ACTUARIAL SOCIETY OF SOUTH AFRICA: COMMENTS ON PROPOSED TWIN PEAKS REGULATORY MODEL

Introduction

The Actuarial Society of South Africa ("the Actuarial Society") wishes to express its appreciation for the opportunity to comment on proposals for the implementation of a Twin Peaks regulatory model for the financial services sector in South Africa. These proposals are likely to have a significant impact on the various industries where actuarial expertise is relied on heavily, i.e. the pensions, life insurance, short term insurance and investments industries, as well as the banking and micro-insurance industries, where actuarial expertise is being relied on to an increasing extent.

For the purposes of this document, the Actuarial Society follows the structure of the discussion document published by the National Treasury on 1 February 2013.

Executive Summary

- The Actuarial Society generally strongly supports the move towards a Twin Peaks regulatory regime, but urges the Financial Regulatory Reform Steering Committee to keep arrangements uncomplicated and to avoid over-regulation.

- Clearly defined roles and areas of jurisdiction are required to avoid confusion and delays. The alignment of regulatory requirements and leveling of playing fields across industries are strongly supported, but the level of regulation should be appropriate for the level of risk in any given institution.

- Clarity is required on the regulatory position in respect of entities that form part of a South African financial services group, but provide products in other regulated markets.

- The position of the National Credit Regulator should be clarified.

- It is noted that micro-insurers and pension schemes will not be subject to supervision by the prudential regulator, which could lead to inconsistencies.

- The inclusion of medical aid schemes in the regulatory regime is logical and in the interests of the consumer.

- The introduction of Twin Peaks and TCF may result in additional costs, which could eventually be passed on to the consumer. In this respect, it may mitigate against increasing access to financial services.

- The granting of more power to the regulators is welcomed, but it is important that regulators are seen to be subject to legislative control.

- There is scope for the various professions to ensure that the regulators have access to the necessary expertise when compliance has to be enforced. The introduction of Twin Peaks may provide an opportunity to provide protection to whistle-blowers.

- The Actuarial Society appreciates the consultative approach taken by the Financial Regulatory Reform Steering Committee and would welcome any opportunity for further collaboration in this regard.

1 Setting the Scene

The Actuarial Society supports developments that improve the quality and effectiveness of regulation and the security of financial services provided by South African financial institutions, provided that the cost of such developments is proportional to the benefit derived. Furthermore, we support consistent regulation across financial services industries and limitation of the scope for regulatory arbitrage. The Actuarial Society has noted that the Financial Stability Board welcomed the proposals and stated 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". We concur with this view.

The introduction of a new regulatory system can be complicated and may result in some confusion, at least initially. The Actuarial Society supports the overarching regulatory and supervisory principles set out in Chapter 1.1, and wishes to emphasise the importance of transparency and consistency. A natural response to a highly complex environment may be to introduce a complex control system. The Actuarial Society supports the view expressed by, *inter alia*, Gigerenzer (2010) that the optimal response to a complex environment is often to simplify and streamline, rather than fully state-contingent rule. Complex rules may result in adherence to the letter being over-emphasised, with a focus on minute detail at the expense of the bigger picture.

Furthermore, while the Actuarial Society fully supports alignment with applicable international standards, we would like to caution against too aggressive an implementation of regulation in an industry that shows important differences to, for example, the United Kingdom and Australia. Over-regulation could result in significant additional cost to the industry, which is more than likely to be passed on to the consumer.

Over-regulation of the South-African financial services sector could, similarly, prevent the country from sharing in economic growth opportunities locally and in other African countries. It may also result in South Africa not being used as the gateway to financial markets in such countries.

Reiterating our support for the principle, however, we would also recommend greater alignment of the investment limits currently prescribed for different institutions. Criteria for a consistent framework could include the following:

- The same definitions for asset classes,
- the same principles on look-through of pooled investments, and
- the same principles for the use of derivatives.

This would not only improve efficiencies and reduce costs for the asset managers, but should also reduce regulatory arbitrage and related systemic risk.

1.1 Scope of Responsibility

The Actuarial Society generally supports the demarcation set out in the discussion document, in terms of which the Financial Services Board ("FSB"), as market conduct regulator, will be responsible for regulating and supervising the market conduct of all regulated financial markets, institutions and activities, while the South African Reserve Bank ("SARB"), as prudential regulator, will be responsible for the prudential regulation and supervision of banks and long-term and short-term insurers. We note that the SARB will also be the systemic regulator and will oversee key financial markets infrastructure and that the FSB will in certain cases be responsible for both prudential and market conduct regulation.

While we support a consistent and level playing field for the regulation of all financial services providers, we also believe that the regulation should be proportional to the level of risk inherent in each institution. For example, a pure linked long-term insurer may require a lighter touch than a more typical traditional long-term insurer underwriting risks directly on its balance sheet. Similarly, although a LISP and a pure linked long-term insurer perform a similar function, they may justify a different approach to regulation. Hence the Actuarial Society would welcome further detail of how the regulations might capture the principle of proportionality.

The proposed role of the SARB should assist in ensuring consistency of approach across industries, with an equivalent response to similar risks taken across industries. Expanding on the point made in the paragraph above, we wish to point out, however, that the SARB's approach to regulation of banks may not necessarily be appropriate to regulation of insurers, and *vice versa*. We would suggest that industry differences be accommodated in the regulatory approach, so as to avoid burdensome regulation that does not achieve its objectives efficiently.

The enhanced regulation of market conduct augurs well for the consumer, and should increase consumer trust in the industry. The FSB's Treating Customers fairly initiative is an important step towards building consumer confidence, and a transparent regulatory overhaul is likely to strengthen that confidence. In this regard, it is noted that a recent CoreData Research study found that some 40% of investors claimed to be significantly influenced by distrust in the financial services industry in their appetite for investing.

We would like to draw attention, however, to the possible ambiguity associated with allocating joint responsibility, for example the "two-key approach" to licensing and registration (p 19). This may lead to uncertainty around which regulator to approach. A process of consultation may also increase the time taken and costs incurred to obtain approval. If the responsibilities of the various role players are not clear enough, it may also lead to important issues not being addressed by either regulator. This means that clear guidelines must be set up for these processes, and that these guidelines have to be communicated efficiently as well.

We believe it is essential that all institutions should be subject to both prudential and conduct regulation to the extent that is appropriate for each institution. We note from the proposal that the prudential regulator will not exercise any supervision over micro-insurance. Similarly, pension funds will only be subject to supervision by the market conduct regulator. We are concerned that this might lead to an inconsistency between these entities and fully regulated long-term insurers that underwrite similar products. For example, retirement annuities can be written on a long-term insurance licence, but would then be subjected to potentially more onerous regulation than the equivalent arrangement under the auspices of a pension fund. Equally, both long-term and short-term insurers write products with benefits and cover levels similar to those written by the micro-insurers; hence the proposed approach may well introduce regulatory arbitrage for these products/policies. While we support the need for proportionality, we strongly support the need for level playing fields and look forward to seeing this addressed once further detail is available. In addition, the scale of some larger pension funds and umbrella funds can potentially have a significant disruptive impact, introducing a level of systemic risk to the economy.

From an actuarial perspective, the proposed changes have little other impact on the pensions industry. With regard to insurance, however, the actuaries will be housed with the prudential group and the market conduct staff will not have the same access to the actuaries. They need this access, as in many cases they need actuaries to quantify issues they are required to deal with.

It is also not clear what the role will be of the Chief Actuary and whether this person will be located at the SARB or the FSB. The proposals may well present an opportunity to consolidate the use of actuarial skills in the public sector by establishing an appropriate entity for this purpose.

We believe it is important that appropriate attention be given to both the long-term and short-term insurance industries. There has been a tendency to focus more on the long-term insurance industry in the implementation of the FSB's Solvency Assessment and Management ("SAM") Project. As stated above, we support consistent regulation across financial services industries.

The discussion document acknowledges the important role played by the National Credit Regulator ("NCR") in the market conduct for credit extension for both banks and non-banking financial institutions. The NCR, however, seems to fall outside the proposed structure. We deem it important for clarification to be provided in this regard. This may include incorporating the NCR into the restructured FSB, as the latter will be responsible for market conduct or, as indicated in the discussion document, having the two separate regulators cover different aspects of market conduct in the retail banking sector in a coherent manner. Again, we would encourage the Financial Regulatory Reform Steering Committee to opt for the simpler, less confusing option.

Similarly, we note that medical aid schemes appear not to be covered by the proposed structure. We are of the opinion that the appropriate management of medical aid schemes requires financial, rather than medical, expertise. Including these schemes in the proposed framework would further enhance the strengthening of financial stability oversight and harmonise supervisory approaches across the various types of financial institutions. Such inclusion seems logical and in the interests of the consumer, and we would strongly urge the Committee to consider this. Medical aids are often managed and underwritten in the same financial groups that manage and underwrite other financial services (including, but not limited to, short- and long term insurance). Placing them under the same regulatory framework will reduce the risks of any contagion impact between the different products impacting market conduct or financial stability, regulatory over- or underlap and regulatory arbitrage within these groups. In addition, this will be in the interests of consumers who may often purchase medical aid products through the same intermediaries and from the same financial groups as they purchase other insurance products.

It is not clear from the document how various entities that form part of a South African financial services group, but provide products in other regulated markets, will be regulated; for example, a branch of a South African insurer in the Isle of Man, or a regulated insurance entity in Namibia. We would appreciate the opportunity to comment on more detailed proposals in this regard.

2 Governance and Accountability Framework

The Actuarial Society supports the proposals set out in Chapter 2 of the discussion document.

While we agree with the approach to, in particular, operational independence, we wish to emphasise the importance for the various regulators under Twin Peaks to have clarity on interaction and areas of jurisdiction. In the absence of sufficient clarity, they may contradict each other, creating confusion among consumers, or the credibility of deterrence may be affected negatively. The theme of appropriate interaction between the various role-players recurs throughout the document, e.g. in Chapter 3.2, Chapter 4.3, Chapter 6.3 and other places.

Adequate clarity will also go a long way towards avoiding the risks held by a "silo" approach. Market conduct risk failures can lead to systemic risk, and *vice versa*. We accordingly appreciate the commitment to strengthening the stability and resilience of the global financial system, as we believe a global perspective to be of vital importance in this regard.

We note with appreciation the intention to fund the regulators according to international best practice. In this regard, we believe a case can be made for industry levies.

3 Strengthening Financial Stability Oversight

We support the stated aim of the Financial Stability Oversight Committee, viz. to coordinate the collective regulatory effort. This also mitigates against a "silo" approach. The Committee will have an important role in respect of avoiding the confusion and ambiguity that may be associated with the allocation of joint responsibility. However, if there is insufficient co-operation between the different regulatory bodies, there is a risk of the Committee being regarded as, or indeed becoming, just one more addition to the bureaucracy.

4 Prudential Regulation and Supervision

The Actuarial Society welcomes the principles-based approach to regulation and supervision, as set out in Chapter 4.3. We dealt with this in some detail as part of our response to the overarching principles discussed in Chapter 1.1.

The implementation of the FSB's SAM Project has thus far required significant risk management and actuarial resources and expertise. Until recently, there have been no regulatory imperatives for the short-term insurance industry to possess such skills. This will place a significant strain on available skills – so caution needs to be exercised in the rollout of changes to ensure a smooth and well managed implementation across all industries.

Noting that the prudential regulator's supervisory approach will be risk-based, we wish to point out that systemic risk differs between types of institution. Systemic risk at a bank, for example, would be different from systemic risk at an insurance company.

As stated in section 1 of this response, we believe the inclusion of medical aid schemes in the structure will contribute to harmonising prudential supervisory objectives, principles and methods across the various types of financial institution and markets.

While we appreciate that there may be certain efficiencies derived from a pooling of the existing prudential regulatory staff from the FSB and SARB, we remain concerned that significant quality improvements in prudential regulation may require the injection of additional resources. In this regard, the discussion on page 27 seems to imply that very limited additional resources will be required to achieve Twin Peaks.

5 Market Conduct Regulation and Supervision

The Actuarial Society strongly supports the drive for strong market conduct supervision across the financial services industry. We believe that measures to improve consumer protection without detracting from consumer value are in the common good and need to be supported. However, caution needs to be exercised in the implementation to ensure that it is not quicker than either the market or the industry can absorb.

It has been stated by the National Treasury that treating customers fairly (TCF) regulation is just the start of market conduct regulation, and that corporations must do more to incorporate TCF principles and break from past practices. The Actuarial Society concurs with this view, but notes that a lot still needs to be done to implement TCF legislation and the associated supervisory framework.

Current practices of the industry have been perceived to be unfair, e.g. approaches to the pricing of insurance products, and the Actuarial Society sees the need to participate in the education and debate on such matters. We hope to participate in discussion and dialogue on industry reforms, as well as issues such as micro-insurance.

The discussion document makes the point that "a good regulatory system needs to balance the cost of compliance with the need to ensure compliance". Implementing a more intrusive level of prudential and market conduct regulation may, however, imply significant further costs for both the short- and long term insurance industries. When considering the costs relating to implementing SAM regulation for companies, it can be anticipated that some costs of implementing Twin Peaks regulation will eventually result in more expensive financial services products. We note with appreciation the research that has been done in this regard, but would nonetheless urge that the cost-effectiveness and economic impact to the end consumer be considered prior to finalising the proposals. Furthermore, regulation should be designed to address well-understood needs and shortcomings of industry practice.

It is not clear from the discussion document how the implementation of Twin Peaks will improve access to financial services. Our concern, as indicated above, is that it could in fact raise the barrier to entry and hence inhibit wider choice of, and access to, financial services. We look forward to greater clarity on how this particular objective will be achieved.

The Actuarial Society concurs that some instances of abuse will occur, even in a comprehensive and rigorous market conduct regulation environment. We welcome the intention to use innovative tools, designed to enable pre-emptive mitigation of market conduct risks. The large number of illegal and fraudulent schemes, examples of which include Sharemax Investments, the Relative Value Arbitrage Fund Trust and others, indicate that stronger powers and deterrents are required.

Ready access to the regulator, as well as a simple process, is essential for consumers if TCF is to hold significant benefits for them. The Actuarial Society welcomes this acknowledgement in the section on enhancing the effectiveness of the ombud system. Consideration could be given to collaborative arrangements with the various financial services professions to ensure the regulator has appropriate access to specialised financial services skills.

6 Crisis Management and Resolution

The Actuarial Society supports the intention to establish mechanisms to prevent and deal with crises. Again, we endorse the view that effective resolution requires coordination among various regulators and stakeholders (Chapter 6.3). We welcome the appointment of the SARB as a resolution authority. The proposed involvement of the Minister of Finance is welcomed, too. We are encouraged by the importance attached to cooperation with foreign resolution authorities (Chapter 6.6) as a further aspect of adopting a global perspective on developments.

Given the considerable powers envisaged for the Resolution Authority, and the fact that judicial review will only be possible after the fact, it is, however, important that the triggers for entry into resolution are defined as transparently and objectively as possible. Furthermore, effective safeguards should be built into the decision making process, including engagement with stakeholders to the extent consistent with effective action.

7 Enforcement

The Actuarial Society supports the initiative to equip both the prudential and market conduct regulators with the necessary powers and tools to act quickly and, where necessary, pre-emptively. We are of the view that considerable scope exists for collaborative endeavours in this regard between the regulators and the various financial services professions.

The Roman poet Juvenal raised the question of guarding the guards. Bearing in mind both this question and the principle of transparency, we would like to caution against perceptions that the regulators' scope for enacting or amending regulation is not appropriately controlled within the legislative framework. Confidence in the system largely depends on this control being seen to be in place.

We also urge the Committee to consider ways to address the situation of whistle-blowers, who are more often than not left without protection.

8 Implementation and Next Steps

The Actuarial Society notes the two phase approach to implementing the Twin Peaks model and agrees that this is a sensible approach. The timelines for implementation of the regime should, however, be realistic. Underlying principles, and how they should be achieved, should be adequately debated and understood by key stakeholders and an appropriate level of guidance should be provided to the industry to assist with implementation. We would like to be involved in these discussions and debate in order to clarify the understanding of market conduct principles and issues specific to the South African environment. In this regard, it is anticipated the actuaries will primarily be concerned with aspects of risk management, product design and pricing.

We note with appreciation the commitment to comprehensive engagement regarding the contemplated changes. We commend the FRRSC for this approach, and once again express our appreciation for the opportunity to submit comments on the proposals. We shall gladly participate in such discussions, or provide such further information, as the Committee may require. We look forward to an efficient working relationship in this regard.

We wish the Committee well in this major initiative.

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