Financial Regulation in South Africa

by

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Financial regulation is a topic that does not enjoy a widespread or thorough understanding. It is often regarded as obscure, arcane and yet another level of bureaucracy that has to be endured by the private sector. The importance of designing and maintaining an efficient and effective system to regulate financial markets, financial institutions and financial service providers lies at the very core of a nation’s economic wellbeing. The collapse of the banking system in many Southeast Asian countries during the closing years of the twentieth century and the economic hardships attendant on these events, are perhaps the most dramatic recent examples of how important the implementation of efficient and effective financial regulation is.

The financial system in general, and the banking sector in particular, has experienced substantial structural changes since the 1980s. One of the main challenges for financial regulators has been to keep up with and adapt to these changes, which are often of an international nature. In South Africa the financial regulatory system has undergone enormous change during this period, including the transfer of responsibility for banking supervision from the Department of Finance (now known as the National Treasury) to the South African Reserve Bank in 1987, the establishment of the Financial Services Board in 1989 and the creation of the Policy Board for Financial Services and Regulation by Act of Parliament in 1993.

An extract from the Mission Statement of the Policy Board reads: “The Board wishes to promote and maintain a safe and sound financial system which will be fair to investors, effective in supplying financial services to all, well structured and co-ordinated in terms of financial and regulatory matters.” It is in line with this objective that the Policy Board has commissioned this report.

The report has the following aims:

- To capture the current “state of the art” of financial regulation in South Africa and the world.
- To catalogue and describe the underlying philosophy, guiding principles, ultimate objectives, intermediate goals, and targets associated with financial regulation.
- To review experience and trends in local and international regulation.
- To draw conclusions about the effectiveness of current regulation in South Africa and what still has to be done.

I commend the reading of this report to all who wish to, or should, know more about financial regulation. Obviously, this has been an ambitious project that is unlikely to satisfy everyone. The report contains conceptual ideas of an exploratory nature and no recommendations should be construed as representing the final view of the authorities.

Gill Marcus

Chairperson of the Policy Board for Financial Services and Regulation
PREFACE

In all countries, the financial system is more regulated and supervised than are other industries. On systemic and consumer protection grounds alone, it is almost universally accepted that this should be so. Over time it has become abundantly clear that regulatory arrangements have a powerful impact on (i) the size, structure and efficiency of a financial system; (ii) the business operations of financial institutions and markets; and (iii) competitive conditions both overall and between subsectors of the system. Depending upon how the objectives of regulation are defined, and how efficiently regulatory arrangements are related to their objectives, the impact of regulation can be either benign or malignant. Some regulatory structures are more likely to contribute to the ultimate objectives than others. Accordingly, regulation has the capacity to do great harm, to be inefficient by imposing unwarranted costs on regulated institutions, and even to be perverse (i.e. to operate counter to the objectives of regulation).

The skill, therefore, is to seek regulatory institutions, structures and mechanisms that maximise the explicit objectives of regulation while minimising imposed costs. This also means that effective mechanisms for supervision and enforcement need to be instituted, as these are as important as formal regulatory requirements in the overall regulatory regime. Effective regulation cannot secure its objectives in the absence of efficient supervision and enforcement. The potential costs of regulation have to be viewed in a far broader light than the actual transactions costs incurred. In particular, the impact on the economy as a whole and the cost imposed on consumers should be considered.

The devising of effective regulation is comparatively easy when six “ideal conditions” are satisfied:

- Competitive pressures in the financial system are weak;
- the financial system is based on subsets of specialist financial institutions, each conducting a narrow range of business, so that there is a reasonably precise parallel between function and institution;
- the structure of the financial system and the business operations of financial institutions are reasonably stable;
- the moral suasion of the regulatory agencies is universally accepted;
- the business of financial firms is predominantly domestic in nature; and
- simple and limited objectives of regulation are set.

The more the actual conditions move away from these “ideal conditions”, the more complex and challenging the regulatory process becomes. For regulation to be effective (in that it contributes to its objectives) as well as cost-efficient it has to adapt and respond to changes in institutional and market circumstances. The more these change, the more flexible the regulatory arrangements should be. Conversely, regulation becomes more demanding, and has to be more adaptable, as the objectives of regulation become more subject to change (more particularly the balance between systemic stability, efficiency and consumer protection). Moreover, as the competitive environment in the financial system becomes more intense and less stable, the business practices of financial institutions and the overall structure of the financial system in turn become increasingly subject to change.

In many countries the financial system in general, and the banking sector in particular, are passing through a period of substantial structural change. The system is subjected to the combined impact of internal competition, global competitive pressures, changes in regulation, new technology and the fast-evolving strategic objectives of financial institutions and their existing and potential competitors. The past two decades resulted in major diversifications (e.g. under the pressure of deregulation and competition), and there was a decisive shift towards the emergence of financial conglomerates. Above all, the competitive environment intensified markedly as banking and other sectors of the financial system faced more inter-sector competition, increased competition from a more innovative capital market, and global competitive pressures.
It seems that during the next decade, the challenges for regulation will remain formidable for three central reasons: (i) the process of structural change will continue, which will require regulation to adapt to, and efficiently reflect, the changing competitive and structural environment; (ii) what is required of regulation has become more extensive, and some of these requirements may be in conflict; and (iii) the environment will be particularly demanding, as each of the six “ideal conditions” noted above will become increasingly undermined.

In many countries the institutional structure of regulation has recently changed or is in the process of being changed. Different models of institutional structure are available. For instance, some countries (notably the UK) have adopted the mega-regulator concept where all regulation is placed within a single, all-embracing agency. Australia, on the other hand, has adopted the “Twin Peak” approach whereby two agencies are created: a single prudential regulator for all institutions, and a single conduct of business regulator for all financial services. There is no universally accepted ideal model.

Many different criteria can be applied. However, when considering the structure of regulatory institutions, a major issue is how the requirement for adaptability can be achieved. The key is how to devise a structure of regulatory institutions so that regulation has the maximum potential to adapt to changing conditions. A major issue in this dimension is the role of consultation between the regulator and regulated, and the extent of participation of the regulated in the regulatory process. The two cases are at opposite ends of a regulatory spectrum: the regulator imposing regulation with Olympian detachment, versus self-regulation with minimum external interference. In practice both extremes are untenable, though this still leaves open the issue of at what point along the spectrum the balance is to be struck.

This report is directed at those interested in or affected by financial regulation and, particularly, financial regulators. The objectives of the research are to

- provide comprehensive information about the theory and practice of financial regulation;
- discuss, in particular, the objectives, goals, targets and instruments of regulation, as well as their alignment;
- focus on the issue of the appropriate balance between statutory regulatory constraints and market incentives;
- discuss international trends in regulation and how regulation evolved in South Africa;
- suggest a possible future regulatory regime for South Africa and identify the key issues associated with such a regime; and
- suggest areas for further investigation and research.

The approach of this report will be along the following lines: Chapter 1 discusses the relationship between the overall regulatory philosophy of the government and the generally accepted regulatory objectives and principles. Chapter 2 focuses more specifically on regulatory objectives and the goals, while Chapter 3 highlights the arsenal of regulatory instruments available within the overall regulatory regime. Chapter 4 combines the instruments and objectives of regulation into an overall regulatory matrix. Chapter 5 examines financial crises, the lessons learnt and the regulatory responses. Chapter 6 describes the current regulatory structure in South Africa, discussing it in terms of financial instruments, markets and institutions. Chapter 7 views regulatory changes in South Africa over time with three snapshots: the regulatory structure in the 1980s, the structure in the 1990s and the likely structural scenario by 2010. This chapter includes an executive summary of outstanding policy issues and the priorities in South African financial regulation.

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Chapter 1

PHILOSOPHY, OBJECTIVES AND PRINCIPLES OF FINANCIAL REGULATION

1. Introduction

Financial regulation can be approached from three different — albeit complementary — perspectives. Firstly, there is the perspective of general philosophy. This is essentially a discussion of the nature of regulation, and describes the rationale of regulation and the philosophical approach of a country to the regulation of financial sector activity. Secondly, there is the perspective relating to the specific objectives to be attained through the regulation of financial sector activity. Thirdly, there is the perspective concerning the broader principles to be applied when formulating regulatory arrangements and structures for the financial sector. Although these three perspectives are closely related, it makes sense to discuss each separately. From the viewpoint of the financial sector practitioner the discussion will be on the principles that are most visible and, at the operational level, that are immediately relevant.

2. General philosophy

In any country the general philosophy of financial regulation is, to a considerable extent, shaped by the accepted norms and conventions of the financial community, as well as the general philosophies and ideologies supported by the political authorities. From a broader perspective, the discussion of the general philosophy can be pursued at two levels. At the higher level the discussion revolves around the ideologies regarding the role and operation of economic markets (financial markets in particular), whereas at the lower level the concern is more with the specific role assigned to the regulation of the financial sector.

With regard to the higher level, the role of regulation should reflect the views of the type of economic system that is appropriate for a country. Currently, industrial countries and many developing economies place a considerable premium on a market-oriented approach. This approach assumes that the working of the market mechanism will, in general, produce the best results in terms of efficiency and the allocation of financial resources. The efficient allocation of such resources would also imply an efficient allocation of physical resources. Consequently, in most countries the general philosophy is firmly anchored on the belief that market mechanisms produce optimal decisions and resource allocation. However, it is also acknowledged that the market mechanism does not operate perfectly under all circumstances and that the role of regulation is to provide redress against identified shortcomings and market imperfections. In other words, allowance has to be made for the use of regulation to secure a high degree of overall economic efficiency, thereby compensating for the negative aspects of unfettered market activity.

With regard to the lower level, the specific problems of financial markets are at issue. It is recognised that financial markets have their own unique characteristics, and that participants in these markets differ from participants in other markets in so far as their activities have a more general impact on economic activity. Accordingly, the working of financial markets as a whole should facilitate rather than impede the efficient operation of the financial system. Regulation therefore has to be both effective (in that it achieves the objectives) and efficient (i.e. is cost-effective in the use of resources). There is also an important economic dimension in that regulation should not impose unwarranted costs on the economy and consumers nor impair the efficiency of financial markets. This dimension also considers whether the objectives of regulation could be achieved in less costly ways. These considerations can be judged...
following cost-benefit analyses of regulatory requirements. There should always be an awareness that specific regulation can inflict damage if it is either flawed or incorrectly applied. In such a case it would actually impair the working of the market mechanism and produce perverse results – i.e. counter to the objectives of regulation.

It is also at this lower level that the nature of the process of regulation\(^1\) has a considerable role to play. The process of regulation consists of two basic activities: the provision of guidance and the imposition of constraints. More specific arguments in favour of regulation are that there may be a need to redress monopoly powers, to compensate for spill-over costs owing to market imperfections such as moral hazard or “gridlock” problems\(^2\), and to facilitate the dissemination of adequate market information. Regulation in finance also has a major “consumer protection” role as consumers may not always have sufficient information upon which to make judgements, and the failure of financial contracts may impose considerable hardship on consumers. To ensure fairness to consumers, the regulatory authorities have to set guidelines and operational constraints which address inter alia moral hazard problems.

The general philosophy regarding the regulation of financial markets therefore implies that the regulatory authorities and the regulated parties both have an interest in the creation and maintenance of an effective and efficient system of regulation.

3. Objectives of regulation

Given the general philosophy, it follows that the ultimate objective of regulation should be to achieve a high degree of economic efficiency and consumer protection in the economy. At a more practical level, however, three specific objectives of regulation are of particular relevance:

- **Securing systemic stability in the economy:** For any economy it is of the utmost importance that its financial markets run smoothly and are not subjected to shocks of their own doing, caused *inter alia* by: ineffective or inefficient trading, clearing and settlement systems; poor market infrastructures; or a major lack of market liquidity. Another major consideration in this regard would be the maintenance of the integrity of the payments system and, in financial markets, the securities delivery system\(^3\).

- **Ensuring institutional safety and soundness:** In their efforts to promote efficiency, the regulatory authorities should exercise extreme caution not to impose – even inadvertently – regulatory obstacles or barriers that would impair the safety and soundness of financial institutions *irrespective of whether or not there is a systemic dimension*. Firms have to be adequately profitable, have sufficient capital to cover their overall risk exposures, be able to face global competitive forces and also have “suitable” directors, management and staff.

- **Promoting consumer protection:** Wherever asymmetric information flows are evident, and where the consumer can potentially be exploited, there is an important “consumer protection” role for the regulatory authorities. Integrity, transparency and disclosure in the supply of financial services have to be promoted. These services have to be supplied by competent staff and consumers should have access to the full spectrum of retail financial services. In instances where consumers are wronged, there should be effective and cost-efficient compensation arrangements.

Even with this limited number of objectives, conflicts can arise between them. For instance, increased competition may result in greater efficiency, but may adversely affect the stability of the financial

\(^1\) The term regulation is used in a generic sense that encompasses regulation (the establishment of specific rules of behaviour), monitoring (observing whether the rules are obeyed), supervision (the more general observation of the behaviour of financial firms) and enforcement (ensuring the rules are obeyed).

\(^2\) See Chapter 2, Section 2.6 for further details.

\(^3\) Called DVP – i.e. delivery versus payment
system. Likewise consumer protection measures, such as single-capacity trading, may impact adversely on competition and hence efficiency.

The more objectives that are set the more demanding the regulatory process becomes. This is especially so because the complexity of the financial system and of the business operations of institutions increases. Efficient regulation requires a multi-dimensional approach, which in turn entails an optimising process. Firstly, the approach requires a clear definition of objectives. Secondly, the impact of each regulatory or deregulatory measure on each objective needs to be measured. Thirdly, an appropriate structure of regulatory arrangements should be devised, taking the above into account. Fourthly, the fulfilment of all aspects of policy (and not only regulation) becomes more difficult as the number objectives to be satisfied increases, most especially if different policy agencies are involved. This suggests a prima facie case for a simple set of objectives.

Care should be taken not to make the objectives unnecessarily sophisticated. Any move in such a direction would undermine the efficiency of regulation in contributing to its objectives. The aim should be, therefore, not to encumber regulation with a multiplicity of objectives that it is ill equipped to deliver. This is not intended to deny the legitimacy of other (perhaps social) objectives that may be secured through financial mechanisms. However, these are more appropriately attained by other means (e.g. tax incentives) rather than by regulation. An example may illustrate this point. Suppose the authorities wish to encourage a distribution of investment different from what the market mechanism – based upon the risk-reward criteria of financial institutions – would achieve. In this case, rather than impose, say, prescribed asset requirements which would result in a suboptimum portfolio, a more efficient approach would be to offer tax incentives to take up such investments. A further example from the UK, relating to competition and contestability, is provided in Box 1.1 overleaf. This example is also of relevance to South Africa – see Box 1.2.

Therefore, financial regulation should be restricted to a narrow range of objectives – it should not be employed as a means of achieving the wider economic and social objectives of the political authorities. This is so for three crucial reasons. Firstly, the regulation of financial institutions and markets is not the most efficient way of securing wider social objectives. Secondly, the wider the objectives, the greater the complexity of regulation as well as the potential for conflicts. Thirdly, these wider objectives are legitimately in the realm of the public accountability of the political authorities rather than the regulatory authorities. Moreover, it is extremely hazardous to involve regulatory authorities in wider political issues. In short, the objectives of financial regulation should not be political issues.

4. Regulatory principles

The third dimension of regulation refers to a set of principles to be applied when formulating regulatory policies, specific regulatory requirements and the structure of regulatory institutions. The principles are derived from the philosophy and objectives and can be grouped into five categories: (i) efficiency-related principles; (ii) stability-related principles; (iii) conflict-conciliatory principles (relevant to address potential conflicts between objectives); (iv) regulatory-structure principles; and (v) general principles.

4.1 Efficiency-related principles

Principles classified in this category are designed to contribute to the promotion of a high level of efficiency in the provision of financial services. Two such principles can be identified:

- Promoting the maximum level of competition among market participants in the financial system; and
- securing competitive neutrality between actual or potential suppliers of financial services.

The reason generally advanced for promoting a maximum level of competition among market participants is that competition is likely to enhance market efficiency. Efficiency is further increased if
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competition causes the removal of restrictive practices that impair trading in financial assets and the rationalisation of market activity. The maximum attainable level of competition requires relative freedom of entry into the financial services industry as well as relative freedom of choice regarding the financial services that any market participant chooses to provide. Taking note of the globalisation of financial markets, such freedom of entry should be allowed also in the case of foreign participants, and in turn local market participants should have (virtually) unrestricted access to global financial markets.

In the financial market environment, the maximum attainable level of competition among market participants implies full competition among financial exchanges and involves all market procedures and modes of trading. As a consequence of the relatively small size of the South African financial market, as well as the extent of the facilities being offered, market efficiency with regard to competition can only be optimised if such competition leads to maximum rationalisation in market structures and procedures. A factor militating against the optimisation of market efficiency is the fact that the South African financial markets are not fully integrated into the global markets, mainly owing to exchange control regulations.

The achievement of competitive neutrality between market participants would promote a high level of efficiency. Competitive neutrality could be defined as a situation in which no party to a financial transaction would enjoy a competitive advantage as a result of regulation, and different suppliers of financial services

Box 1.1: Limiting the objectives of financial regulation: Competition and contestability

In a situation where an industry is not contestable, mergers and acquisitions (M&As) have the inherent danger that they reduce competition (at least in the domestic market). At the same time M&As may improve systemic risk management and institutional soundness and even efficiency. There is currently a debate on a recommendation that: (i) the financial regulatory authorities should become involved in M&A policy; and (ii) contestability in competition policy should be included as an explicit objective of the UK’s Financial Services Authority (FSA).

There are several reasons for doubting the wisdom of this: (i) it would almost certainly create conflicts of interest within the FSA, and the FSA could defend almost anything it did by arguing that it was balancing the conflicting objectives of contestability and other objectives it is required to meet; (ii) it would therefore make the FSA’s accountability more uncertain as there would be too many escape routes; (iii) the FSA’s objectives would become too diffused and unfocused; (iv) there would be a potential danger of regulatory overload as more objectives became added; and (v) applying the “target-instrument” paradigm,² the legitimate and very important public policy objective of sustaining and enhancing competitive conditions in all markets would be more efficiently pursued by a dedicated agency which did not have internal conflicts.

Assessment and the evaluation of the effect of activities such as M&As on competition are more powerful when made by an external agency (e.g. in the UK, the Office of Fair Trading (OFT)). In addition, the resolution of conflicts, in the final analysis, may often involve judgements that have a political dimension and this should be made explicit rather than somehow resolved internally within the FSA. The UK’s approach in its Financial Services and Markets Bill (whereby the FSA is required to be conscious of the competition implications of its actions) is a more appropriate approach. The current practice (whereby the OFT is required to scrutinise the competition implications of regulatory agencies in relation to activities such as M&As) works well and is more efficient than internalising the process by establishing competition enhancement as an explicit objective of the regulator.

1 An industry is said to be contestable if there are low barriers to entry and exit. For instance, should M&A activity reduce competition in the domestic banking industry resulting in excess profits, there would be no barrier to the entry of foreign banks.

2 The target-instrument approach establishes that, when each instrument differentially affects each target, all targets can be achieved simultaneously only if there are as many instruments as targets: i.e. there exists some combination of instruments that achieves the desired combination of targets (see Chapter 4 for a further discussion).
would not have regulatory advantages. From a regulatory perspective this would involve the creation of a “level playing field” for the concluding of financial transactions. In practice this would require competitively neutral legislation as well as the avoidance of any form of functional or institutional discrimination against particular market participants (see Section 4.4 below). In addition, it is important to pursue a minimalist approach to regulation in the sense of redressing only inherent market deficiencies such as externalities, moral hazards, imperfect competition and natural monopolies. Imperfect competition and natural monopolies could be effectively removed by abandoning regulations and such factors as would impede the necessary rationalisation of market activity.

4.2 Stability-related principles
Principles in this category should contribute to the promotion of a high measure of stability in the financial system, and an appropriate degree of safety and soundness in financial institutions. Three such principles can be identified:

- Incentives for the proper assessment and management of risk;
- the use of regulatory requirements (e.g. related to capital) based, where possible, on current market values rather than historic values; and
- a willingness of the regulators to take timely action to redress developments threatening the existing and future stability of financial institutions and markets.

The proper assessment and management of risk requires the identification and successful handling of such risks. To the extent that the regulatory authorities do not wish to be concerned with day-to-day risk management, they should at least impose acceptable minimum prudential standards to be observed in respect of risk management by all financial sector participants. Appropriate information systems are required for the successful and timely identification of the relevant risks.

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Box 1.2: Limiting the objectives of financial regulation: Contestability and mergers and acquisitions – South Africa

Late in 1999, the Standard Bank Investment Corporation (Stanbic) was on the receiving end of a hostile R30 bn (US$5 bn) takeover bid from Nedcor Limited. Of competitive significance are the facts that Nedcor is effectively a subsidiary of the SA insurance giant, Old Mutual plc, while Stanbic also controls the large Liberty Life SA insurance company. It may be noted that the South African banking industry is not contestable because of exchange controls and constraints on foreign banks’ deposit-taking activities. Clarification is required on the responsibilities of the Registrar of Banks (SA Reserve Bank) and the Competition Commission with regard to this and future mergers. In 2000, the Courts ruled that the Minister of Finance in terms of the Banks Act should judge Nedcor’s bid. The Courts found that the Competition Act did not apply because of provisions which exempt “acts subject to or authorised by public regulation”. The ruling raises the prospect that deals in numerous sectors, such as insurance, telecommunications and liquor retailing, will fall outside the ambit of the competition watchdog.

This ruling appears to explicitly assign the handling of mergers and acquisitions as an objective of the financial regulators albeit after consultation with the Competition Commission. According to the Minister of Trade and Industry, the ruling was an extreme interpretation, which ruled in favour of exclusivity, and companies would use this as a precedent. It was always the intention of the Competition Act that mergers and acquisitions should be subject to both the competition law and legislation regulating particular sectors. The Minister of Trade and Industry wishes to amend the Act to make it clear that concurrence was intended between the Competition Act and other regulatory statutes – except that the Competition Commission shall not have jurisdiction where the Minister of Finance issues a notice that the proposed merger is in the best interests of the stability of the financial system in the Republic. This matter is still under debate.

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risks. Successfully dealing with the identified risks would demand procedures for minimising risks and establishing adequate capital requirements.

In financial markets, cross-market risk management is inevitable, as market participants are likely to operate in different financial markets simultaneously. Therefore, provision should be made for the offsetting of risks, for example between transactions in spot and derivative markets. Since the management of risks is to be conducted by market participants at all levels, the introduction of “fit and proper” standards for participants as well as for trading procedures should enhance financial market stability.

From a stability perspective, the use of current market values is extremely important. The viability of an institution can ultimately be determined only by reference to the current (rather than historic) market values of balance sheet items. A major problem in the US, for instance, was that for much of the 1980s many Savings and Loan Associations were trading on a technically insolvent basis obscured by a failure to present accounts on a current-value basis. The continuation of trading meant that the eventual degree of insolvency, and hence the claim on the taxpayer through the deposit-insurance system, became far greater than would have been the case had initial insolvency been detected earlier. This is a controversial issue, particularly when the price of some assets on the balance sheet is prone to volatility. There is a discernable trend in accounting standards towards greater sympathy with current-value accounting concepts. Nevertheless, there are many technical accounting problems to be solved before current-value accounting can fully replace the traditional historic-value accounting.

Developments threatening the existing and future stability of financial markets that might have additional disruptive consequences should be dealt with expeditiously. The regulatory authorities, in their role as the issuers of directives and in their capacity as financial market supervisors, should take or initiate the necessary corrective action whenever actual or potential market deficiencies are detected. Postponing action ("forbearance") could cause an accumulation of adverse effects and unwarranted contagion, which could exacerbate the disruption of financial market activity and consequently pose an ever greater threat to the achievement of financial market stability. Again, the US experience with Savings and Loan Associations illustrates the costs of delayed action.

4.3 Conflict-conciliatory principles

As with the objectives of regulation, principles may also be in conflict with one another. Conflict-conciliatory principles are designed to resolve potential conflicts between regulatory principles. These conflict-conciliatory principles would involve

- following an integrated approach, aiming at the simultaneous achievement of regulatory objectives; and
- pursuing a target-instrument procedure, whereby the regulatory instruments would be so selected and applied that they would facilitate the implementation of an integrated approach.

The target-instrument approach establishes that, when each instrument affects each target, all targets can be achieved simultaneously only if there are as many instruments as targets: i.e. there is some combination of instruments that achieves the desired combination of targets. Therefore, the value of each instrument is set not only to have positive effects on targets, but also to neutralise the negative effects of other instruments. This analysis, therefore, indicates that, if each of the regulatory objectives is to be secured, a multi-instrument approach is required. This is an optimising approach designed to achieve satisfactory levels of competition, soundness and safety. No single instrument will suffice, and the more one objective is sought, the greater the demand on other instruments to offset the potentially negative effect upon other regulatory objectives. Therefore, a co-ordination of the various objectives and instruments is required. A good example can be found in arrangements made for the protection of the consumer. One way of dealing with potential conflicts of interest that may work against the interests of the consumer is regulation that restricts the
range of allowable business. If, for any reason, such regulation is eased, it may be necessary to resort to other measures to limit the potential for conflicts of interest. Accordingly there may have to be recourse to dedicated capital, Chinese walls, rules of conduct, compliance officers, disclosure rules, etc.

4.4 Principles related to the regulatory structure
A major issue in regulation, especially as financial institutions become more complex and diversified, relates to the structure of regulatory institutions and, in particular, whether regulation and supervision should be conducted on the basis of a multiplicity of specialist agencies or by a single regulatory authority. Three principles are established in this regard:

• The following of a functional as well as an institutional approach to the regulation of financial market activity;

• the co-ordination of regulation by different authorities and agencies in order to achieve consistency; and

• a presumption in favour of a small number of regulatory agencies.

The problems of official regulation and supervision multiply when a financial system develops multifunctional institutions or financial conglomerates rather than being based on clearly differentiated functional institutions. A choice has to be made whether institutions or functions are to be regulated and supervised. In a differentiated system the problem does not arise, as institutions and functions are synonymous. Therefore, as structural change entails a trend towards financial conglomerates, a choice has to be made between functional regulation or conglomerate regulation. In the former case, specialist regulators and regulatory arrangements are established to regulate and supervise clearly defined financial activities independently of which institutions are providing the service. This implies that a financial conglomerate may be subjected to the jurisdiction of several regulatory authorities. The alternative is conglomerate regulation, where a single regulatory authority is established to regulate and supervise all aspects of financial institutions’ business.

Historically, the institutional approach has been dominant, largely because institutions have tended to be specialist in nature. Since the 1990s, however, more emphasis is being placed on a functional approach to regulation. The functional approach places more emphasis on regulating a specific type of activity irrespective of the type of institution involved. This is perceived to be more pervasive, and the presumption is that it would yield sounder results.

In practice, however, the institutional and functional approaches need to be employed in parallel because regulatory authorities are concerned with the soundness of institutions – at both the level of the institution and at a systemic level – as well as the way in which particular services are provided. Therefore although it is institutions that become bankrupt and not functions, business practices relate to functions. Accordingly, the approaches need to be synchronised, and some common ground for such synchronisation is found in the fact that risk identification and risk management are common to both the institutional and functional approaches. In terms of the functional approach, self-regulation has adopted an important role. The co-existence of self-regulation and official institutional regulation requires proper co-ordination in order to ensure regulatory consistency.

Self-regulation has always been a feature of the South African financial market control system. There is much to commend self-regulation – through recognised bodies – especially if there are built-in safeguards to protect against the obvious potential for an abuse of authority. The self-regulatory body has the required expertise and is in a position to monitor financial innovations. The participants, being members of the industry, have a professional interest in ensuring that standards and public confidence are maintained. They have an interest in ensuring that less scrupulous financial firms do not gain a “free rider” advantage.

Consumers assume that others have investigated the safety and integrity of suppliers of financial services.
based upon the public’s positive perception of the regulated industry. By eliciting the consent of the regulated, a high degree of compliance with regulations and standards can be secured. It may also be the case that self-regulation is generally concerned with standards, rather than the strict “letter of the law” which may be the case with prescriptive legislative regulation. This is particularly important when the business is very technical and, in a competitive environment, when financial innovation is an important feature of the industry. Above all, self-regulation is more likely to be flexible and adaptable to a changing market environment than regulation based upon legislatively imposed requirements. A consideration in this regard is that it can prove difficult and time-consuming to have the law amended or revised.

In terms of the functional approach, self-regulation has become all the more important – indeed the cornerstone of much financial regulation. The co-existence of self-regulation and official institutional regulation requires proper co-ordination to ensure regulatory consistency. The regulatory structure that has evolved over time could pose difficulties for the achievement of proper co-ordination, as it may prove difficult to merge the responsibilities or to reassign them more effectively. To the extent that responsibilities cannot be merged – the case of self-regulation by a financial exchange and official regulation by the statutory regulatory authorities – co-ordinating mechanisms need to be introduced. Such mechanisms may consist of co-ordinating boards, committees, or “lead-regulator” arrangements. Without co-ordination there is little likelihood of achieving competitive neutrality between the different financial market participants.

Related to cost-efficiency is the issue of the structure and number of regulatory authorities and the relationship between them. When a financial institution, or financial activity, involves more than one regulatory authority, there has to be effective co-ordination and consistency between them as well as consistent rulebooks and regulatory requirements. The existence of numerous regulatory authorities gives rise to the hazards of complexity, inconsistencies, overlaps, duplication and higher administrative costs. In principle, there must be a general presumption that the fewer the regulatory authorities, the fewer the problems of consistency and co-ordination. However, this consideration must be balanced against the advantage of efficiency to the extent that this requires specialist regulators, especially if there is a strong element of self-regulation. Self-regulation is more effective as the regulated activity becomes more specialised. It is a question of balance between cost-efficiency and administrative effectiveness. The issues are complex as has been demonstrated in virtually all countries with split regulatory responsibilities.

The question of the distribution of supervisory responsibilities and co-ordination among different authorities has acquired greater significance in the light of the despecialisation and internationalisation of institutions. National authorities remain divided as to the merits of the centralisation of supervisory responsibilities, with views being significantly affected by the historical legal framework. There is consensus, however, on the need for further co-operation domestically and internationally in areas such as the precise allocation of responsibilities, the exchange of information and, to a lesser extent, greater consistency of supervisory methods.

4.5 General principles

General principles are those that have a bearing on the general conduct of the regulatory process. With one or more regulatory instruments being employed in any specific regulatory arrangement, the following general principles may be formulated:

- Every regulatory arrangement should be related explicitly to one or more of the objectives identified.
- All regulatory arrangements should be justified with respect to their cost-efficiency.
- The costs of regulatory arrangements should be distributed equitably.
- All regulatory arrangements should be sufficiently
flexible, in the sense of being amenable to changes in markets, competition and the evolution of the financial system.

- Regulatory arrangements should be practitioner-based.
  Regulatory arrangements (especially with respect to capital) should be precisely related to the objectives they are designed to achieve. If regulatory arrangements are not related to the objectives (in the sense of being consistent with the objectives of financial regulation), negative effects would be inevitable. These negative effects would include the discouraging of competition and the stifling of financial innovation. Accordingly, it is essential that all regulatory arrangements should be applied judiciously.

  In the context of consumers valuing both the benefits of regulation and competition, and with regulation imposing costs both on consumers and the regulated, regulatory structures and detailed regulatory arrangements need to be based upon explicit cost-benefit analysis. The requirement is that regulation should be not only effective, but also cost-efficient. Certain regulatory arrangements may be desirable in terms of the regulatory objectives but may, nevertheless, not be justified in terms of their wider costs. Because of the increased complexity and the wider range of financial services covered, the direct costs of regulation have risen. Given these costs, a judgement clearly has to be made as to how far the objectives of regulation (e.g. protection of the consumer from all possible abuse) can reasonably be pursued and what cost is reasonable to bear. Leaving aside the direct administrative costs, if the result of a totally abuse-free and safe system means a serious impairment of competition, the stifling of financial innovation and the loss of business to foreign centres, then a judgement has to be made, on cost-benefit terms, whether further regulatory imposts yield diminishing marginal returns and so cease to be cost-effective.

  Regulation is not a free good and the costs of an effective regulatory system and regulatory arrangements are substantial. The question arises as to who should bear such costs – two basic models are employed in most countries as follows:

- The costs are borne by a government or parastatal agency and hence by taxpayers in general. This is not necessarily inequitable as a substantial number of taxpayers are directly or indirectly the beneficiaries of an effective regulatory system.

- The regulatory agency recovers its costs from the institutions which it supervises. In practice this means that the institutions pass on the costs of regulation to their customers in their pricing structures. It can be argued that this system is more equitable since it places the costs of regulation with those who benefit directly from such regulation, i.e. the customers of the regulated institutions.

  Neither the structure of financial systems nor the business operations of institutions are static – both evolve over time. Similarly, regulation should also evolve, and a major principle to be applied is that regulation should be a dynamic process which changes to reflect the competitive climate and market environment. If regulation moves out of step with competition, serious business distortions and inefficiencies are likely to arise. Sufficient flexibility of regulatory arrangements would ensure the necessary adaptability to changes and could assist in achieving the regulatory objectives in an optimum fashion by permitting the appropriate response to such changes. Whether they be market changes or changes in competitive positions, they emanate from the continuous process of financial innovation as well as other evolutionary forces present in the national economy.

  For regulatory arrangements to be practitioner-based, they need to be devised in consultation with market participants. With consultations opening the door for divulging information and responses between regulators and the regulated, the industry would contribute significantly to the development of the regulatory system. Better results would be forthcoming if such practitioner-based regulatory arrangements were employed. By creating a better understanding between the regulators and the regulated, practitioner-based regulatory arrangements would serve the additional purpose of facilitating the regulatory process itself. Overall, explicit arrangements need to
be made to ensure that regulated institutions and market practitioners participate in the establishment of specific regulatory requirements.

5. Conclusion

Financial systems around the world are undergoing major structural changes, owing largely to increased competition. At the same time, regulatory arrangements have also changed and become more complex. In many countries a global dimension to regulation has emerged. Today the tendency is to harmonise national financial regulation with the international standards set by bodies such as the International Accounting Standards Committee (IASC), the Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO) or the International Association of Insurance Supervisors (IAIS).

In a rapidly changing market environment, traditional views about financial regulation should always be subject to scrutiny and challenge. It should never be taken as axiomatic that regulation is always effective and efficient and precisely related to its alleged objectives. If the ultimate purpose of regulation is to protect the consumer and serve systemic interests, then it should be subjected to the test of whether it does so effectively and cost-efficiently. It also requires that specific regulatory arrangements should be subjected to the same test, for arguments against particular mechanisms may not invalidate the arguments for regulation in general. The precise rationale of all regulatory arrangements and structures needs to be succinctly identified rather than taken for granted. Regulation should, therefore, be an evolving process and responsive to changes in the market environment. Indeed, regulation that remains stable irrespective of changes to the financial system will be inefficient at best and perhaps even perverse.