South Africa's Twin Peaks model look strong but needs more independence

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This blog comments on the findings of the IMF/World Bank's Financial Sector Assessment Programme's (FSAP) 2022 report on South Africa, published in February 2022, and the three subsequent Technical Notes published in June 2022. This body of assessment makes specific reference to the implementation of the 'Twin Peaks' regulatory model in South Africa since 2018 and, in addition to overall assessment, makes a number of specific recommendations for reforms and development.

The FSAP's overarching report (February 2022) found that South Africa's 'financial sector oversight is strong, reflecting a commitment to independent supervision and the implementation of international standards'. It found that there has been 'significant progress' since the previous FSAP assessment (2014) especially when it comes to 'implementation of the 'Twin Peaks' regulatory structure' (p. 7). From a prudential perspective, South Africa enjoys 'a strong decision-maker in the South Africa Reserve Bank (SARB) Governor… supported by an advisory committee structure, fostering effective cooperation and coordination'.

This is the first independent assessment of South Africa's financial sector since the implementation of the 'Twin Peaks' regulatory system in terms of the Financial Sector Regulation Act (9 of 2017). The 'Twin Peaks' system was developed in the wake of the 2008 global financial crisis and is designed to produce more robust prudential and market conduct supervision. In particular it is designed to deal with systemic financial risk in an age where banking and insurance are highly interconnected, as is the case in South Africa.

Prior to the 'Twin Peaks' model, financial institutions were regulated on a sectoral basis. Different sections of the market, notably banks on the one hand and the insurance sector on the other, were regulated by different institutions under separate regulatory frameworks and guidelines. In South Africa, under the old system, banks fell under the

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South African Reserve Bank (SARB) while non-banks were regulated by the Financial Services Board (FSB). Regulatory activities conducted by both sets of institution were overseen by the National Treasury.

These arrangements resulted in a regulatory system which, it has been suggested, was 'fragmented and ineffective'. The National Treasury, in a 2014 'Response and Explanatory Document', argues that 'The 'Twin Peaks' approach represents a decisive shift away from a fragmented regulatory approach, minimising regulatory arbitrage … (and) focussed on a more streamlined system of licencing, supervision, enforcement, customer complaints (including ombuds), appeal mechanism (tribunal) and customer service and education'.

The two 'Twin Peaks' institutions introduced in South Africa were the Prudential Authority (PA) located in the SARB and the Financial Sector Conduct Authority (FSCA), both established in 2018. Both institutions cover all financial role-players, including banks and insurers, but are differentiated by their roles. The PA is mandated to monitor and assess the stability of the financial system as a whole, while the FSCA is required to consider the market conduct of firms, especially as these impact on consumers.

A further institution, the National Credit Regulator (NCR), founded in 2006, was (and remains) responsible for regulating credit and protecting customers against lending abuse, in terms of the National Credit Act (34 of 2005). Some regard this as a third 'peak' in the South African system with the SARB itself constituting a possible 'fourth peak'. Australian scholar Andrew Schmulow regards this as 'laying the foundation for a four peak model'.

The 'Twin Peaks' model requires a difficult balancing act. On the one hand, the prudential (PA) and good conduct (FSCA) peaks needs to have an on-going cooperative relationship. On the other hand, they need to conduct their activities independently from each other and also from institutions with regulatory and political oversight (the SARB, the National Treasury and Parliament).

The FSAP assessment finds that the South African system is very good on cooperation but far poorer on the independence of institutions. This is in part a consequence of the institutional origins of the 'Twin Peaks' system in South Africa. The PA had to combine three existing institutions, the old SARB Bank Supervision Department, the Insurance Prudential Supervisory Team from the old FSB and the Cooperative Banking Supervisory Unit which previously fell under the National Treasury. It does however still operate within the SARB, with staff seconded from that institution.

This arrangement, in the view of the FSAP, leaves room 'to strengthen the PA's independence and accountability and better articulate its mandate'. It singles out a number of issues which may arise from this state.

The first is that the PA may, under certain circumstances, not provide an effective check on the Governor of the SARB, as the system intends. It notes that the chief executive of the PA is appointed by the Governor, that the SARB sits on the PA and that it provides financial support (Technical Note on Banking Supervision and Supervision, p. 18).

Second, the FSAP also believes that lines of authority regarding technical issues such as solvency, leverage ratios' liquidity, risk management and recovery and resolution planning are also weighted in favour of SARB decision-makers (p. 17). The limited independence of the PA, the FASP notes, could give rise to a conflict of interests in the context of state-owned banks, a development enabled by the 2019 Amendment to the Banks Act.

Third, the FSAP also notes that licencing matters are divided between the PA and the FSCA and that this may give rise to 'regulatory paralysis' in cases of disagreement between the two agencies. For example, the PA may not revoke a licence without the agreement of the FSCA. The FSAP notes that in case of disagreement, there is no dispute resolution mechanism.

Among the solutions prescribed by the FSAP are that the PA be fully funded by levies on the banking and financial services industry, instead of only partially funded as is the case at present. This would facilitate greater independence from the SARB but poses challenges in terms of the PA's own financial planning and transparency (p. 19).

While the independence of the PA is problematic, in the view of the FSAP, cooperation between the various bodies developed to manage regulatory supervision has been excellent. These bodies include the Prudential Committee, the Monetary Policy Committee, the Financial Stability Committee, the PA Management Committee and the PA's Policy Panel. Further cooperative platforms include the Financial System Council of Regulators (FSCR), the Financial Stability Oversight Committee (FSOC) and the Financial Sector Contingency Forum (FSCF).

The FSAP observes in its Technical Note on Systemic Risk Oversight and Macroprudential Policy that 'this wide-ranging committee structure is what sets the South African arrangements apart from many other Emerging Market Economies' (p. 7). The extent to which regulation is in the hands of technocrats is demonstrated by the fact that the only overtly political committee in the system, the Financial Sector Inter-ministerial Council (FSIC) has yet to meet for the first time.

South Africa's 'Twin Peaks' regulatory system is now the basis for both prudential risk management and market conduct (and hence consumer welfare). But its implementation has been obscure, partly through the failings of the domestic financial press and partly because it has not had a domestic political profile. The FSAP publications provide a welcome shaft of light on the subject. They also provide an assurance that the system is functioning well. But it is still work in progress and attention needs to be paid to the FSAP's detailed suggestions.

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