the current fashion for piousness may be fading.¹⁵³

At first glance, Wall Street's ability to block Dodd–Frank's implementation seems surprising. After all, public outrage over Wall Street's role in the global financial crisis impelled Congress to pass Dodd–Frank in 2010 despite the financial industry's intense opposition. Moreover, scandals at systemically important financial institutions (SIFIs) have continued to tarnish Wall Street's reputation since Dodd–Frank's enactment. However, as the general public's focus on the financial crisis has waned—due in large part to massive governmental support that saved Wall Street—the momentum for meaningful financial reform has faded.¹⁵⁴

Similarly, in Australia there are examples of what in the UK came to be known as the 'light touch'.¹⁵⁵ For example the regulators follow policies set forth under Basel II in which banks are permitted to determine their own internal risk ratings.¹⁵⁶ Put differently, IRB¹⁵⁷ models, as they are known, permit a bank to determine whether it

¹⁵² Anonymous, 'Britain's bank-basher-in-chief is toppled', *The Economist*, Britain ed., (17th July, 2015), <http://www.economist.com/news/britain/21659145-ousting-citys-fiercest-watchdog-suggests-more-emollient-political-mood-britains>; C. Binham & J. Guthrie, *supra* note 128; T. Wallace, 'FCA chief Martin Wheatley ousted by George Osborne', *The Telegraph*, (Friday, 17 July, 2015), <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11746504/Coup-in-the-City-as-George-Osborne-ousts-UKs-top-financial-regulator-Martin-Wheatley.html>.

¹⁵³ P. McConnell, *supra* note 30. See also: K. C. Engel & P. A. McCoy, 'Turning a Blind Eye: Wall Street Finance of Predatory Lending', 75 (4) *Fordham Law Review* (March, 2007), 2040.

¹⁵⁴ A. E. Wilmarth Jr., *supra* note 142, 1283.

¹⁵⁵ See for example J. Treanor, 'Farewell to the FSA – and the bleak legacy of the light-touch regulator', *The Guardian/The Observer*, (24 March, 2013).

¹⁵⁶ See for example: Basel Committee on Banking Supervision, 'An Explanatory Note on the Basel II IRB Risk Weight Functions', Bank for International Settlements, (July, 2005).

¹⁵⁷ Internal ratings-based.

is complying with overall prudential principles. A model which gives rise to a dangerous conflict of interest,¹⁵⁸ and one that is now being dismantled.¹⁵⁹

So while risk-based supervision, within a framework of outcomes-focused and principles-based regulatory strategies has advantages – especially as regards the prioritising of risks in an environment where risks and potential risks are potentially limitless – they are nonetheless vulnerable to institutional inadequacies, incorrect priorities, political interference, industry pressure and a failure to foresee the unforeseeable. They lead to a capricious and an unpredictable regulatory environment in which priorities are malleable, and in which regulators are susceptible to capture.¹⁶⁰

IV AUSTRALIA AND SOUTH AFRICA, DIFFERENCES AND SIMILARITIES

The most noticeable difference between the Australian approach and the proposed South African model, is that the Australian Prudential Regulator is an independent

¹⁵⁸ An example of what, according to Sheehy *et al*, is a form of ‘internal incoherence’. B. Sheehy & D. Feaver, *supra* note 150, 417.

¹⁵⁹ D. Henry & E. Stephenson, ‘Fed may shun global risk rules banks spent billions to meet’, *Reuters*, United States ed., (Wednesday, 4 June, 2014, 9:16pm EDT), <http://www.reuters.com/article/2014/06/05/us-banks-regulations-insight-idUSKBN0EF09U20140605>.

¹⁶⁰ For a balanced view on this issue as it presents in the United States, see: L. G. Baxter, ‘Capture Nuances in Financial Regulation’, 47 (3) *Wake Forest Law Review* (Fall, 2012). Cf A. E. Wilmarth Jr., *supra* note 142. For the position in Australia see: P. McConnell, ‘Debunking the myth of our ‘well-regulated’ banks’, *The Conversation*, (13 September, 2012 6.38am AEST), <https://theconversation.com/debunking-the-myth-of-our-well-regulated-banks-9333>, 4. For more on the susceptibility of fragmented agencies to capture, see: J. K. Gakeri, ‘Financial Services Regulatory Modernization in East Africa: The Search for a new paradigm for Kenya’, 1 (16) *International Journal of Humanities and Social Science* (November, 2011), 167/8; and on the advantages of the functional approach to resisting capture, see: Working Group on Financial Supervision, ‘The Structure of Financial Supervision. Approaches and Challenges in a Global Marketplace’, in *Special Report*, Group of Thirty, Consultative Group on International Economic and Monetary Affairs, Inc., (2008), 35. On accountability as a bulwark against capture, see: R. J. Herring & J. Carmassi, ‘The Structure of Cross-Sector Financial Supervision’, 17 (1) *Financial Markets, Institutions & Instruments*, (February, 2008), 24.

entity,¹⁶¹ whereas the South African proposal is for the Prudential Authority to be a division of the South African Reserve Bank,¹⁶² albeit as a separate juristic person.¹⁶³

While the Australian model provides a high degree of statutory independence to the system stability regulator,¹⁶⁴ APRA, it is to a degree answerable to the Treasurer,¹⁶⁵ and both APRA¹⁶⁶ and ASIC¹⁶⁷ to the Federal Parliament by way of submission of Annual Reports. Taylor envisages either Ministerial oversight or Parliamentary oversight¹⁶⁸ in his model. The South African Bill envisages accountability to the National Treasury (and ultimately Parliament) through the Financial Stability Oversight Committee¹⁶⁹ and the annual reporting requirements.¹⁷⁰ Consequently, this comports with Taylor's original recommendation,¹⁷¹ which he claims is more likely to negate the politicisation of the regulator, than would an arrangement that requires the regulator to be responsible only to Parliament. The internal logic of this argument is, however, difficult to discern. It could just as easily

¹⁶¹ Established under s 7, *Australian Prudential Regulation Authority Act (Cth)*, No. 50 of 1998, as a body corporate, s 13, *ibid.*

¹⁶² S 24 (1), (3) and (4) read with the objects and purport of s 33 (2), *Financial Sector Regulation Bill*, 11 December, 2013.

¹⁶³ S 11 (2), *Financial Sector Regulation Bill*, 11 December, 2013.

¹⁶⁴ S 11, *Australian Prudential Regulation Authority Act (Cth)*, No. 50 of 1998.

¹⁶⁵ S 12, *ibid.*; The Treasury, Australian Government, 'Statement of Expectations for the Australian Prudential Regulation Authority', published by The Treasury, Commonwealth Government of Australia, (20 February, 2007), 4/5.

¹⁶⁶ S 59, *Australian Prudential Regulation Authority Act (Cth)*, No. 50 of 1998.

¹⁶⁷ S 136, *Australian Securities and Investments Commission Act (Cth)*, No. 51 of 2001.

¹⁶⁸ M. W. Taylor, *supra* note 6, 11.

¹⁶⁹ The Financial Stability Oversight Committee gives the SARB, (of which the prudential regulator would be, it is envisaged, a department,) ultimate responsibility for financial stability: s 4, *Financial Sector Regulation Bill*, 11 December, 2013, and would be required to report to the Minister any threats to system stability: s 5 (2)(d), *ibid.*, and which would, twice a year, be required to report to the Minister on the overall state of system stability: s 9, *ibid.*

¹⁷⁰ Part 7, s 39 (1)(a), *ibid.*, which requires the regulatory authorities to report within 90 days of the end of the financial year, and s 39 (1)(b) which requires the Minister to table the regulatory authorities' reports within 30 days to the National Assembly (Parliament of the Republic of South Africa). S 39 (3), *ibid.*, requires the regulatory authorities to submit to the Minister a report on any other matter that may affect system stability, public finances, or any other matter deemed necessary, and must do so on an *ad hoc* basis, and of its own initiative.

¹⁷¹ M. W. Taylor, *supra* note 6, 11.

be argued that responsibility to Parliament may ameliorate pressure from the Treasury, and may serve to countervail the possibility of regulatory capture.

While there is no definitive answer to the question of whether it is better to locate the prudential regulator within the NCB, or outside, the balance of probabilities favours the latter.¹⁷²

V CONCLUSION

If South Africa continues to develop, and succeeds in lifting more South Africans out of poverty, ever greater calls will be made on the private sector to provide a wide variety of savings and investment products, and self-funded social insurance. An agency dedicated to market conduct and consumer protection will, therefore, become ever more necessary.

A bifurcated system, it is argued, is preferable. One entity will be responsible for system stability, including ongoing prudential regulatory enforcement and development, of all financially significant firms, including banks, insurers or a combination of the two, on a single and consolidated basis. This will prove even more important in the future, as the lines between banks, merchant banks and insurers continues to be blurred, and as the scale of interconnectedness between financial firms continues apace, particularly in the OTC¹⁷³ derivatives market, in which banks and securities firms are the primary dealers. The size of the OTC market, the global notional value of which was a staggering US\$ 710 trillion as at December 2013,¹⁷⁴ represents the clearest indication of the potential for interconnectedness, and poses a significant threat to any financial system through contagion, both endogenous and exogenous. Only a whole of entity, consolidated group approach can hope to address this interconnectedness. So, while South Africa came through the GFC relatively unscathed, due mainly to the conservative nature of its banking system,¹⁷⁵ the

¹⁷² See: A. D. Schmulow, *supra* note 1, 51ff.

¹⁷³ Over the counter.

¹⁷⁴ Bank for International Settlements, 'International banking and financial market developments', in *BIS Quarterly Review*, Bank for International Settlements, (September, 2014), Table 19, A 141.

¹⁷⁵ D. Cavvadas, 'South Africa: A Sophisticated Securities and M&A Regime', *Securities and Mergers & Acquisitions Newsletter*, Q1, (April 2010), accessed: 21 September, 2014, <http://www.fasken.com/en/south-africa-sophisticated-securities-ma-regime/>.

experience gained from the GFC was that increasingly esoteric products, created by securities firms beyond the purview of institutional or functional regulators, created a blind spot for regulators in the USA and Europe;¹⁷⁶ one that ultimately had catastrophic economic consequences.

The second entity will be responsible for market conduct and consumer protection. It is argued such a system would more likely to resolve fragmentation, provide clarity of ambit, be more cost-effective due to rulebook simplification, and improve accountability – more likely, but not definitely, as the recent failings of ASIC in Australia have demonstrated.¹⁷⁷ If the consumer protection and market conduct regulator does prove effective, then advantages accrue to consumers for a ‘one-stop shop’¹⁷⁸ for complaints against regulated firms.

Ultimately, of course, the success of a Twin Peaks regime in South Africa will depend upon the efficacy of enforcement – *governance* – and this in turn will depend upon the goals that are set – *the principles* – and on how those goals are pursued. That in turn will depend upon market intelligence – *the risks* – along with the independence and the capacity of the regulators to pursue corrective action, free of interference or industry capture; co-ordination between the peaks; the resources – physical and human – which the regulators bring to bear, and their willingness, if need be, to take on vested and powerful interests.

If successful, Twin Peaks will help lay the foundations for a dynamic financial sector, one that already plays a significant role - an excessive role according to

¹⁷⁶ Working Group on Financial Supervision, *supra* note 160, 20.

¹⁷⁷ For a detailed account of the financial advice scandals in Australia, and the failures of ASIC, see: A. D. Schmulow, *supra* note 1, 47ff; Senator M. Bishop (Chair), Senator D. Bushby (Deputy Chair), Senator S. Dastyari, Senator L. Pratt, Senator J. Williams, Senator N. Xenophon, Senator D. Fawcett & Senator P. Whish-Wilson, ‘Performance of the Australian Securities and Investments Commission’, Parliament of Australia, The Senate, (June, 2014); A. Ferguson, *supra* note 30; A. Ferguson & D. Masters, *Banking Bad*, in ‘Four Corners’, Audiovisual Material, Documentary, Sydney, NSW, Australian Broadcasting Corporation, (5 May, 2014); J. Lee, C. Houston & C. Vedelago, ‘CBA customers lose homes amid huge fraud claim’, *The Age*, (29 May, 2014); A. Ferguson & B. Butler, ‘Commonwealth Bank facing royal commission call after Senate financial planning inquiry’, *The Sydney Morning Herald*, Business Day ed., (26 June, 2014).

¹⁷⁸ M. W. Taylor, *supra* note 6, 11.

some¹⁷⁹ - in South Africa's economy. If Twin Peaks fails, and fails under the wrong circumstances, such as another global financial crisis, the results will be catastrophic.

¹⁷⁹ 'Dangerously over-financialised', and contributing twenty-eight per cent of South Africa's GDP. B. Brkic, 'Analysis: Is South Africa over-banked?', *Daily Maverick*, (23 February, 2010 12:57) (South Africa)).