

**A COMPARATIVE ANALYSIS OF THE ROLE OF THE  
CENTRAL BANK IN PROMOTING AND MAINTAINING  
FINANCIAL STABILITY IN SOUTH AFRICA**

by

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**BOET AND MARTIE FOURIE**

who are such good examples of living  
meaningful lives

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<sup>1</sup> From ‘Because you loved me’ – written by Diane Warren.

## SUMMARY

The 2008 Global Financial Crisis shook financial systems worldwide to their roots and set regulators on a new course post Crisis where the pursuit of financial stability emerged as apex regulatory objective. This new regulatory paradigm resulted in an expanded financial stability mandate for central banks. Given the “fuzziness” of the concept of financial stability it is quite challenging to regulate this new mandate. Inevitably it also entails considering which model of financial regulation is the optimal model within which to locate the central bank and its expanded mandate. Pertinently it needs to be considered how the appropriate legislative and institutional framework can be designed in order to specifically enable effective execution of the financial stability mandate of the central bank and also enable the promotion of financial stability in the broader regulatory context via prudential and market conduct regulation of financial institutions.

This thesis thus trails the evolution of central banks and their various roles that are relevant in the context of financial stability. It considers the impact of the GFC on regulation and ponders the concept of financial stability as core regulatory objective, post GFC, and how it has had an impact on the role of the central bank in this regard. It further considers the main models of financial regulation focusing specifically on Twin Peaks, given that that is the model that has been selected by South Africa, and in which the South African Reserve Bank and its expanded financial stability mandate will be positioned.

The study delves deeper into the role of the South African central bank in respect of the promotion and maintenance of financial stability, and considers how this role has changed in the context of the Twin Peaks model (as set out in the Financial Sector Regulation Act) that South Africa recently adopted in August 2017. A comparative investigation is then undertaken of the Twin Peaks models, adopted in Australia and the Netherlands respectively. These comparative investigations focus specifically on the role of the central bank in the Twin Peaks context, insofar as promotion and maintenance of financial stability is concerned, but also more broadly into Twin Peaks as a regulatory model that enables financial stability on a broader scale. The study is concluded with recommendations for future reform and research.

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## LIST OF ABBREVIATIONS

Herewith a list of the main abbreviations used in this thesis in alphabetical order:

<u>Words in full</u>	<u>Abbreviation</u>
Authorised Deposit-taking Institution	ADI
<i>Stichting Autoriteit Financiële Markten</i>	AFM
Australian Prudential Regulation Authority	APRA
Australian Prudential Regulation Commission	APRC
Australian Securities and Investments Commission	ASIC
European Bank Recovery and Resolution Directive	BBRD
Basel Committee on Banking Supervision	BCBS
Bank for International Settlements	BIS
Council of Financial Regulators	CFR
Corporations and Financial Services Commission	CFSC
Committed liquidity facility	CLF
Constitution of the Republic of South Africa, 1996	Constitution
Fourth Capital Requirements Directive	CRD IV

Capital Requirements Regulation accompanying CRD IV	CRR
De Nederlandsche Bank	DNB
Debt-to-income	DTI
Domestic systemically important banks	D-SIBs
European Banking Authority	EBA
European Central Bank	ECB
European Economic Community Treaty	EC Treaty
European Insurance and Occupational Pensions Authority	EIOPA
Emergency liquidity assistance	ELA
European Supervisory Authorities	ESAs
European System of Central Banks	ESCB
European System of Financial Supervisors	ESFS
European Stability Mechanism	ESM
European Securities and Markets Authority	ESMA
European Systemic Risk Board	ESRB
European Union	EU
Financial Intelligence Centre	FIC
Financial Sector Assessment Program	FSAP
Financial Stability Board	FSB
Financial Stability Committee	FSC
Financial Sector Conduct Authority	FSCA

Financial Sector Contingency Forum	FSCF
Financial System Council of Regulators	FSCR
Financial Stability Department	FSD
Financial System Inquiry	FSI
Financial Stability Oversight Committee	FSOC
Financial Sector Regulation Act	FSR Act
Financial System Stability Assessment	FSSA
Global Financial Crisis	GFC
Global systemically important banks	G-SIBs
International Financing Reporting Standards	IFRS
International Monetary Fund	IMF
Key Attributes of Effective Resolution Regimes for Financial Institutions	KAs
Large Complex Financial Institutions	LCFIs
Liquidity Assets and Government Securities	LGS
Loan-to-value	LTV
Mortgage interest deductibility	MID
Memorandum of understanding	MOU
National Credit Regulator	NCR
Non-operating Holding Company	NOHC
Prudential Authority	PA
<i>Stichting Pensioen- en Verzekeringkamer</i>	PVK

Reserve Bank of Australia	RBA
<i>Raad van Financiële Toezichthouders</i>	RFT
South African Reserve Bank	SARB
South African Reserve Bank Act	SARB Act
Systemically important financial institution	SIFI
Single Resolution Mechanism	SRM
Single Supervisory Mechanism	SSM
<i>Stichting Toezicht Effectenverkeer</i>	STE
<i>Wet op het financieel toezicht</i>	Wft
<i>Wet toezicht beleggingsinstellingen</i> 1990	Wtb
<i>Wet toezicht kredietverkeer</i> 1992	Wtk 1992
<i>Wet toezicht verzekeringsbedrijf</i> 1993	Wtv
<i>Wet inzake de wisselkantoren</i> 1994	Wwk

No civilization - the man-made artefact to house successive generations - would ever have been possible without a framework of stability, to provide the wherein for the flux of change. Foremost among the stabilizing factors, more enduring than customs, manners and traditions, are the legal systems that regulate our life in the world and our daily affairs with each other.

Hannah Arendt (1906-1975) German-born American political theorist in *The Crises of the Republic* on "Civil Disobedience" (1972)

# **CHAPTER 1**

## **INTRODUCTION AND BACKGROUND TO THE STUDY**

- 1.1 Introduction**
  - 1.2 The evolution of central banking**
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-

## 1.1 Introduction

The financial system is pivotally important to a country's economy. It enables the financial intermediation process which facilitates the flow of funds between savers and borrowers, and by doing so ensures that financial resources are allocated efficiently for the promotion of a country's economic growth.<sup>2</sup> It is a critical cog in the machinery of modern society.

In the context of the financial system, banks are generally the major players. It has long been recognized that banks play a special role in the economy because they perform financial intermediation services that are fundamental to the functioning of an economy.<sup>3</sup> These financial services vary from the taking of deposits and the extension of credit, to the processing of payments and a myriad other functions.<sup>4</sup> Given their crucial importance, and by virtue of their role in the financial system, especially their function as deposit-taking institutions, it is well accepted that banks have to be closely regulated and supervised.<sup>5</sup> It is inter alia this realization that gave birth to the notion of central banks as a locus of control in the fast-paced, dynamic banking industry.<sup>6</sup>

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<sup>2</sup> Merton RC "The Financial System and Economic Performance" 1990 *Journal of Financial Services Research* 263; Prast H and van Lelyveld I "New architectures in the regulation and supervision of financial markets and institutions" DNB Working Paper No. 21/December 2004 (2004) [https://www.dnb.nl/binaries/Working%20Paper%2021\\_tcm46-146678.pdf](https://www.dnb.nl/binaries/Working%20Paper%2021_tcm46-146678.pdf) (accessed 26 February 2018) 16. Delete highlighted spacer

<sup>3</sup> Corrigan GE "Are Banks Special?" Federal Reserve Bank of Minneapolis (1 January 1983) <https://www.minneapolisfed.org/publications/annual-reports/are-banks-special.pdf> (accessed 8 May 2017) 1; Bossone B "What makes Banks Special? A study of Banking Finance and Economic Development" World Bank Policy Research Working Paper (August 2000) [https://openknowledge.worldbank.org/bitstream/handle/10986/19815/multi\\_page.pdf?sequence=1&isAllowed=y](https://openknowledge.worldbank.org/bitstream/handle/10986/19815/multi_page.pdf?sequence=1&isAllowed=y) (accessed 9 May 2017) 15.

<sup>4</sup> Hupkes E and Devos D "Cross-Border Bank Resolution: A Reform Agenda" in Giovanni M and Devos D (eds.) *International Monetary and Financial Law the Global Crisis* (2010) 362.

<sup>5</sup> Dow S C "Why the banking system should be regulated" 1996 (106) *The Economic Journal* 698; Schwarcz SL "Banking and Financial Regulation" in *Oxford Handbook of Law and Economics* (2015) 2.

<sup>6</sup> Bordo M "A brief history of central banks" Federal Reserve Bank of Cleveland research department (December 2007) [www.ec%2020071201%20a%20brief%20history%20of%20central%20banks%20.pdf.pdf](http://www.ec%2020071201%20a%20brief%20history%20of%20central%20banks%20.pdf.pdf) (accessed 1 December 2016) 1, hereinafter Bordo 2007; De Jager J "The South African Reserve Bank: An Evaluation of the Origin, Evolution and Status of a Central Bank (Part 1)" 2006 *SA Merc LJ* 159, hereinafter De Jager 2006 no. 1.

Since their inception central banks have dominated the history of banking.<sup>7</sup> As such central banks have gained importance not only in the banking industry, but also in the broader financial system and economy. Central banks accumulated many functions that added gravitas to their role: responsibility for monetary policy; supervision of payment and settlement systems; bank supervision; banker for the government and other banks; lender of last resort, and the maintenance of financial stability.<sup>8</sup>

Over the years many financial crises have threatened the existence of financial systems in various parts of the globe. However in 2008 the world experienced a global meltdown of epic proportions, spreading from its toxic epicenter in the US to eventually bringing age European Union (EU) Member States such as Greece to its knees.<sup>9</sup> The 2008 Global Financial Crisis (GFC) was a seismic event that has been cemented into the history of mankind. It turned long-held beliefs about financial regulation on its heads; for example that sound monetary policy will guarantee financial stability or that a micro-focus on prudential regulation is sufficient to guard the financial system against risk.<sup>10</sup> Following waves of regulation and deregulation the build-up to the GFC was characterized by rapid innovation in financial markets, profit-seeking and risk-taking driven by unchecked greed and, unfortunately, lax financial regulation.<sup>11</sup>

The regulatory landscape that emerged after the GFC is very different from the one that prevailed prior to the Crisis. A new holy grail of financial regulation has emerged: the pursuit of financial stability.<sup>12</sup> With it came a changed role for the central bank - in

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<sup>7</sup> Bordo 2007; See also Lowe P “Maintaining financial stability: the role of the central bank” December 1999 *Economic Papers A Journal of applied economics and policy* Vol 18 Issue 4 26, hereinafter Lowe 1999; Arner DW and Taylor W “The Global Financial Crisis and the Financial Stability Board: Hardening the soft law of international financial regulation?” 2009 (32) *UNSW Law Journal* 488, hereinafter Arner & Taylor 2009 at 509.

<sup>8</sup> Blinder AS “How central should the central bank be?” CEPS Working Paper No 198 (January 2010) <https://www.princeton.edu/ceps/workingpapers/198blinder.pdf> (accessed 27 February 2018) 2.

<sup>9</sup> Allen F and Carletti E “An Overview of the Crisis: Causes, Consequences and Solutions” (26 November 2009) <http://apps.eui.eu/Personal/Carletti/IRF-Overview-Allen-Carletti-26Nov09-final.pdf> (accessed 30 April 2018), hereinafter Allen & Carletti 2009; Nelson RM, Belkin P and Mix DE “Greece’s Debt Crisis: Overview, Policy Responses and Implications” Congressional Research Service (August 2011) <https://fas.org/sgp/crs/row/R41167.pdf> (accessed 30 April 2018).

<sup>10</sup> Goodhart CAE “The Changing Role of Central Banks” BIS Working Paper No. 326 (25 November 2010) <https://www.bis.org/publ/work326.htm> (accessed 9 May 2018), hereinafter Goodhart 2010.

<sup>11</sup> Allen & Carletti 2009.

<sup>12</sup> Group of Thirty Consultative Group on International Economic and Monetary Affairs Inc “Financial reform - a framework for financial stability” (15 January 2009) <http://group30.org/images/uploads/>

the post Crisis landscape: the part that central banks should play in the promotion and maintenance of financial stability has been expanded and illuminated.<sup>13</sup> In this regulatory helter-skelter many countries have not only augmented the role of their central banks with regard to financial stability but have embarked on wholesale reviews of their approach to financial regulation in a quest to find the most suitable model of financial regulation within which to locate their central bank with its expanded financial stability mandate.

This first chapter aims to give the reader a comprehensive background on the topic of the study in order to inform and contextualize the discussions that follow in successive chapters. Consequently this chapter will be longer and more detailed than what the reader would generally expect when reading the introductory chapter to a thesis but it is submitted that only by having the broader picture in full view, will the reader be better positioned to evaluate the magnitude and complexities of the research subsequently undertaken. Once the full picture is provided of what informs the context against which this research is undertaken, will the reader be introduced to the research statement and objectives, the selection of the comparative jurisdictions and the roadmap for the chapters that follow. Chapter One is thus of necessity a long chapter but its length is

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publications/G30\_FinancialReformFrameworkFinStability.pdf (accessed 9 May 2018), hereinafter Group of Thirty 2009, at 36: "Where not already the case, central banks should accept a role in promoting and maintaining financial stability. The expectation should be that concerns for financial stability are relevant not just in times of financial crisis, but also in times of rapid credit expansion and increased use of leverage that may lead to crises"; Goodhart CAE "A Framework for Assessing financial stability" 2006 (30) *Journal of Banking and Finance* 3415, hereinafter Goodhart 2006, at 3415 - 3422; Allen "What is "financial stability"? The need for some common language in international financial regulation" 2014 *Georgetown Journal of International Law* 929, hereinafter Allen 2014; Allen, William and Geoffrey Wood (2006) "Defining and achieving financial stability" *Journal of Financial Stability* Vol 2 issue 2 June 2006 152-172, hereinafter Allen & Wood 2006.

<sup>13</sup> Goodhart CAE "The Past Mirror: Notes, Surveys, Debates – The changing role of central banks" 2011 *Financial History Review* 135, hereinafter Goodhart 2011, at 142; Goodhart 2010; Speech by Peter Praet, Member of the Executive Board of the European Central Bank at the 14<sup>th</sup> Annual Internal Banking Conference, organised by the Federal Reserve Bank of Chicago and the European Central Bank "The (changing) role of central banks in financial stability policies" on 10 November 2011 at Chicago <https://www.ecb.europa.eu/press/key/date/2011/html/sp111110.en.html> (accessed 9 May 2018); Buiter "The role of central banks in financial stability: How has it changed?" International Macroeconomics Centre for Policy Research (2012) <http://www.cepr.org> (accessed 30 April 2018); Nier EW "Financial Stability Frameworks and the role of central banks: lessons from the crisis" IMF Working Paper WP/09/70 (April 2009) <https://www.imf.org/external/pubs/ft/wp/2009/wp0970.pdf> (accessed 15 February 2018); Georgsson M, Vredin A and Sommar PA "The modern central bank's mandate and the discussion following the financial crisis" (20 March 2015) [http://www.riksbank.se/Documents/Rapporter/POV/2015/2015\\_1/rap\\_pov\\_artikel\\_2\\_150325\\_sve.pdf](http://www.riksbank.se/Documents/Rapporter/POV/2015/2015_1/rap_pov_artikel_2_150325_sve.pdf) (accessed 15 February 2018).

vital - it is one instance where it will not suffice to make a long story short because the long story matters.

## **1.2 The evolution of central banking**

In the context of bank regulation and supervision, central banks feature prominently. The origins of central banking date back to the seventeenth century when the Swedish Riksbank was established in 1668 as a joint stock bank, chartered to lend the government funds and to act as a clearing house for commerce.<sup>14</sup> A few decades later, in 1694, the most famous central bank of the era, the Bank of England, was also established as a joint stock company to purchase government debt. Several other central banks were subsequently established across Europe. These early central banks issued private notes which served as currency and they often had a monopoly over such note issue.<sup>15</sup>

Bordo points out that while these early central banks helped fund the government's debt, they were also private entities that engaged in banking activities. Due to the conflict that arose between the profit maximizing objectives of central banks and the role they came to fulfil in the financial system, central banks moved away from the notion of profit maximizing and became non-profit entities that operated in the public interest. As they held the deposits of other banks, they came to serve as banks for bankers, facilitating transactions between banks or providing other banking services. They became the repository for most banks in the banking system because of their large reserves and extensive networks of correspondent banks. These roles allowed them to become the "lender of last resort" in times of financial crisis, as they were willing to provide emergency cash to their correspondent banks in times of financial distress.<sup>16</sup> The early history of central banking led to the function of monetary management and the role of lender of last resort being combined within the developing central banks. The banks that evolved into central banks were often the government's

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<sup>14</sup> Bordo 2007. See also Lowe 1999.

<sup>15</sup> Bordo 2007 1.

<sup>16</sup> See 1.3.2 and 1.4.2 below for an overview of the central bank's role as lender of last resort.

bank and, until the latter part of the 19<sup>th</sup> century, generally the largest bank within the economy.<sup>17</sup>

A later wave of central banks emerged at the turn of the twentieth century. These banks were created primarily to consolidate the various instruments that people were using for currency, and to ensure financial stability. Many were also created to manage the gold standard,<sup>18</sup> to which most countries adhered at the time. Central banks of this era, like their earlier counterparts, also acted as “lenders of last resort” injecting liquidity into the market in times of financial distress when events like bad harvests, railroad defaults, or wars precipitated a scramble for liquidity - typical “bank-runs” in which investors ran to their banks and tried to withdraw and convert their deposits into cash.<sup>19</sup>

Bordo remarks that “the lesson” for central banks began early in the nineteenth century as a consequence of the Bank of England’s routine response to bank panics, which

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<sup>17</sup> Bordo 2007 1; See also Goodhart C & Schoenmaker D “Should the functions of monetary policy and banking supervision be separated?” October 1995 *Oxford Economic Papers* Volume 47 No. 4 539, hereinafter Goodhart & Schoenmaker 1995, at 540 – 541.

<sup>18</sup> Bordo 2007 1 explains that the gold standard, which prevailed until 1914, meant that each country defined its currency in terms of a fixed weight in gold. Central banks held large gold reserves to ensure that their notes could be converted into gold, as was required by their charters. When their reserves declined because of a balance of payments deficit or adverse domestic circumstances, they would raise their discount rates (being the rates at which they lent money to other banks) and this in turn would raise interest rates more generally, which attracted foreign investment, thereby bringing more gold into the country; Borio C “The search for the elusive twin goals of monetary and financial stability” (August 2004) [https://www.researchgate.net/publication/248521863\\_The\\_Search\\_for\\_the\\_Elusive\\_Twin\\_Goals\\_of\\_Monetary\\_and\\_Financial\\_Stability](https://www.researchgate.net/publication/248521863_The_Search_for_the_Elusive_Twin_Goals_of_Monetary_and_Financial_Stability) (accessed 13 February 2017) 6, hereinafter Borio 2004, states “Under the classical Gold Standard a liberalised financial regime coexisted with monetary arrangements that resulted in a good measure of price stability over longer horizons. One can think of convertibility into gold as acting as the single anchor for monetary and financial stability. Monetary stability was defined in terms of maintenance of convertibility. In turn, the convertibility constraint would typically give way at times of financial instability, when deposits could no longer be turned into gold at par.” Borio explains that in the inter-war years, still against the background of liberalised financial markets, the progressive emergence of fiat standards clouded the tight link between monetary and financial stability and loosened the constraints on credit expansion.

<sup>19</sup> Bordo 2007 1 and 2; Hockett R “The macroprudential turn: From institutional safety and soundness to systematic financial stability in financial supervision” 2015 (9) *Virginia Law and Business Review* 201, hereinafter Hockett 2015, at 208 explains: “A bank-run can start when there is a rumour of a bank that might possibly become insolvent. It would be rational for depositors in the bank to withdraw their funds as soon as possible. If they wait too long, they might lose their deposits. These rational decisions by the depositors will bring about exactly what they are fearing. Therefore mere fears of a solvency crisis can morph into a liquidity crisis that morphs into a solvency crisis. Everyone is then harmed, although their decisions to withdraw their money, were reasonable.”

response entailed that the Bank would protect its own gold reserves, turning away its correspondents in need, and subsequently leading to major panics in 1825, 1837, 1847 and 1857. The Bank of England was severely criticised for this reaction and, in response, it adopted the ‘Responsibility doctrine’, proposed by economic writer Walter Bagehot. This doctrine required the bank to subsume its private interest to the public interest of the banking system as a whole. The Bank of England began to follow “Bagehot’s rule”<sup>20</sup> which entailed lending freely on the basis of any sound collateral offered - but at a penalty rate so as to prevent “moral hazard”.<sup>21</sup> Bagehot accepted that the central bank should only attempt to assist those banks which could expect to be solvent (or to regain solvency) under normal conditions where there was no panic,

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<sup>20</sup> Goodhart & Schoenmaker 1995 541: Bagehot wrote *Lombard Street: A description of the money market* in 1873 after the Overend Gurney crash in 1866, when it was suspected that the reluctance of the Bank to support that House was due to commercial rivalry. De Jager J “Central bank, lender of last resort assistance: An elusive concept?” 2010 (43) *De Jure* 228, hereinafter De Jager 2010, at 233 mentions that Bagehot elaborated on the classic theoretical foundation of the lender of last resort doctrine of Henry Thornton, who defined its principles in 1802. Thornton suggested that the provision of liquidity to the market was the best way of containing a panic. De Jager points out that both Thornton and Bagehot contended that the lender of last resort responsibility was owed to the market and the entire financial system, and not to specific institutions. It was aimed at restoring confidence and re-establishing credibility in a bank or banks.

<sup>21</sup> Bordo 2007 2; Halme L, Hawkesby C, Healy J, Saapar I and Soussa F “Financial Stability and Central Banks: Selected issues for Financial Safety Nets and Market Discipline” - issued by the centre for central banking studies, Bank of England (2000) <https://pdfs.semanticscholar.org/9fb7/71799165d984af987bed03e6b2be45c2b174.pdf> (accessed 3 December 2017) 19, hereinafter Halme et al 2000, state that moral hazard occurs when people like bank managers are given incentives to take on more risk than they should and they then rely on the central bank to provide liquidity when the bank is in distress; The Economic Times (undated) <http://economictimes.indiatimes.com/definition/moral-hazard> (accessed 15 December 2016) explains that the economic concept “moral hazard” describes a situation in which one party gets involved in a risky event knowing that it is protected against the risk and the other party will incur the cost. In a financial market, there is a risk that the borrower might engage in activities that are undesirable from the lender’s point of view because they are less likely to pay back a loan. It occurs when the borrower knows that someone else will pay for the mistakes they make. This in turn gives the borrower the incentive to act in a riskier way; see also Financial Stability Forum guidance for developing effective deposit insurance systems (2001) [http://www.fsb.org/wp-content/uploads/r\\_0109b.pdf?page\\_moved=1](http://www.fsb.org/wp-content/uploads/r_0109b.pdf?page_moved=1) (accessed 5 July 2016) where it is mentioned that moral hazard refers to the tendency for excessive risk taking by those protected by deposit insurance; Mishkin FS “What should Central Banks do?” Paper prepared for the Homer Jones Lecture, Federal Reserve Bank of St. Louis (30 March 2000) [http://www.tek.bke.hu/files/szovegek/mishkin\\_what\\_should\\_central\\_banks\\_do.pdf](http://www.tek.bke.hu/files/szovegek/mishkin_what_should_central_banks_do.pdf) (accessed 25 January 2017), hereinafter Mishkin 2000, at 14: Central banks need to focus on financial stability, because they should care about fluctuations in output, that is in the quantity of goods and services produced, and the most serious economic shrinking arises when there is financial instability. Therefore central banks need to focus on preventing financial instability. A vital way of preventing financial instability is by acting as a lender of last resort, that is, by supplying liquidity to the financial system to keep a financial crisis from spinning out of control. Mishkin aptly remarks “Because acting as a lender of last resort in effect provides a safety net for financial institutions to whom the funds will be channelled, it creates a moral hazard problem in which these institutions who are potential borrowers have incentives to take on excessive risk, which can make financial instability more likely. Central banks thus need to consider the trade-off between the moral hazard of last resort and the benefit of preventing financial crises. To keep moral hazard from getting out of hand indicates that central banks should not perform the role of lender of last resort unless it is absolutely necessary and this role should, therefore, occur very infrequently.” (See more on lender of last resort in 1.2.2 and 1.3.2 below).

but he advocated the idea that a central bank should seek to act for the public good, and not simply as a private competitor for business.<sup>22</sup> Tucker therefore notes that the classic Bagehot view of the central bank's lender of last resort function was to lend freely to solvent but illiquid firms against good collateral at a high rate of interest.<sup>23</sup> Given the central bank's stabilizing role as lender of last resort, Goodhart and Schoenmaker thus remark that from an early date, the functions of macro-monetary policy and of micro-crisis management were carried out by the same institution, namely the central bank.<sup>24</sup>

Until 1914, and to a large extent thereafter, central banks saw themselves as special kinds of banks, and not as official agencies, or public sector bodies. Like other commercial bankers, central banks assessed the quality of the paper offered by other banks on the market and assessed fellow banks' credit-worthiness. They however never had a formal duty to inspect and to give regulatory orders to the other commercial banks at any time prior to 1914. Therefore the central bank's function at that stage did not generally imply any large scale exercise of supervisory or regulatory operations.<sup>25</sup> Bordo further indicates that before 1914 central banks did not attach great weight to maintaining the domestic economy's stability. After World War 1 this approach however changed as central banks began to be concerned about employment, real economic activity and the price level.<sup>26</sup>

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<sup>22</sup> Goodhart & Schoenmaker 1995 541.

<sup>23</sup> Tucker P "The lender of last resort and modern central banking: principles and reconstruction" Bank for International Settlements Papers No.79 10 (September 2014) [www.bis.org/publ/bppdf/bis\\_pap79b\\_rh.pdf](http://www.bis.org/publ/bppdf/bis_pap79b_rh.pdf) (accessed 28 October 2016) 12, hereinafter Tucker 2014, at 16.

<sup>24</sup> Goodhart & Schoenmaker 1995 541. They indicate that it was the willingness of central banks to take the lead in bank rescues during the late 19th century that helped to establish their role as a quasi-official monetary authority. They further point out that the Bank of England's rescue of Baring Bros in 1890 is probably the best known, but both the Banque de France in 1889 and the Banca d'Italia in 1893 were similarly involved in crisis management and bank rescues.

<sup>25</sup> Goodhart & Schoenmaker 1995 541 – 542.

<sup>26</sup> Bordo 2007 2; Arner & Taylor 2009 509 – 510 mention that during the period of global finance before the First World War, there was not only no international financial regulation, but there was also very little domestic financial regulation as well. At the end of the Second World War, the premise was still that finance would be domestic and subject therefore only to domestic regulation. This only changed in the 1970s when finance was internationalising. In response to the risks raised by the increasing internationalisation of finance, domestic central banks and regulators established informal committees hosted by the Bank for International Settlements (BIS). As finance continued to internationalise throughout the 1970s and 1980s, these initial efforts expanded beyond banking to a range of other areas, including securities and accounting. As a result of the 1980s debt crisis and other cross-border financial problems, these informal committees began to agree common approaches to common problems, with such approaches implemented via domestic legal and regulatory systems – a network

A key force in the history of central banking has been central bank independence.<sup>27</sup> Although the position of central banks in terms of different countries' constitutions and the central bank's affiliation with their government, commercial banks and the financial system in the country as a whole, varies, the general foundation of the central-banking doctrine was that central banks should be independent of political influences.<sup>28</sup> Central-bank independence and autonomy starts with the premise that it is the prerogative of the State to formulate and implement monetary policy and to ensure a sound financial system which fosters efficient resource allocation. De Jager remarks that it is therefore rational for a Government to delegate this authority to an autonomous central bank, and to provide such institution with clearly defined and prioritised goals, and sufficient powers, to achieve these objectives. The central bank is then held accountable in order to maintain some checks and balances. Accordingly, the functions of a central bank and the effective execution thereof, depend on the degree of autonomy afforded to it, in order for it to function independently within, and not from, the Government.<sup>29</sup>

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based, soft law approach of which the 1988 Basel Capital Accord is the leading and most widely implemented example.

<sup>27</sup> Goodhart 2011 142 remarks that if a central bank is independent, it provides credibility for a policy targeting inflation. In contrast, a Minister of Finance has conflicts of interest by being responsible for inflation policy, since a Minister could lower the interest rate to get more votes, especially before an upcoming election; De Jager J "Room to manoeuvre: the concept of central banks independence and the South African Reserve Bank" in Hugo C and Kelly-Louw M (eds.) *Jopie: Jurist, Mentor, Supervisor and Friend – Essays on the Law of Banking, Companies and Suretyship* (2017) 79, hereinafter De Jager 2017, at 83 indicates that to ascertain whether a central bank is independent or not, the legal mandate and procedures to ensure transparency remain key elements. The more independent a central bank is, the more accountable it should be; Canova TA "Black Swans and Black Elephants in Plain Sight: An Empirical Review of Central Bank Independence" 2011 (14) *Chapman Law Revue* 237, hereinafter Canova 2011, at 283; Canova on the other hand opines that the assumptions made by Samra HJ in "Central Bank Autonomy in Latin America: A survey and case studies" 2009 (14) *Chapman Law Review* 63, who argued for central bank independence, are flawed. Canova also opines on 283 that the regime of independent central banking has contributed significantly to a financial and economic crisis of historic proportions.

<sup>28</sup> De Jager 2006 no. 1 159 and 161; De Jager 2017 93 states: "The independence of a central bank to conduct monetary policy without being influenced by short-term political considerations, is important as well as fragile. The independence of the SARB depends on the measure of understanding, acceptance and respect that the notion has in the political culture in the RSA and how deep and firmly the rule of law is embedded in the constitutional construct of this country."

<sup>29</sup> De Jager J "The South African Reserve Bank: An Evaluation of the Origin, Evolution and Status of a Central Bank (Part 2)" 2006 *SA Merc LJ* 274, hereinafter De Jager 2006 no.2, at 283 and 288. An oft-quoted remark with regard to central banks is that such institutions "should possess sufficient independence and authority to take away the punch bowl at a stage when the party is still going on". (William McChesney Martin, Federal Reserve chairman in the 1950s and 1960s, is credited with the punch bowl aphorism as mentioned in Canova 2011 237.) Accordingly, central-bank autonomy and accountability constitute internationally accepted norms of good practice. Central-bank independence

Lybek and Morris distinguish between the following kinds of central bank autonomy: goal autonomy; target autonomy; instrument autonomy and limited autonomy.<sup>30</sup> “Goal autonomy”, which is the broadest form of autonomy, entrusts the central bank with responsibility for determining monetary policy and the exchange rate regime, or monetary policy if the exchange rate is floating. Goal autonomy gives the central bank the authority to determine its primary objective from among several objectives included in the legislation governing the central bank.<sup>31</sup> “Target autonomy” also entrusts the central bank with responsibility for determining monetary policy and the exchange rate regime, or simply monetary policy where the exchange rate is floating. Other than goal autonomy, target autonomy has one clearly defined primary objective stated in the legislation.<sup>32</sup> “Instrument autonomy” implies that the government or legislature decides the monetary policy target, in agreement with the central bank, or the exchange rate regime. However the central bank retains sufficient authority to implement the monetary policy target using the instruments it deems fit.<sup>33</sup> “Limited” or “no autonomy” refers to instances where the central bank is basically a government agency. The government determines the monetary policies and influences the implementation thereof. This mainly occurs in centrally planned economies and in some developing countries.<sup>34</sup>

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is regarded as a major issue largely because of the need for an institutional framework that could assist monetary policy in delivering low inflation; According to De Jager in De Jager J “The South African Reserve Bank: Blowing Winds of Change (Part 2)” 2013 *SA Merc LJ* 492, hereinafter De Jager 2013 no. 2, at 498: The independence of central banks could possibly be diminished by the government’s participation in and accountability for affairs related to financial stability. He remarks that it has been seen that it is more difficult for central banks to act separately of, and independently from, governments, with regards to pursuing the purpose of financial stability, specifically when financial turmoil occurs on a large scale, than it is to act in order to bring to bear monetary policy objectives.

<sup>30</sup> Lybek T and Morris J “Central Bank Governance: A survey of boards and management” IMF Working Paper No. 04/226 (1 December 2004) <http://www.imf.org/en/Publications/WP/Issues/2016/12/31/Central-Bank-Governance-A-Survey-of-Boards-and-Management-17846> (accessed 15 October 2017), hereinafter Lybek & Morris 2004, at 9.

<sup>31</sup> Lybek & Morris 2004 11. The authors point out that in goal autonomy also gives the central bank the authority to determine its primary objective in the rare instance that there are no clearly defined objective.

<sup>32</sup> Lybek & Morris 2004 11.

<sup>33</sup> Lybek & Morris 2004 11-13.

<sup>34</sup> Lybek & Morris 2004 13.

The original central banks were thus private and independent – although they depended on the government to maintain their charters, they were otherwise free to choose their own tools and policies. Their goals were constrained by gold convertibility. In the twentieth century however many of these central banks were nationalized and completely lost their independence, and their policies were dictated by fiscal authorities.<sup>35</sup>

According to Bordo the maintenance and promotion of financial stability became an increasingly important role for central banks over the years. Trailing the evolution of this responsibility he remarks that in the gold standard era, central banks further developed their lender of last resort function, following Bagehot's rule, mentioned above. However financial systems became unstable between the world wars and widespread banking crisis plagued the 1920s and 1930s, giving rise to a response of "bailing out"<sup>36</sup> troubled banks with public funds. These crises occasioned a more stringent regulatory response backed in many countries by deposit insurance schemes in order to protect depositors and water down the moral hazard created by bank bail-outs.<sup>37</sup>

From the aforesaid historical overview it appears that, globally, it was realised that under typical conditions of banking and financial business, it would be to the advantage of a country to establish a central bank where the country's currency and credit could be controlled, and where its monetary reserves could be managed.<sup>38</sup>

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<sup>35</sup> Bordo 2007 2.

<sup>36</sup> Kuepper J "What is a bail-in and how does it work?" Trade Online (2016) <https://www.thebalance.com/what-is-a-bail-in-and-how-does-it-work-1979089> (accessed 15 November 2016): A bail-in involves rescuing a financial institution on the brink of failure by making its creditors and depositors take a loss on their holdings. A bail-in is the opposite of a bail-out, which involves the rescue of a financial institution by external parties, for instance governments using taxpayers' money; See also Department of National Treasury (Republic of South Africa) and the South African Reserve Bank and the Financial Services Board (20 August 2015) "Strengthening South Africa's resolution framework for financial institutions" [http://pmg-assets.s3-website-eu-west-1.amazonaws.com/150813Resolution\\_Framework\\_Policy.pdf](http://pmg-assets.s3-website-eu-west-1.amazonaws.com/150813Resolution_Framework_Policy.pdf) (accessed 22 October 2017), hereinafter Strengthening resolution framework 2015 where bail-ins are discussed in annexure B at 43 - 50.

<sup>37</sup> Bordo 2007 2; Padoa-Schioppa T "Central Banks and Financial Stability: exploring a land in between" European Central Bank (2002) [www.ecb.int/events/pdf/conferences/tps.pdf](http://www.ecb.int/events/pdf/conferences/tps.pdf) (accessed 25 May 2017) 6: The role of central banks in financial stability was part of their genetic code. It was, and still is, an integral part, or an inseparable component of, the central bank as a bank, of its monopoly on ultimate liquidity, of its role as the bankers' bank, and of commercial banks as creators of money themselves.

<sup>38</sup> De Jager 2006 no. 1 159; See also Goodhart 2010.

Central banks have thus in many jurisdictions evolved to be the source of stability in a country, and to be available to assist when a financial crisis is threatening the country, especially in the turbulent financial markets of today. Generally their ultimate objective is to serve the public interest.<sup>39</sup> Central banks are, however, not the only bodies that regulate and supervise financial institutions: over the years other supervisors were established by the state to regulate financial institutions, such as insurance companies and security traders, but central banks have generally been the primary institutions in promoting and maintaining a stable financial system.<sup>40</sup>

### **1.3 The main functions of a central bank**

From the aforementioned it appears that the basic roles that central banks have traditionally had were those of maintaining price stability, maintaining financial stability and acting as lender of last resort. Many central banks also acted as microprudential supervisors of the banking system and of the payments, clearing and settlements system. During the 1970s another role of the central bank emerged, namely that of macroprudential regulation and supervision, although as indicated below, it was not until the 2008 Global Financial Crisis (GFC), that highlighted the need to promote and maintain financial stability as an apex objective of financial regulation in the post GFC regulatory landscape, that macroprudential regulation and supervision took the limelight.

In order to assess the central bank's role in the financial system and broader economy of a country, it is necessary to look at these roles in more detail. The discussion below will provide a brief but instructive overview of each of the most prominent traditional

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<sup>39</sup> Keynes JM *The end of Laissez-Faire* (1926) in *Essays in Persuasion* (1963) in Canova 2011 239 and 245: John Maynard Keynes endorsed the autonomy of central bankers. He argued that they should be motivated solely by public interest; Goodhart CAE "Why do banks need a central bank?" 1987 (39) *Oxford Economic Papers* 75, at 75 and 88, states that the successful functioning of the monetary system is an essential public good. Independent central banks serve the public interest when they help with deposit flows to banks facing liquidity problems, and when they support and/or rescue potentially insolvent banks.

<sup>40</sup> Denters E "Regulation and supervision of the global financial system. A proposal for institutional reform" 2008-2009 *Amsterdam Law Forum* 63, hereinafter Denters 2009, at 66.

roles of central banks, starting with monetary policy and price stability, and concluding with the central bank's role in respect of financial stability. Given that the focus of this thesis is on the financial stability role of the central bank, the interaction of each of these roles with the central bank's role in regard to financial stability will then be analysed.

### **1.3.1 Monetary policy: Price stability**

The central bank's role in maintaining price stability is normally carried out subject to how a government at a particular time applies the monetary policy which can be affected by adherence to the gold standard, an inflation target or a fixed exchange rate.<sup>41</sup>

Several mechanisms are used to achieve price stability, like managing liquidity by controlling the circulation of money in the national economy, or by determining short-term interest rates. Central banks usually have to balance the goal of price stability with the objective of encouraging employment. If a central bank follows a very strict policy with regard to price stability, it may suppress economic growth. On the other hand, unlimited economic growth may trigger higher inflation. To obtain a balance between economic growth and price stability, the representatives of the central bank and finance ministries and other relevant agencies have to communicate regularly with each other. Deters, remarks, inter alia, that a central bank that is accountable should not give in to demands from a government to allow financing of state projects or the expansion of the money supply, if that would lead to price inflation above an appropriate level.<sup>42</sup>

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<sup>41</sup> Buitter WH "Rethinking inflation targeting and central bank independence" (28 October 2006) <https://www.researchgate.net/publication/228730268> (accessed 30 January 2017), hereinafter Buitter 2006, at 1, points out that inflation targeting is the pursuit of a low and stable rate of inflation over the medium-to-long term for some broadly based indices of consumer prices or cost-of-living. It is best rationalised as the operational expression of the pursuit of the more fundamental objective of price stability.

<sup>42</sup> Deters 2009 67.

### 1.3.2 Lender of Last Resort

Central banks have been acting as lenders of last resort for more than one hundred and fifty years, trying to avert depressions when financial crises loomed.<sup>43</sup>

A “lender of last resort” is, simply put, a body that is prepared to offer loans as a last resort. Where the central bank of a country acts as lender of last resort it lends money to banks or other institutions that are experiencing financial difficulty, or are considered highly risky or near collapse.<sup>44</sup> De Jager comments that the central bank’s role of supporting the financing needs of the state in times of crisis, in its capacity as lender of last resort, also entailed that the misuse of the financial powers of the ruling government in normal times would be constricted.<sup>45</sup>

Freixas et al define “lender of last resort” more comprehensively as the institution that provides liquidity to an individual financial institution (or the market as a whole) in reaction to an abnormal increase in demand for liquidity that cannot be met from an alternative source.<sup>46</sup> Domanski, Moessner and Nelson indicate that “lender of last resort” credit in these situations is often referred to as emergency liquidity assistance (ELA). In the standard conception of such lending, the financial institution in question would be solvent but illiquid, meaning that its assets are more valuable than its liabilities but that it is unable to raise funds to meet short-term obligations. Last resort

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<sup>43</sup> CentralBanksGuide.com (2015) <http://www.centralbanksguide.com/lender+of+last+resort/> (accessed 28 October 2016), hereinafter CentralBanksGuide 2015.

<sup>44</sup> CentralBanksGuide 2015; Tucker 2014 12, explains that “central banks provide liquidity insurance to the banking system, which in turn provides liquidity insurance to the rest of the economy including households and businesses. Thus, central banks are liquidity re-insurers. In each case, their capability to provide insurance stems from their liabilities. The central bank acts as a liquidity re-insurer: as a general matter, it does not provide liquidity insurance directly to everyone in the economy but rather to the private sector liquidity insurers, the banks.”

<sup>45</sup> De Jager 2013 no. 2 494.

<sup>46</sup> Freixas X, Giannini C, Hoggarth G and Soussa F “Lender of last resort: What have we learnt since Bagehot?” 2000 (18) *Journal of Financial Services Research* 63, hereinafter Freixas et al 2000, 63 - 84.

lending to such an institution would prevent costly and unnecessary default by the institution.<sup>47</sup>

The main reason thus identified for ELA to individual banks is to avoid a solvent bank becoming illiquid because of inefficiencies in the interbank market, which may prevent such a bank from lending to other banks.<sup>48</sup> The need for liquidity support arises from the existence of asymmetric information, which can lead to bank-runs and a failure of interbank markets. Bank failures can also lead to negative externalities for systemic financial stability, due to contagion and interbank credit exposures. As such, ELA can also help prevent contagion. Such contagion could occur for two primary reasons. First, an institution that had lent money to a defaulting borrower could become insolvent because of losses on the defaulted obligations. Second, an institution could be viewed as having similar portfolios to the defaulting borrower, and worried creditors could stop funding it. In either case, if an institution is unable to raise funds, and is forced to sell assets at a fire sale, those lower asset values can push it and other institutions into insolvency. ELA can therefore prevent unnecessary fire sales by providing liquidity to otherwise solvent institutions. Finally ELA can also prevent a disorderly bankruptcy, which in turn can have disruptive effects on the wider financial system.<sup>49</sup>

As pointed out by Domanski, Moessner and Nelson the role of the lender of last resort is probably the most ambiguous function of a central bank.<sup>50</sup> On the one hand it is typically regarded as a core responsibility of central banks, given their unique ability to create liquid assets in the form of central bank reserves, their central position within the payment system, and their macro-economic stabilization objective. On the other hand, if the availability of central bank liquidity were certain, individual banks would have reduced incentives to maintain sufficient stocks of liquid assets to cover their

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<sup>47</sup> Domanski D, Moessner R and Nelson W “Central Banks as lenders of last resort: experiences during the 2007-10 crisis and lessons for the future (May 2014) <https://www.federalreserve.gov/econresdata/feds/2014/files/2014110pap.pdf> (accessed 31 December 2017), hereinafter Domanski et al 2014, at 45.

<sup>48</sup> Freixas et al 2000 63.

<sup>49</sup> Domanski et al 2014 45 - 46.

<sup>50</sup> Domanski et al 2014 45.

liquidity needs. Hence to limit moral hazard, central banks have in many cases left open how they would respond to liquidity shortages at the level of individual institutions, or the market as a whole – with the result that generally the specifics of this traditional role of the central bank is not captured in legislation.<sup>51</sup>

### 1.3.3 Microprudential supervision of banks

Traditionally many central banks also focused on microprudential supervision of banks, which usually entailed supervising the safety and soundness of banks as financial institutions. The purpose of microprudential supervision is, ultimately, to protect a bank from distress or insolvency, and by doing so, also protect the public and depositors from the ill-effects that may follow. A bank is thus generally considered sound from a prudential perspective when it meets all the mandated regulatory requirements, and customers of the bank are protected.<sup>52</sup> Supervision and regulation by central banks therefore has to aim to prevent and/or manage the risks of market failure. Various supervisory tasks may be taken up by the central bank, such as licensing, monitoring compliance with minimum capital requirements, reviewing disclosure requirements, monitoring compliance with anti-money laundering regulation, and overseeing mergers and acquisitions.<sup>53</sup>

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<sup>51</sup> Domanski et al 2014 45.

<sup>52</sup> Denters 2009 77; Oosterloo S and de Haan J “Central Banks and financial stability: a survey” 2004 (1) *Journal of Financial Stability* 257, hereinafter Oosterloo & de Haan 2004, at 263; Gohari B & Woody KE “The new global financial regulatory order: Can macroprudential regulation prevent another global financial disaster?” 2015 *Journal of Corporation Law* 403, hereinafter Gohari & Woody 2015, at 406. They state that microprudential regulation focuses primarily on regulating institutions and transactions. Risk is thus managed by focusing on external risks, and protects customers of financial services, namely depositors and investors; Arpa M, Giulini I, Ittner A and Pauer F “The influence of macroeconomic developments on Austrian banks: implications for banking supervision” in BIS Paper No. 1 91 (March 2001) <http://www.bis.org/publ/bppdf/bispap01.htm> (accessed 30 January 2017) at 92 remark that although banking crises are mainly caused by microeconomic factors, disturbances anywhere in the economy are likely to have repercussions on the banking system. Due to the nature of their business, banks are exposed to many potential sources of distress. The most dangerous of these are banks’ above average reliance on creditors’ funds (for instance deposits) and their low capital ratio when compared to the corporate sector, their risky claims on different sectors of the economy, and the fact that their assets are in effect longer-term and less liquid than their liabilities. Banks’ health reflects to a large extent the health of their borrowers, which in turn reflects the health of the economy as a whole; Borio 2004 32: The objective of a microprudential approach is to limit the risk of failure of institutions, regardless of their impact on the overall economy and thereby protect consumers, including depositors and investors.

<sup>53</sup> Denters 2009 67.

However in the last few decades some central banks, such as the Australian Reserve Bank, has moved away from this microprudential supervision role and has had microprudential supervision assigned to another separate, dedicated regulatory authority<sup>54</sup> (discussed in Chapter Three).

### **1.3.4 Payment System Supervision**

Money, in the form of either cash or bank deposits, is commonly the preferred means of payment for the purchase of goods and services, and for the repayment of debts. While many smaller-value payments are made with cash, larger payments usually involve the transfer of bank deposits. Modern financial systems also involve trade in financial instruments such as bonds, equities and derivatives. Payment and settlement systems enable these transfers of money and financial instruments to take place. A developed-market economy typically has various payment and settlement systems, including large-value and retail payment systems, as well as securities systems. Important roles may also fall to various other institutions that provide payments and settlements services, such as central counterparties, large correspondent banks, and custodians.<sup>55</sup>

Johnson and Steigerwald observe that whatever else central banks may do, they almost always play a foundational role in the payment system.<sup>56</sup> Millard and Saporta state that historically central banking can be traced back to the market's natural demand for an efficient way to make payments. They remark that "[C]entral banking

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<sup>54</sup> For more, see paragraph 1.9 below on the question of whether the central bank should be both the guardian of financial stability and the prudential regulator.

<sup>55</sup> Bank for International Settlements "Central bank oversight of payment and settlement systems" (May 2005) <http://www.bis.org/cpmi/publ/d68.htm> (accessed 2 September 2017), hereinafter BIS payment 2005, at 8.

<sup>56</sup> Johnson CA and Steigerwald RS "Legal and policy aspects of the central bank's role in the payment system: some costs and benefits of the choice of settlement asset" Federal Reserve Bank of Chicago – Financial Markets Group – Policy discussion series (23 May 2007) <https://www.chicagofed.org/publications/policy-discussion-papers/2007/pdp-3> (accessed 2 September 2017), hereinafter Johnson & Steigerwald 2007, at 7.

and payment systems - systems consisting of a settlement asset, credit arrangements, infrastructure and rules over which monetary value can be transferred - are inextricably linked. In a number of countries, central banking institutions evolved naturally or were imposed by the state to provide the ultimate settlement asset at the apex of the payment hierarchy.”<sup>57</sup>

Equally pertinent is the statement by Lamfalussy that central banks oversee developments in their domestic interbank markets and in the payment and settlement systems that support these markets. Since central banks act as lenders of last resort, they have a specific interest in the credit and liquidity management practices of banks, as well as the settlement arrangements. This “oversight” of the domestic payment system coordinates the various functions of the central bank as well as the responsibilities of the monetary and supervisory authorities.<sup>58</sup>

### **1.3.5 Financial stability**

Traditionally the central bank’s role in maintaining financial stability included encouraging more broadly, financial development. This financial stability role was not one of its initial core roles and, as indicated above by Bordo, developed only at a later stage, notably around 1914. However in the years prior to the 2008 GFC an increased appreciation of the necessity of a stable financial system emerged on the regulatory front, and it also became clear that this role by central banks yielded many complexities that had, properly, to be thought through.

The main challenge is that “financial stability” appears to be notoriously hard to define precisely, or comprehensively. Allen points out that although many international

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<sup>57</sup> Millard SP and Saporta VS “Central banks and payment systems: Past, present and future” paper presented at the Bank of England Conference on “The Future of Payments” (May 2005) <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.576.7497&rep=rep1&type=pdf> (accessed 2 September 2017).

<sup>58</sup> Bank for International Settlements *Lamfalussy Report: Report of the Committee on Interbank Netting Schemes of the central banks of the Group of Ten countries* (November 1990) <http://www.bis.org/cpmi/publ/d04.htm> (accessed 2 September 2017).

financial instruments mention the concept of financial stability they generally neglect to define this concept.<sup>59</sup>

She therefore proposes that the term “financial stability” should mean “a state of affairs wherein (i) financial institutions and markets are able to facilitate capital intermediation, risk management, and payment services in a way that enables sustainable economic growth; (ii) there is no disruption to the ability of financial institutions or markets to carry out such functions that might cause harm to persons (wherever they may be resident) who are not customers or counterparties of those financial institutions, nor participants in those financial markets; and (iii) financial institutions and markets are able to withstand economic shocks (such as the failure of other markets and institutions, or a chain of significant losses at financial institutions) so that (x) there will be no disruption to the performance of the functions set forth in (i) and (y) no harm will be caused to the persons set forth in (ii).”<sup>60</sup>

Allen and Wood aptly remark that “defining” financial stability is a thorny issue and conclude that the best approach is to define the characteristics of an episode of financial *instability* and then to simply define financial stability as a state of affairs in which episodes of instability are unlikely to occur.<sup>61</sup> Likewise Borio and Drehmann

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<sup>59</sup> Allen 2014 933. Allen points out that the Financial Stability Board Charter states that “financial stability” is its core mission. Members of the Financial Stability Board (FSB) also commit to “pursue the maintenance of financial stability”, yet there is no attempt to define what is meant by “financial stability”. Similarly the Basel Committee on Banking Supervision (BCBS) has a mandate “to strengthen the regulation, supervision and practices of banks worldwide” with the purpose of enhancing financial stability, but that mandate also does not make it clear what is meant by financial stability. Basel III standards promulgated by the BCBS do note that their objective is to “improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill over from the financial sector to the real economy”. And while Article IV of the IMF’s Articles of Agreement provides that “a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability” it again gives no indication of what “financial stability” means; See also Oosterloo & De Haan 2004; Houben ACFJ, Kakes J and Schinasi J “Toward a framework for safeguarding financial stability” IMF Working Paper No. WP/04/10 (June 2004) <http://www.imf.org/en/Publications/WP/Issues/2016/12/30/Toward-a-Framework-for-Safeguarding-Financial-Stability-17446> (accessed 3 December 2017), hereinafter Houben et al 2004; Schinasi GJ “Defining Financial Stability” IMF Working Paper No. 04/187 (October 2004) <https://www.imf.org/external/pubs/ft/wp/2004/wp04187.pdf> (accessed 5 April 2016), hereinafter Schinasi 2004, at 1 remarks that “Financial stability is defined in terms of its ability to facilitate and enhance economic processes, manage risks, and absorb shocks. It is changeable over time and consistent with multiple combinations of the constituent elements of finance.”

<sup>60</sup> Allen 2014 932.

<sup>61</sup> Allen & Wood 2006.

point out the “fuzziness” surrounding the measurement of financial stability and absent an appropriate definition, conclude that “[F]inancial stability is the converse of financial instability”.<sup>62</sup>

Halme sheds more light on this elusive concept by stating that what all central banks have in common is “an interest in financial stability as a public policy objective, as a key factor influencing macro-economic performance and the potential for systemic disturbances”.<sup>63</sup> Gadanez and Jayaram remark that unlike price stability, financial stability is not easy to define or measure given the interdependence and the complex interactions of different elements of the financial system among themselves and with the real economy.<sup>64</sup> They indicate that “[S]trictly speaking a financial system can be characterized as stable in the absence of excess volatility, stress or crisis.” According to them this narrow definition is relatively simple to formulate but fails to capture the positive contribution of a well-functioning financial system to overall economic performance. They state that broader definitions of financial stability encompass the smooth functioning of a complex nexus of relationships among financial markets, infrastructures and institutions operating within the given legal, fiscal and accounting frameworks. Such definitions, although more abstract, are however more inclusive of the macro-economic dimension of financial stability and interactions between the financial and real sectors. Gadanez and Jayaram thus conclude that from this perspective, financial stability can be defined (as was done by the European Central Bank in 2007) as a “condition in which the financial system - comprising financial intermediaries, markets and market infrastructure - is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities.”<sup>65</sup>

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<sup>62</sup> Borio C and Drehmann M “Towards an operational framework for financial stability: ‘fuzzy’ measurement and its consequences” BIS Working Papers No. 284 (June 2009) <https://www.bis.org/publ/work284.htm> (accessed 3 December 2017).

<sup>63</sup> Halme et al 2000 106.

<sup>64</sup> Gadanez B and Jayaram K “Measures of financial stability – a review” Bank for International Settlements – Proceedings of the IFC Conference (26 – 27 August 2008) <https://www.bis.org/ifc/publ/ifcb31ab.pdf> (accessed 31 December 2017) 365, hereinafter Gadanez & Jayaram 2008.

<sup>65</sup> European Central Bank Eurosystem “Glossary” (undated) <https://www.ecb.europa.eu/home/glossary/html/act4f.en.html#706> (accessed 19 March 2018). See also Gadanez & Jayaram 2008 365-366.

Given the imprecise nature of this broader view of financial stability Gadanecz and Jayaram point out that most analysts concentrate on the risks and vulnerabilities of the financial system as these are “relatively easy” to understand and quantify. Policymakers and researchers have thus focused on a number of qualitative measures in order to assess financial stability such as for example the set of Financial Soundness Indicators developed by the IMF in 2006.<sup>66</sup> The application of these indicators entail complex mathematical and economic calculations which are beyond the scope of this thesis and inter alia relate to aspects such as capital adequacy, asset quality, earnings and profitability, liquidity and exposure to foreign exchange risk. The use of these indicators is further supplemented by various early warning indicator methods.<sup>67</sup>

Houben, Kakes and Schinasi have compiled a working paper examining the emergence of financial stability as a key policy objective in the years before the GFC. The authors indicate that the increased importance of financial stability was related to four major trends in the financial economy of the decades prior to compilation of their working paper in 2004: First, the financial sector has expanded at a significantly faster pace than the real economy. Second the process of “financial deepening” has been accompanied by a changing composition of the financial system, with an increasing share of non-monetary assets and greater leverage of the monetary base. Third, financial systems have become more interconnected nationally and internationally. Fourth, the financial system has become increasingly complex “in terms of the intricacy of financial instruments, the diversity of activities, and the concomitant mobility of risks.”<sup>68</sup>

In their study Houben, Kakes and Schinasi also emphasise the lack of a general, coherent definition of financial stability. Their view of financial stability is that it entails a situation in which the financial system is capable of: “(1) allocating resources efficiently between activities and across time; (2) assessing and managing financial

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<sup>66</sup> IMF Financial Soundness Indicators – Compilation Guide (March 2006) <https://www.imf.org/external/pubs/ft/fsi/guide/2006/index.htm> (accessed 29 December 2017).

<sup>67</sup> Gadanecz & Jayaram 2008 371.

<sup>68</sup> Houben et al 2004 3.

risks and (3) absorbing shocks.”<sup>69</sup> Their notion of a stable financial system is thus one that enhances economic performance and wealth accumulation while it is also able to prevent economic disturbances arising from an inordinate disruptive impact. They further indicate that due thereto that finance is a dynamic concept, involving inter-temporal transactions and innovations, financial stability may be seen as “occurring along a continuum, changeable over time and consistent with manifold combinations of its constituent elements.”<sup>70</sup>

They accordingly propose a framework for financial stability which has the objective to provide a coherent structure for the analysis of financial stability issues in order to :”(1) foster an early identification of potential vulnerabilities; (ii) promote preventative and timely remedial policies to avoid financial instability; and (iii) resolve instabilities when preventative and remedial measures fail.” Thus financial stability has to be dealt with in terms of the following measures: prevention, remedial action, and resolution.<sup>71</sup> They indicate that a natural point of departure in operationalizing the framework for financial stability should be the analysis of potential risks and vulnerabilities in the financial system, guided by the definition of financial stability as a continuum. This analysis should be comprehensive and ongoing, examining all factors that impact the workings of the financial system such as the macro-economy, financial markets, financial institutions and infrastructure in order to enable the early identification of financial vulnerabilities. Thereafter an assessment of the situation must be made, indicating the extent to which those vulnerabilities pose a threat to financial stability and what policy responses would be appropriate.<sup>72</sup>

The aforementioned discussion, in addition to being informative, should also serve to foster some appreciation by the reader of the inherent difficulty of regulating a mandate for financial stability. Malcolm Edey, previously an Assistant–Governor of the Reserve Bank of Australia, is probably correct in his belief that financial stability is incapable of being defined in exact terms but at least he offers the following consolation that can

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<sup>69</sup> Houben et al 2004 11.

<sup>70</sup> Houben et al 2004 10. See Appendix II of their Working Paper for an overview of many proposed definitions of financial stability.

<sup>71</sup> Houben et al 2004 15.

<sup>72</sup> Houben et al 2004 16.

guide interpretation of this complex role of central banks: “We do know financial instability when we see it and we have a good idea of the kinds of behaviour that can contribute to it.”<sup>73</sup>

## **1.4 The interaction between the various traditional roles of the central bank and financial stability**

### **1.4.1 Monetary policy and financial stability**

Financial stability hinges largely on macroprudential policy that is properly translated into appropriate macroprudential tools. As a mechanism geared towards enabling financial stability macroprudential policy clearly interacts, and is interdependent on monetary policy. Both are aimed at economic stability in the interest of maximising sustained long-term growth.<sup>74</sup>

However there is also some tension between monetary policy that pursues price stability, and financial system stability: If a central bank eases monetary policy, it stimulates the economy, by encouraging households and companies to borrow more and pushing up the prices of many types of financial assets. The increased borrowing, together with the greater wealth that comes with higher asset prices, encourages

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<sup>73</sup> Edey M “The Financial Stability Role of Central Banks” Address to the Thomson Reuters Australian Regulatory Summit, Sydney (1 May 2013) <https://www.bis.org/review/r130508b.pdf> (accessed 25 November 2017), hereinafter Edey 2013. Author’s emphasis.

<sup>74</sup> South African Reserve Bank – Financial Stability Department “A new macroprudential policy framework for South Africa (November 2016) <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/7660/Macroprudential%20policy.pdf> (accessed 29 August 2017), hereinafter SARB Macroprudential policy document 2016, at 8; Habermeier K, Mancini-Griffoli T, Dell’Ariccia G and Haksar V “Monetary policy and financial stability” International Monetary Fund IMF Policy Paper (28 August 2015) <http://www.imf.org/external/np/pp/eng/2015/082815a.pdf> (accessed 9 August 2017) at 9 indicate that the Bank for International Settlements (BIS) has expressed support for a stronger role for monetary policy in maintaining financial stability: “Financial stability is too large a task for prudential [...] frameworks alone. Monetary policy strategies also need to [...] lean against the build-up of financial imbalances even if near-term inflation remains low and stable.” They remark (at 29) with regards to the case for using monetary policy to lean against the wind: “Macroprudential policies, including both cyclical and structural measures, remain a key element of the defence against financial instability. If these measures are well targeted and effective, it can target imbalances and market imperfections much closer to their source than monetary policy does. Also, they could allow monetary policy to focus on its price stability mandate, thereby simplifying communication and enhancing accountability.”

households to spend more, generating income for other households and creating opportunities for companies. But, at the same time, more debt and higher asset prices may create vulnerabilities in the financial system.<sup>75</sup>

Goodhart states that in the years prior to August 2007 central banks had appeared to have almost perfected the conduct of monetary policy. The standard regime was one in which the central bank was given operational independence to vary the official short-term interest rate in order to achieve an inflation target, which target was mandated either in general terms or in specific numerical terms by the democratically elected government. However Goodhart remarks “[W]hat we now recognize is that the achievement of price stability by this procedure does not achieve financial stability” thus pointing out that in isolation monetary policy by itself is not sufficient to make a financial system stable<sup>76</sup>

#### **1.4.2 Lender of last resort and financial stability**

Arguably the most important function of the central bank that ties in with the notion of maintaining and promoting a stable financial sector, is the central bank’s traditional role as lender of last resort in terms whereof it can infuse volatile and financially depressed markets with emergency liquidity assistance in order to avert financial crisis. Tucker points out that, as the liquidity reinsurer for the financial system, central banks are called to the scenes of financial disasters regardless of whether or not they have prudential mandates.<sup>77</sup>

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<sup>75</sup> Lane T “Monetary policy and financial stability – looking for the right tools” Remarks by Deputy Governor of the Bank of Canada (8 February 2016) <http://www.bis.org/review/r160210b.htm> (accessed 28 May 2017), hereinafter Lane 2016; See also Heath D “International coordination of macroprudential and monetary policy” 2014 *Georgetown Journal of International Law* 1093.

<sup>76</sup> Goodhart 2011 145; Blanchard O, Dell’ Ariccia G and Mauro P “Rethinking macroeconomic policy” IMF Staff Position Note SPN/10/03 (12 February 2010) <http://www.imf.org/external/pubs/cat/longres.aspx?sk=23513.0> (accessed 29 May 2017) at 16: The GFC has shown that policy makers have many more macroprudential instruments available that have not been used before the crisis; the challenge is how to use these instruments in the best way.

<sup>77</sup> Tucker P “The design and governance of financial stability regimes – a common-resource problem that challenges technical know-how, democratic accountability and international coordination” CIGI Essays on International Finance Volume 3 (September 2016) [https://www.cigionline.org/sites/default/files/financial\\_essay\\_vol.3\\_web.pdf](https://www.cigionline.org/sites/default/files/financial_essay_vol.3_web.pdf) (accessed 7 March 2018) in Edge R and Liang N “New financial

The predominant responsibility of the central bank as lender of last resort is to protect the financial stability of the economy by safeguarding funds that were deposited by customers. The central bank has to put measures in place in order to stop huge withdrawals from banks driven by panic during periods where banks have limited liquidity (“bank-runs”) and these measures often take the form of liquidity injections into a financially constrained market or rescuing banks from the brink of collapse.<sup>78</sup>

When instability occurs, the central bank might therefore have to provide short-term emergency liquidity assistance (ELA) as discussed in par 1.2.2 above, in order to stabilize troubled institutions or the market as a whole. Liquidity support from the central bank to troubled financial institutions however usually starts long before the systemic nature of a banking crisis has been recognized and this aspect of its role as lender of last resort speaks to the ability of the central bank to maintain stability in the financial markets. When a bank, or several banks, start experiencing withdrawals from depositors and creditors (both domestic and foreign), and they cannot borrow directly, or only at high rates, from the inter-bank market, the intervention by the central bank - as lender of last - is pivotal to stabilize the market.<sup>79</sup> Hence it is evident that financial stability is critically dependent on the central bank’s stabilizing role as lender of last resort.

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stability governance and central banks” Reserve Bank of Australia Conference Draft (8 March 2017) <https://www.rba.gov.au/publications/confs/2017/pdf/rba-conference-2017-edge-liang.pdf> (accessed 8 August 2017), hereinafter Edge & Liang 2017, at 111.

<sup>78</sup> CentralBanksGuide 2015. See footnote 19 above on bank-runs.

<sup>79</sup> Oosterloo & de Haan 2004 263; Alford DE “Core principles for effective banking supervision: an enforceable international financial standard?” 2005 (28) *Boston College International and Comparative Law Review* 237, hereinafter Alford 2005, at 238 - 239: National governments generally wish to retain control over banking systems because of the high costs and negative political repercussions of bank failures. National governments, and related agencies such as central banks, typically have lender of last resort responsibility for banks operating within their borders. If a bank has insufficient liquid funds to meet payment demands from depositors, the national government, through its central bank, may lend funds to the bank to meet these demands. Furthermore, a major disruption in the financial system generally leads to a change in government.

### 1.4.3 Prudential Bank Supervision and Financial Stability

Given the huge role that banks fulfil in the financial system there is an undeniably strong link between the prudential soundness of banks and financial stability. Where a central bank is also the prudential supervisor of banks it will be in a prime position to detect at an early stage any liquidity problems that may escalate to systemic proportions and requires the central bank to intervene to avert a crisis.<sup>80</sup> Spendzharova thus remarks that effective banking supervision is critically important for ensuring financial sector stability.<sup>81</sup> In similar vein Barth et al point out that stable banking systems are an important component of well-functioning financial systems. When banking systems break down or operate ineffectively, the ability of firms to obtain funds necessary for continuing existing projects and pursuing new endeavours, is curtailed. Severe disruptions in the intermediation services rendered by banks can lead to financial crises and may undo years of economic and social progress. In their comprehensive global study Barth and his co-authors have thus found a strong and robust link between financial stability and the regulatory environment prevalent in a country, i.e. whether systems for sound prudential regulation are in place.<sup>82</sup>

### 1.4.4 Payment systems and financial stability

Safe and efficient systems are fundamental to money being an effective means of payment and to the smooth functioning of financial markets. Well designed and managed payment and settlement systems help to maintain financial stability by

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<sup>80</sup> Srejber E and Noreus M "The future relationship between financial stability and supervision in the EU" (2005) [http://www.riksbank.se/Upload/Dokument\\_riksbank/Kat\\_publicerat/Artiklar\\_PV/2005\\_4srejber\\_noreus.pdf](http://www.riksbank.se/Upload/Dokument_riksbank/Kat_publicerat/Artiklar_PV/2005_4srejber_noreus.pdf) (accessed 2 December 2017) at 51.

<sup>81</sup> Spendzharova A *The Quest for Financial Stability: Determinants of Regulatory approach in banking supervision: Does Counter-Cyclical Regulation play a Role? Regulating Banks in Central and Eastern Europe* (2014) at 10 -31.

<sup>82</sup> Barth JR, Caprio G Jr and Levine R "Banking Systems around the Globe: Do Regulation and Ownership Affect Performance and Stability? 31 <http://www.nber.org/chapters/c10757.pdf> (accessed 4 December 2017).

preventing or containing financial crises and help to reduce the cost and uncertainty of settlement, which would otherwise act as an impediment to economic activity.<sup>83</sup>

The Bank for International Settlements (BIS) compiled a research paper in 2005 titled “Central bank oversight of payment and settlement systems” in which it is indicated that central banks have long played a crucial role by providing a safe settlement asset, and in many cases by operating one or more systems themselves and also by contributing to the agreement and exercise of appropriate rules and standards for the system.<sup>84</sup> Through the combination of their banking function and their key role in fostering public confidence in money, BIS states that central banks have acquired unique expertise in the way payment and settlement systems work and the potential market failures that can exist, an expertise they have always used to promote systems which provide an effective means of implementing monetary policy and which help to achieve financial stability.<sup>85</sup>

The BIS Report further indicates that payment and settlement systems are relevant to financial stability for two reasons: Firstly because the very large values they often handle creates the possibility that a failure in the payment and settlement system could cause broader financial and economic instability. BIS thus indicates that because these systems form a network linking all those who participate in them, it is important that they are designed and operated in such a manner that the probability of financial difficulties spreading from one participant to another is very small.<sup>86</sup> Secondly, because in the event of financial stress, market participants or central banks may wish to supply emergency liquidity to certain participants in a payment and settlement system in an attempt to encourage the orderly settlement of transactions in the overall financial system. Safe and efficient payment and settlement system facilitate the provision of such support should it prove necessary.<sup>87</sup>

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<sup>83</sup> BIS payment 2005 8.

<sup>84</sup> BIS payment 2005 10.

<sup>85</sup> BIS payment 2005 10.

<sup>86</sup> BIS payment 2005 8.

<sup>87</sup> BIS payment 2005 8 to 9.

The smooth functioning of payment and settlement systems is also a necessary condition for the effective supply of central bank money in pursuit of monetary stability objectives. The BIS Report indicates that in many countries central banks implement monetary policy by influencing short-term interest rates through the purchase and sale of government securities or through collateralized lending. It is important that safe and efficient payments systems are available to allow a reliable transfer of funds and securities between the central bank, its counterparties and the other participants in the financial system so that the effect of these transactions and thus the impact of monetary policy is spread throughout the economy.<sup>88</sup>

Crockett highlights that the size of inter-bank exposures in the payments system has led some observers to conclude that a disruption transmitted through the payments system is the largest single threat to financial stability. Having access to such timely, anecdotal information on inter-bank activities provides a valuable complement to the information gained through standard prudential supervision, which is less frequent and may become redundant if a significant amount of time has passed since the last up-to-date bank balance sheet was made available.<sup>89</sup>

#### **1.4.5 Conclusion**

It is submitted that on its own the effective execution of none of the above traditional roles of the central bank is able to guarantee financial stability. Even in a financial system where the central bank has perfected monetary policy and the pursuit of price stability it may happen that, for instance, the payment system collapses resulting in widespread financial instability. A country may for instance have a sound and effective framework for regulation of banks but that will not necessarily guarantee financial stability because the safety of the financial system may be threatened by risk

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<sup>88</sup> BIS payment 2005 9.

<sup>89</sup>Crockett A "Why is financial stability a goal of public policy?" (1997) <https://www.kansascityfed.org/NViVZ/publicat/sympos/1997/pdf/s97crock.pdf> (accessed 3 December 2017). See also Hawkesby C in Halme et al 2000 95.

emanating from the non-bank parts of the financial sector. The pursuit of financial stability as a standalone objective without the necessary support of sound monetary policy, a sound payments and settlement system, effective and efficient prudential regulation and the ability of the central bank to intervene as lender of last resort, is also not possible.

As explained above, the role of maintaining financial stability is elusive and its parameters are hard to pinpoint. Exactly what this role entails in its totality is difficult to fathom especially as no universally accepted definition for financial stability exists. As such it is submitted that the financial stability role of the central bank appears to be a role in respect of which the effective execution can only be properly gauged in conjunction with the other roles of the central bank, such as monetary policy and the pursuit of price stability, its role as lender of last resort, prudential supervisor of banks and supervisor of the payments system.

One would accordingly be justified in remarking that the central bank's role with regard to financial stability prior the 2008 GFC was largely an "indirect" and anomalous role where the achievement of financial stability in a specific financial system was the de facto "result" of the central bank's combined efforts in fulfilling its other roles of price stability, lender of last resort and supervisor of the payments system and of banks but where financial stability itself also underpinned those other roles.

However, it also needs to be appreciated that financial stability is broader than merely fulfilling these roles of the central bank effectively and that even in circumstances where one would have the smooth and effective functioning of monetary policy, payment systems and prudential oversight of banks coupled with appropriate lender of last resort-assistance, threats to financial stability may still emanate from other parts of the non-banking financial sector or broader economy or beyond that may require stabilizing intervention by the central bank.<sup>90</sup>

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<sup>90</sup> See also Fischer S "The Importance of the Nonbank financial sector" at the Debt and Financial Stability – regulatory challenges Conference Bundesbank Frankfurt Germany (27 March 2015)

## 1.5 The 2008 Global Financial Crisis and the new regulatory paradigm

The GFC that peaked in 2008, radically changed the landscape of financial regulation across the globe. This crisis that was triggered largely by the collapse of the subprime mortgage market in the USA,<sup>91</sup> revealed a number of very important lessons that eventually informed the regulatory turnabout post the Crisis. The GFC made it clear that large, complex and highly interconnected financial institutions (and not only banks) that were allowed to become disproportionately big to such an extent that they were systemic time-bombs whose distress could take down a whole domestic, or in some instances, even global financial system, were a major regulatory concern and had to be monitored, managed and where possible, “cut down to size”. These systemically important financial institutions were popularly referred to as “Too-Big-To-Fail”,<sup>92</sup> given that due to their size, complexity and interconnectedness they would not

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<https://www.federalreserve.gov/newsevents/speech/fischer20150327a.htm> (accessed 7 March 2018), hereafter Fischer 2015, at 7 and 12 on the threats to financial stability from the non-banking financial sector and the role of central bankers and bank supervisors in regulating and supervising thereof.

<sup>91</sup> The Balance.com. Subprime Mortgage Crisis: Effect and Timeline (8 September 2006, updated 23 December 2015) <https://www.thebalance.com/subprime-mortgage-crisis-effect-and-timeline-3305745> (accessed 15 December 2016) where it is stated that “The subprime mortgage crisis occurred when banks sold too many mortgages to feed the demand for mortgage-backed securities. When home prices fell in 2006, it triggered defaults. The risk spread into mutual funds, pension funds and corporations who owned these derivatives. Its effect was the 2007 banking crisis, the 2008 financial crisis, and a recession that was the worst since the 1930’s.”; See also Ciro T and Long M “The global financial crisis: causes and implications for future regulation: Part 1” 2009 (24) *Journal of International Banking Law and Regulation* 599 at 602; Rajapakse P and Gardner J “The Unconscionable Conduct and Consumer Protection in Subprime Lending in Australia” 2014 (29) *Banking and Finance Law Review* 485: The GFC is strongly linked to unsuitable subprime loans or non-confirming loans and subsequently high levels of defaults have occurred and continue to occur; See also Crash of a titan: The inside story of the fall of Lehman Brothers. Independent News 7 September 2009. <http://www.independent.co.uk/news/business/analysis-and-features/crash-of-a-titan-the-inside-story-of-the-fall-of-lehman> (accessed 29 August 2016) where it is reported that “Lehman Brothers was the fourth largest and the oldest of the Wall Street investment banks and was in business for 158 years, it had over \$600bn of assets. It was almost too big to fail. And yet it did fail. Lehman Brothers filed for bankruptcy on 15 September 2008. The CEO of Lehman Brothers, Dick Fuld, like CEO’s of other investment banks, had made enormous profits for the bank in the US since 2005 by cutting bonds into smaller parts and selling it as securities to investors all over the world. Lehman ignored alarms about the American real estate market that was apparently living on borrowed time and the fact that loans that were impossible to be paid back, were advanced to consumers by mortgage brokers. Lehman Brothers took even more risks than other investment banks when it enlarged its debts in order to get better results than other banks. At that stage Lehman’s reserves was not even one dollar for every thirty dollars of its obligations. It did have enough assets equivalent to its liabilities and that was acceptable. But later on investors doubted whether the value placed on the assets were correct. The CEO Fuld disclosed another 3.9 billion dollar loss, confidence was lost and clients started to leave. This happened, despite the fact that Fuld and his team were warned for more than three years that the housing market was overheating and that a very large problem regarding subprime mortgages is developing.”

<sup>92</sup> Stewart McKinney popularised the “Too-Big-To-Fail” concept in 1980 by referring to Continental Illinois as a “wonderful” and “Too-Big-To-Fail” bank when the Comptroller of the Currency, CT Conover,

be able to exit the financial system without causing major disruption and eroding financial stability. Because of the ill effects their demise could have on financial stability they were able to continue their excessive risk-taking endeavours banking on the regulatory response to be an implied guarantee that should they fail, they would be bailed out by Government with taxpayers money. This implied guarantee of a bail-out however exacerbated the moral hazard<sup>93</sup> problems associated with the “Too-Big-To-Fail” phenomenon as it served as an incentive for the risky endeavours undertaken by the large institutions and it also fed the risk appetite of their investors.<sup>94</sup>

The Crisis thus exposed the toxicity of these “Too-Big-To-Fail” institutions and the vulnerabilities they created in the financial system. It also revealed the failure of “light touch” regulation by regulators who failed to reprimand and sanction reckless risk-takers in the financial system. It accentuated the dire need for a holistic approach to financial regulation, comprising a macroprudential approach within a regulatory regime that recognises the need for prudential regulation to be supported by efficient market conduct regulation.<sup>95</sup> A major criticism levied against central banks was that before

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stated that Continental Illinois would not be allowed to collapse; See Dash E (2009) “If it’s too big to fail, is it too big to exist?” <http://www.nytimes.com/2009/06/21/weekinreview/21dash.html?partner=rss> (accessed 19 August 2016); See also Farrell S “Too important to fail: legal complexity in planning for the failure of financial market infrastructure” 2014 (29) *Journal of International Banking Law and Regulation* 461 at 469.

<sup>93</sup> See more on moral hazard in footnote 20 above and more on bail-outs in footnote 36 above.

<sup>94</sup> The Cypress Group “Too big to fail: an assessment of progress on SIFI regulation in the United States and European Union” (2011) [http://www.cicero-group.com/files/Cypress\\_Cicero\\_Too\\_big\\_to\\_fail.pdf](http://www.cicero-group.com/files/Cypress_Cicero_Too_big_to_fail.pdf) (accessed 31 May 2016); Morisson AD “Systemic risks and the “Too-Big-To-Fail” problem” 2011 (27) *Oxf. Rev.Econ. Policy* 498 at 498 - 516; Yuksel M “Identifying global systemically important financial institutions (2014) <http://www.rba.gov.au/publications/bulletin/2014/dec/pdf/bu-1214-8.pdf> (accessed 7 June 2016); Haltom R “Failures of Continental Illinois” (1984) <http://www.federalreservehistory.org/Events/Detail/View/47> (accessed 22 August 2016); APRA “Information paper Domestic systemically important banks in Australia” (December 2013) <http://www.apra.gov.au/adi/Publications/Documents/Information-Paper-Domestic-systemically-important-banks-in-Australia-December-2013.pdf> (accessed 21 February 2018), hereinafter APRA D-SIBs 2013, at 4: Systemically important financial institutions (SIFIs) are institutions of such size, market importance and interconnectedness that their distress or failure would cause significant dislocation in the financial system and adverse economic consequences. The ‘too-big-to-fail’ problem arises when the threatened failure of a SIFI leaves public authorities with no option but to bail it out using public funds to avoid financial instability and economic damage. As the Basel Committee argued, the moral hazard associated with implicit guarantees derived from the perceived expectation of government support can encourage SIFIs to take excessive risks, reduces market discipline and creates competitive distortions, further increasing the probability of distress in the future. As a result, the direct cost of support associated with moral hazard is borne by taxpayers, representing a large and unacceptable implicit public subsidy of private enterprise.

<sup>95</sup> “A safer financial sector to serve South Africa better” published by the Department of National Treasury 23 February 2011 <http://www.treasury.gov.za/twinpeaks/20131211%20%20Item%202%20A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf> (accessed 9 November 2015), hereinafter National Treasury Red Book 2011 regarding the lessons learnt from the

the GFC central banks did not do enough to develop macroprudential tools that could have been used to address the escalation of vulnerability to the risks that accumulated in the financial system. Central banks were particularly blamed for their failure to develop and apply greater prudential standards for “Too-Big-To-Fail” institutions, whose failure would have a major disruptive effect on financial markets. It is also alleged that central banks in rapidly evolving financial markets, did not develop enough systemic procedures for the clearing and settlement of trades and that their structures were not such as to enable the achievement of their objectives. In this regard De Jager remarks that the general criticism was that the responsibility of financial stability was not well defined and the tools to ensure the maintenance of financial stability were not developed well enough before the GFC.<sup>96</sup>

Much of the problems that contributed to the 2008 GFC can be ascribed to the regulatory sentiment that prevailed before the GFC, namely that microprudential supervision was by and large considered as sufficient to maintain financial system stability. It was argued that if all institutions were soundly regulated, then the financial system would be stable. The GFC, however, has shown that the build-up of macro-economic risks (such as asset bubbles, high household debt levels or the increasing interconnectedness between large financial institutions) may pass unnoticed by microprudential regulators who focus only in silos on individual institutions.<sup>97</sup> The Crisis changed this narrow regulatory mind-set as it clearly revealed that approaching financial regulation on a microprudential level only was insufficient. It was thus realized that a new approach to financial regulation was required wherein timely macroprudential supervision has to take centre stage and has to operate in tandem with microprudential supervision and conduct of business supervision in order to ensure not only the maintenance of financial stability but also the active promotion thereof.<sup>98</sup>

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GFC 9 – 22; Guyun DR “The Global Financial Crisis and the proposed regulatory reform” 2010 *BYU LR* 421; Ciro T “Policy responses to the global financial crisis in South East Asia, Latin America and the Russian Federation” 2014 (29) *Journal of International Banking Law and Regulation* 471.

<sup>96</sup> De Jager 2013 no. 2 494; Oosterloo & de Haan 2004 265: There is no definite ‘tool kit’ available to prevent or cure episodes of financial instability. When an approach is too clearly formalized for observers, it could also give rise to moral hazard considerations.

<sup>97</sup> National Treasury Red Book 2011 12.

<sup>98</sup> Denters 2009 78.

The promotion and maintenance of financial stability accordingly became the overriding theme of the 2008 GFC narrative and lies at the core of the new regulatory paradigm that has developed in response to the Crisis. Globally, post the GFC, many jurisdictions considered their existing models of financial regulation and its ability to ensure and contribute to financial stability. This global wave of regulatory reform was largely occasioned by guidelines issued by international standard-setting bodies such as the Financial Stability Board (FSB),<sup>99</sup> specially established to co-ordinate financial stability on a global basis, and the Basel Committee.<sup>100</sup> Given that appropriate

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<sup>99</sup> Arner & Taylor 2009 489 – 490 indicate that the Financial Stability Board (FSB) was originally established as the Financial Stability Forum by the G7 Finance Ministers and Central Bank Governors in 1999 to promote international financial stability through enhanced information exchange and international cooperation in financial market supervision and surveillance. The FSB was reconstituted in April 2009 and comprised of financial authorities (usually the central bank and/or ministry of finance plus in some cases one or more regulatory agencies) from Argentina, Australia (represented by the Reserve Bank of Australia and the Treasury), Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Switzerland, Turkey, the United Kingdom and the United States; and major international financial institutions (the Bank for International Settlements, IMF, World Bank, OECD, ECB and European Commission) and international standard-setting and policy bodies (like the Basel Committee and IOSCO). And at 487 – 498: Specifically, the FSB's mandate is to: assess vulnerabilities affecting the financial system and identify and oversee action needed to address them; promoting co-ordination and information exchange among authorities responsible for financial stability; monitor and advise on market developments and their implications for regulatory policy; advise on and monitor best practice in meeting regulatory standards; undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps; set guidelines for and support the establishment of supervisory colleges; manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and collaborate with the IMF to conduct Early Warning Exercises. As obligations of membership, FSB members commit to pursue the maintenance of financial stability, maintain the openness and transparency of the financial sector, implement international financial standards, and agree to undergo periodic peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Program reports; See also Financial Services Board in "About Us" (1996 – 2017) <https://www.fsb.co.za/aboutUs/Pages/About-FSB.aspx> (accessed 8 June 2017).

<sup>100</sup> Alford 2005 241: the Basel Committee on Banking Supervision was created in 1975 on the initiative of the Group of Ten (G-10) countries' central bank governors. The Committee's members consisted of banking regulators from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. The Basel Committee secretariat is located at the offices of the Bank for International Settlements in Basel, Switzerland. Alford 2005 242: The purpose of the Basel Committee is to provide regular cooperation between its member countries on banking supervisory matters. The Committee issued various guidelines for bank supervision in order to amend the lack of regulation of banks and eventually provided comprehensive minimum standards for bank supervision when it published the Basil Core Principles in 1997. In 2006 it published a revised version of the Basel Core Principles for effective banking supervision (October 2006) <http://www.bis.org/publ/bcbs129.htm> (accessed 2 December 2016) and in 2012 a review of the 2006 Core Principles was published, namely the Basel Core Principles for effective banking supervision (September 2012) <http://www.bis.org/publ/bcbs130.htm> (accessed 2 December 2016). In 1988 Basel I, also known as the First Basel Capital Accord, in June 2004 Basel II, also known as the Second Basel Capital Accord, and in December 2010 Basel III, known as the Third Basel Capital Accord was adopted by the Basel Committee.

macroprudential regulation is the main driver of financial stability the mechanism of macroprudential regulation thus became the key focus area of this new regulatory landscape that emerged post GFC.

## **1.6 Financial stability: the role of systemic risk and the importance of sound macroprudential policy and tools**

As central banks pre-GFC generally did not have explicit financial stability mandates to be carried out within a designated regulatory framework that focused on the content and extent of such mandate and the manner by which and measures through which it should be sought to be achieved, they also did not have an explicit legislatively entrenched obligation to conduct macroprudential or system-wide surveillance within a dedicated framework, of *all* the financial institutions (and not only banks) that were active in a given financial market. It was alluded to in paragraph 1.5 that the concept of macroprudential supervision was not always part of the context of financial regulation. As documented by Clement, the origin of the term “macroprudential” can be traced back to unpublished documents prepared in the late 1970s - minutes of a meeting of the Cooke Committee (the predecessor of the present Basel Committee on Banking Supervision) and a document prepared by the Bank of England. The term was at that time generally used to indicate systemic regulation that was aimed at the macro-economy.<sup>101</sup> Concerns regarding financial stability in the financial system changed over time to focus more on excessive lending to developing countries, the impact of financial innovation and the development of capital markets, the influence of regulation on the procyclicality of the financial system, and the implications of the failure of systemically significant institutions.<sup>102</sup>

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<sup>101</sup> Clement P “The term ‘macroprudential’: origins and evolution” BIS Quarterly Review, March (2010) [http://www.bis.org/publ/qtrpdf/r\\_qt1003h.pdf](http://www.bis.org/publ/qtrpdf/r_qt1003h.pdf) (accessed 26 May 2017) at 59 and 60, hereinafter Clement 2010, in Galati G and Moessner R “Macroprudential policy – a literature review” DNB Working Paper No. 267 (December 2010 [https://www.dnb.nl/binaries/267%2020 Macroprudential\\_ tcm46-243120.pdf](https://www.dnb.nl/binaries/267%2020%20Macroprudential_tcm46-243120.pdf) (accessed 19 May 2017), hereinafter Galati & Moessner 2010; Romano R “For diversity in the international regulation of financial institutions: critiquing and recalibrating the Basel architecture” 2014 (31) *Yale Journal on Regulation* 1 at 4: confirms that the regulatory approach to systemic risk has been altered to include a macro- and not solely a micro-level perspective.

<sup>102</sup> Clement 2010 65.

Over time, attempts were made to define the meaning of the term “macroprudential”. This was done with reference to its antonym, “microprudential”. In this sense, “macroprudential” supervision refers to the use of prudential tools with the clear objective of promoting the stability of the financial system as a whole, not necessarily only that of the individual institutions within it.<sup>103</sup>

During the 1990s and 2000s, through various financial crises, the concept of macroprudential regulation and supervision in order to ensure financial stability, gained widespread acceptance among central bankers. It gained the reputation as a regulatory mechanism that would assist to achieve the goal of preventing and containing systemic financial crises. The characteristics of a macroprudential regulatory system are in part contradictory and in part complementary to that of a microprudential system. It provides a necessary set of tools that aims to manage systemic risk in the global financial system. Since macroprudential policy is sometimes difficult to understand, it is often described by referring to its objectives, tools and metrics. Its goal is to provide balance in regulating the financial sector and to mitigate the perceived weaknesses of a microprudential regulatory system. Macroprudential regulation as the practical implementation of macroprudential policy thus functions as an early warning system, consisting of various tools, the most important of which are those used to supervise the financial system in order to prevent the accumulation of risk.<sup>104</sup>

Central to the concept of macroprudential regulation and supervision and a macroprudential framework to facilitate such regulation and supervision, is the notion

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<sup>103</sup> Clement 2010 65; Salerno ME “The renewed objectives of financial regulation after the global financial crisis” 2015 (30) *Journal of International Banking Law and Regulation* 315 at 317: The regulatory objective of financial stability cannot be limited to microprudential regulation as was previously done, but it has to include macroprudential regulation concerning the financial system as a whole; Yue E “Marrying the micro- and macroprudential dimensions of financial stability – the Hong Kong experience” in BIS Paper No. 1 230 (March 2001) <http://www.bis.org/publ/bppdf/bispap01.htm> (accessed 30 January 2017) at 235 point out that “[M]icroprudential regulation and macroprudential stability feed through each other in various ways. Therefore the efforts on the two fronts should be well coordinated.’

<sup>104</sup> Gohari & Woody 2015 411.

of “systemic risk” and the sources thereof. Macroprudential policy is primarily concerned with the use of macroprudential instruments or tools to limit systemic risk. In the 2009 Report of the Financial Stability Board (FSB), the International Monetary Fund (IMF) and the Bank for International Settlement (BIS), systemic risk is described as “the risk of disruptions to the provision of key financial services that is caused by an impairment of all or parts of the financial system, and which can cause serious consequences for the real economy.”<sup>105</sup> As such systemic risk may for example arise at certain points in the economic cycle where borrowers exceed their means, when leverage in the financial sector is high and when maturity transformation is excessive.<sup>106</sup>

Systemic risks are usually divided into two broad categories, namely cyclical risks and structural risks. The cyclical or time dimension of systemic risk focuses on how risk can build up over time, for example through credit booms<sup>107</sup> and asset price bubbles, and how it impacts negatively on the real economy following such busts. The structural or cross-sectional dimension is concerned with how the concentration of risk and the interconnectedness of different parts of the financial system contribute to systemic risk.<sup>108</sup>

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<sup>105</sup> Report to the G-20 Finance Ministers and Central Bank Governors (2009) *Guidance to assess the systemic importance of financial institutions, markets and instruments: initial considerations* <http://www.imf.org/external/np/g20/pdf/100109.pdf> (accessed 2 June 2016).

<sup>106</sup> SARB Macroprudential policy document 2016 9.

<sup>107</sup> Dell’Ariccia G, Igan D, Laeven L and Tong H - IMF Staff Discussion Note - “Policies for Macrofinancial Stability: Dealing with Credit Booms and Busts” (7 June 2012) <https://www.imf.org/external/pubs/ft/sdn/2012/sdn1206.pdf> (accessed 30 January 2017), hereinafter Dell’Ariccia et al 2012, at 5 and 17: They point out that episodes of rapid credit growth, as with credit booms, have been associated with financial crises, and it poses a dilemma, since more credit means increased access to finance and greater support for investment and economic growth. But when expansion is too fast, such booms may lead to vulnerabilities and be dangerous or even a recipe for disaster. Until the GFC limited attention was paid to credit booms. One of the reasons for this is that bank regulation focused on individual institutions. The macro-economic cycle was thus ignored and bank regulation was not equipped well enough to respond to aggregate credit dynamics.

<sup>108</sup> SARB macroprudential policy document 2016 9. Gohari & Woody 2015 409 – 410: Gohari and Woody proposed in 2015 that macroprudential regulation consists of two parts, namely capital conservation and countercyclical buffers. Capital conservation focuses on enhancing the capital requirements of bank holding companies and systemically important nonbank financial institutions, especially those operating on a global scale. Countercyclical buffers, meanwhile, provide for constraints on capital during periods of rapid credit growth in order to prevent or mitigate the build-up of risk in the system.

Cyclical risks refers to the tendency of financial institutions and households to assume excessive risks during upswings in financial and credit cycles, and then to become exceedingly risk-averse during downswings. However it is during the upswing phase (that is characterised by aspects such as strong optimism, financial innovation, underpricing of risk and strong credit growth) that systemic risk usually builds up. When these bubbles in the asset market bursts the result is often fire sales of assets, prices that drop and a credit crunch leading to financial crises with serious consequences for the real economy. As stated in the South African Reserve Bank's 2016 position paper on macroprudential policy "[C]yclical risks also have the ability to amplify the impact of adverse aggregate shocks to feedback mechanisms between excessive credit growth, asset price bubbles, excessive leverage and maturity mismatches."<sup>109</sup>

Structural risks concern the distribution or concentration of aggregate risk in the financial system at any given time. As pointed out above, financial institutions are often so closely interconnected through exposures to counterparties that it results in a complex network of direct and indirect inter-linkages throughout the financial system. Adverse aggregate shocks could thus be amplified through spill overs, contagion, moral hazard, opacity and complexity of financial institutions and also markets and products. The degree of concentration in the financial system, where a large portion of the financial system's functions are conducted by a few financial institutions that are heavily interconnected and exposed to the same risks and dependent on the same funding, could also contribute significantly to the degree of risk in the financial system.<sup>110</sup>

The possible adverse effects of events on financial stability has to be mitigated through macroprudential policy instruments. The concept "systemic event", is therefore paramount to successful macroprudential regulation, since a systemic event is an

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<sup>109</sup> SARB Macroprudential policy document 2016 9-10. Roubini N "Why Central Banks should burst bubbles" *International Finance* 9:1 2006 87 <http://web-docs.stern.nyu.edu/salomon/docs/crisis/Bubbles%20and%20Monetary%20%20Policy%20-%20Roubini.pdf> DOI:10.1111/j.1468-2362.2006.0032.x (accessed 26 January 2017) at 105: Roubini does not suggest an aggressive monetary policy approach to asset bubbles, but that monetary policy should respond to asset bubbles in a cautious and moderate manner.

<sup>110</sup> SARB Macroprudential policy document 2016 10; See also Goodhart CAE & Huang H "The lender of last resort" 2005 (29) *Journal of Banking & Finance* 1059 at 1063.

event that has the potential to break down the whole financial system and therefore could be a threat to financial stability.<sup>111</sup> In the context of financial stability it is important to consider what future adverse systemic events could entail and to reflect on steps needed to strengthen regulation in a way to reduce or mitigate the impact of such future systemic events.<sup>112</sup>

Although the focus of this thesis is not macroprudential policy or tools per se some background on these concepts are necessary to enable a better appreciation of the role of the central bank in the context of financial stability post GFC especially as macroprudential policy informs certain aspects of the legislative framework within which the financial stability mandate has to be executed. Macroprudential policy has two broad aims that are not mutually exclusive: firstly it aims to strengthen the resilience of the financial system to economic downturns and other adverse aggregate shocks. Secondly, it aims to “lean against” the financial cycle to limit the accumulation of financial risks and the likelihood or extent of a financial crisis.<sup>113</sup> To be successful it needs to identify certain intermediate policy objectives such as reducing excessive growth in credit, asset prices and leverage; reducing excessive lending and funding maturity mismatches; reducing direct and indirect concentrations of exposures to the same markets, products and institutions and reducing moral hazard by avoiding situations where institutions increase their exposure to risk with the expectation that they will be bailed out by the government.<sup>114</sup>

Sound macroprudential policy thus increases the resilience of the financial system to adverse aggregate systemic shocks by establishing buffers to help cushion their

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<sup>111</sup> SARB Macroprudential policy document 2016 3; Smaga P “Assessing involvement of central banks in financial stability” Centre for financial stability – Policy paper (23 May 2013) [http://www.centerforfinancialstability.org/research/Assessing\\_052313.pdf](http://www.centerforfinancialstability.org/research/Assessing_052313.pdf) (accessed 9 August 2017) at 4: Among central banks, there is no consensus as for the tools used to achieve financial stability.

<sup>112</sup> Caruana J “Minimising the impact of future financial crises: six key elements of regulatory reform we have to get right” 2009 *Banque de France Financial Stability Review* 2009 No. 13 43 at 44.

<sup>113</sup> SARB Macroprudential policy document 2016 10; See Kearns J and Rigobon R “Identifying the efficacy of central bank interventions: Evidence from Australia and Japan” 2005 (66) *Journal of International Economics* 1 at 1 and 3 on central banks that “lean against the wind” in foreign exchange markets

<sup>114</sup> SARB Macroprudential policy document 201610-11.

impact and sustain the provision of financial services and credit to the economy.<sup>115</sup> As such macroprudential policy focuses on the interactions between financial institutions, infrastructure, markets and the real economy. Thus macroprudential policy focuses on endogenous risk, aiming to restrain the build-up of systemic vulnerabilities over time (cyclical dimension) by limiting the procyclical feedback effects between excessive credit growth and asset prices and by discouraging unsustainable increases in leverage and risky funding operations. Macroprudential tools are also aimed at restraining build-up of systemic vulnerabilities within the financial system (structural dimension) by reducing the risk of concentration that can result from financial institutions having similar exposures or direct balance sheet linkages.<sup>116</sup>

As indicated in the SARB's macroprudential policy position paper released in 2016, three steps can be identified in the macroprudential policy process leading up to the activation of macroprudential tools, namely systemic risk assessment, building a case and motivation for macroprudential intervention and selecting and implementing the macroprudential instruments.<sup>117</sup>

Systemic risk assessment requires that the financial system be monitored for risk, especially risk that may be of a systemic nature. Such monitoring focuses on systemic vulnerabilities that propagate adverse shocks and includes analyses of risks in systemically important financial institutions, shadow banks, asset markets and the non-financial sector. The systemic risk assessment process uses indicators that confirm the build-up of imbalances in the financial system.<sup>118</sup> Examples of such indicators are the following:<sup>119</sup>

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<sup>115</sup> See also Borio 2004 32.

<sup>116</sup> SARB Macroprudential policy document 2016 11.

<sup>117</sup> SARB Macroprudential policy document 2016 11; Nier E, Osinski J, Jacome L and Madrid P 2011. "Towards Effective Macroprudential Policy Frameworks: An Assessment of Stylized Institutional Models" IMF 11/250 (1 November 2011) <https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Towards-Effective-Macroprudential-Policy-Frameworks-An-Assessment> at 10: Interestingly, this IMF Working Paper mentions that the decision to use macroprudential tools appears uncorrelated with whether an institution has an explicit macroprudential mandate. Some countries do not have an institution with a macroprudential mandate, but nonetheless reported using instruments to address systemic risks. On the other hand other countries have an institution with a macroprudential mandate but did not use any such instrument.

<sup>118</sup> SARB Macroprudential policy document (2016 12).

<sup>119</sup> SARB Macroprudential policy document 2016 12.

- (a) macro-economic indicators: these indicators entail the assessment and monitoring of the level of leverage and general credit market conditions;
- (b) financial sector indicators: these are measures related to maturity and currency mismatches that point to funding vulnerabilities in the financial sector. Changes to lending standards are assessed to determine the level of risk appetite. The resilience of the financial sector to severe adverse market conditions is further assessed through periodic stress tests;<sup>120</sup>
- (c) market-based indicators: house prices, commercial property prices and asset valuations in equity markets are used to assess asset market conditions. Government and corporate bond spreads, credit default swap spreads and measures of risk premiums could be used to assess funding and credit market conditions; and
- (d) qualitative information: underwriting standards, asset quality and credit conditions are examples of typical information generally used in this context.

Gohari and Woody point out that macroprudential supervision post GFC has four goals, namely to prevent and/or contain systemic shocks to the financial system; to supervise SIFIs and their risk accumulation; to provide a conservation buffer<sup>121</sup> above that what it was before the GFC and to provide for countercyclical measures.<sup>122</sup>

Macroprudential policy is thus characterised by reference to three defining elements:

- (a) Its objective: to limit systemic risk - the risk of widespread disruptions to the provision of financial services that have serious negative consequences for the economy at large.

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<sup>120</sup> Fischer 2015 8: Stress tests evaluate banks' ability to remain solvent and liquid when under severe macro-economic stresses. It is an analysis conducted under unfavourable economic scenarios designed to determine whether a bank has enough capital to withstand the impact of adverse developments.

<sup>121</sup> Gohari & Woody 2015 409 – 410 explain that capital conservation focuses on enhancing the capital requirements of bank holding companies and systemically important non-bank financial institutions, especially those operating on a global scale. Countercyclical buffers provide for constraints on capital during periods of rapid credit growth in order to prevent or mitigate the build-up of risk in the system; Dell'Ariccia et al 2012 23 and 24 remark that capital conservation buffers are implemented to ensure that capital buffers (for instance the mandatory capital that a financial institution is required to hold) are increased in good times in the form of reserves that could absorb losses during bad times.

<sup>122</sup> Gohari & Woody 2015 417; Schwarcz SL "Regulating financial change: a functional approach" 2016 (100) *Minnesota Law Review* 1441 at 1466 further explains that countercyclical capital requirements, for instance, help to discourage the build-up of imbalances during economic booms and bubbles by reducing excessive risk-taking and credit expansion.

(b) Its scope: the focus is on the financial system as a whole (including the interactions between the financial and real sectors) as opposed to individual components.

(c) Its instruments and associated governance: It uses primarily prudential tools calibrated to target the sources of systemic risk. Any non-prudential tools that are part of the framework need to clearly target systemic risk.<sup>123</sup>

In the 2011 Joint FSB IMF BIS Report on Macroprudential Policy Tools and Frameworks it is indicated that countries have a wide range of indicators and models to assess systemic risk and that after the GFC the main measurement approaches can be categorized as follows: aggregate indicators of imbalances; indicators of market conditions; metrics of concentration of risk within the system; macro stress testing; and integrated monitoring systems.<sup>124</sup> The most commonly used tools to address macroprudential risks include:<sup>125</sup>

(a) tools to address threats to financial stability arising from excessive credit expansion and asset price booms, particularly in real estate markets, both residential and

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<sup>123</sup> Joint FSB, IMF, BIS Paper *Macroprudential policy tools and frameworks – Progress Report to G20* (27 October 2011) <https://www.imf.org/external/np/g20/pdf/102711.pdf> (accessed 2 September 2017), hereinafter FSB IMF BIS 2011, at 4. See also IMF-FSB-BIS “Elements of Effective Macroprudential Policies: Lessons from International Experience” (31 August 2016) <https://www.imf.org/external/np/g20/pdf/2016/083116.pdf> (accessed 1 December 2017). See also Claessens S “An overview of Macroprudential Policy Tools” IMF Working Paper 14/214 (December 2014) <https://www.imf.org/external/pubs/ft/wp/2014/wp14214.pdf> (accessed 5 December 2016)), hereinafter Claessens 2014; Dell’Ariccia et al 2012 23 and 24: According to Dell’Ariccia et al, the most commonly used macroprudential tools can be grouped into three categories:

(a) Capital and liquidity requirements: These measures affect the cost and/or composition of the liabilities of financial institutions by increasing their capital and liquidity buffers. For instance, countercyclical capital requirements increase the cost of bank capital, and thus lending, in good times. Dynamic loan-loss provisioning rules, which build up capital buffers in the form of reserves in good times to absorb losses during bad times, also fall into this category. Capital and liquidity requirements can be countercyclical to smooth the credit cycle and/or include surcharges for systemically important financial institutions to limit the build-up of systemic risk.

(b) Asset concentration and credit growth limits: These measures alter the composition of the assets of financial institutions by imposing limits on the pace of credit growth or on their asset concentration. Examples include speed limits on credit expansion, limits on foreign currency exposure or foreign-currency-denominated lending, and limits on sectoral concentration of loan portfolios. The aim of these measures is to reduce the exposure of bank portfolios to sectoral shocks and, to the extent that slower credit growth improves average loan quality, to aggregate shocks.

(c) Loan eligibility criteria: These measures limit the pool of borrowers that have access to finance to improve the average quality of borrowers. Examples include loan-to-value (LTV) and debt-to-income (DTI) limits. These limits seek to leave the “marginal” borrowers out of the pool. LTVs also safeguard lenders by increasing loan collateral. Eligibility criteria can be tailored to fit a loan portfolio’s risk profile. For example, LTV limits can be linked to local house price dynamics or be differentiated based on whether loans are made in foreign currency to unhedged households or not.

<sup>124</sup> FSB IMF BIS 2011 5 to 6.

<sup>125</sup> FSB IMF BIS 2011 10.

commercial (for example dynamic capital buffers,<sup>126</sup> dynamic provisions,<sup>127</sup> loan-to-value (LTV) and debt-service-to-income ratios (DTI) ratios) but also the terms and conditions of transactions in wholesale financial markets (for example margins);<sup>128</sup>

(b) tools to address key amplification mechanisms of systemic risk linked to leverage for example capital tools)<sup>129</sup> and maturity mismatches (eg market and funding liquidity tools), including adjustments to take into account the prominent role played by ballooning intra-financial system exposures in the run up to the 2008 GFC (eg risk weights or limits on intra-financial system exposures); and

(c) tools to mitigate structural vulnerabilities in the system and to limit systemic spillovers in times of stress such as additional loss absorbing capacity for SIFIs. Disclosure requirements that target common exposures, common risk factors and

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<sup>126</sup> Mohan R “Emerging contours of financial regulation: challenges and dynamics” 2009 (13) *Banque de France Financial Stability Review* 103 at 109 remarks that capital buffers for the system should be enhanced during the economic expansion in order to be drawn down as needed in downturns; Wellink N “Beyond the crisis: the Basel Committee’s strategic response” 2009 (13) *Banque de France Financial Stability Review* 123 states that a strong capital buffer enhances a financial institution’s creditworthiness and, from the market’s perspective, reduces its counterparty risk and helps to ensure continued access to funding.

<sup>127</sup> Claessens 2014 16 points out that dynamic provisioning is a measure that aims at strengthening the banking system, and even though it might not be able to stop a boom, it might be able to help to cope with the possible bust; Jimenez G, Ongena S, Peydro J and Saurina J “Macroprudential policy, countercyclical bank capital buffers and credit supply: Evidence from the Spanish dynamic provisioning experiments” European Banking Center Discussion Paper No. 231 (October 2012) <https://www.econstor.eu/bitstream/10419/144443/1/wp231en.pdf> (accessed 31 December 2017) at 3: explains the concept as follows: “With dynamic provisioning, banks’ capital is increased in good times and decreased in bad times. Dynamic provisions are forward-looking provisions that – before any credit loss is individually identified on a specific loan – build up a buffer of bank own funds from retained profits in good times that can be used in bad times to cover the realized losses”. At 9: “Dynamic provisions are a special kind of general loan loss provision and the buffer they accumulate in the expansion phase can be assimilated to a capital buffer”. At 13:” Dynamic provisioning requirements thus follow an identical formula applied to all the banks that states how much each bank has to provision depending on its credit portfolio.”

<sup>128</sup> Bank for International Settlements “Collateral in wholesale financial markets: recent trends, risk management and market dynamics” (March 2001) <https://www.bis.org/publ/cgfs17.pdf> (accessed 8 March 2018) at 2-3: The use of collateral has become one of the most important and widespread risk mitigation techniques in wholesale financial markets. Margin calls are one of several mechanisms in financial markets that can add to selling pressure and an overshooting of prices. To margin or buying on margin, refers to buying an asset where the buyer pays only a percentage of the asset’s value and borrows the rest from the bank or broker. The broker acts as a lender, and he uses the funds in the securities account as collateral on the loan’s balance.

<sup>129</sup> Freixas X, Laeven L and Peydro J *Systemic risk, crises, and macroprudential regulation* (2015) 279: Macroprudential policy instruments will tend to be complements that can be used to address different aspects of systemic risk at the level of individual vulnerabilities. For example, excessive leverage can be curtailed both through raising capital requirements and a tightening of LTV ratios. See also European Systemic Risk Board “Recommendation on leverage and liquidity in investment funds” (14 February 2018) <https://www.esrb.europa.eu/news/pr/date/2018/html/esrb.pr180214.en.html> (accessed 8 March 2018): The European Systemic Risk Board has published a recommendation on action to address systemic risks related to liquidity mismatches and the use of leverage in investment funds. This recommendation is designed to facilitate the implementation of a macroprudential tool to limit leverage in alternative investment funds.

interconnectedness (rather than the risk profiles of individual institutions on a stand-alone basis) and specific requirements for SIFIs in the context of effective resolution frameworks are also key supportive instruments in this area.

This macroprudential toolkit has since the 2011 Joint Report been the subject of much debate and many writers are constantly contributing to this evolving debate on what the most appropriate macroprudential tools are.<sup>130</sup> An analysis of these tools is beyond the scope of this thesis; suffice to say that the effective execution of a financial stability mandate will require an appropriately enabling legal framework founded on sound macroprudential policy stemmed at detecting, preventing and managing systemic risk and systemic events (i.e. where the risk has materialized) and should include an effective macroprudential toolkit.

## **1.7 The central bank as guardian of financial stability post GFC**

Although central banks have traditionally had a role in the maintenance of financial stability, this role was somewhat underplayed and generally not entrenched within a comprehensive legislative framework. As indicated the recognition of the importance of financial stability and macroprudential regulation and supervision gained some momentum<sup>131</sup> prior to the 2008 GFC, but this development was unfortunately not timely, progressive and comprehensive enough to provide a buffer against the Crisis. The GFC marked a definitive turning point – it was an absolute and undeniable game changer in the context of financial regulation.

The 2008 GFC revealed the crucial importance of financial stability and it emerged as defining regulatory pursuit post GFC with emphasis being placed on the role of the

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<sup>130</sup> See for example Lim C “Macroprudential Policy: What instruments and how to use them” IMF Working Paper No. 11/238 (8 November 2011) [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1956385](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1956385) (accessed 30 November 2017); Claessens 2014; Hockett 2015 219-228.

<sup>131</sup> See for example Halme et al 2000; Oosterloo & de Haan 2004; Schinasi 2004; Allen & Wood 2006; Goodhart 2006; Arner DW *Financial stability, economic growth and the role of the law* (2007); Goodhart CAE “Analysis of Financial Stability” London School of Economics Financial Markets Group Paper Series (2007) <http://www.lse.ac.uk/fmg/home.aspx> (accessed 25 November 2017). See also particularly quarterly publications of the Global Financial Stability Reports issued by the IMF since 2002.

central bank as “keeper or guardian of financial stability”.<sup>132</sup> In their Framework for Financial Stability the Group of Thirty recommended that where not already the case, central banks should accept a role in promoting and maintaining financial stability. They further recommended that in countries where the central bank is not the prudential regulator it should have a strong role on the governing body of the prudential regulator - thus acknowledging the essential link between prudential regulation and financial stability.<sup>133</sup>

Goodhart poses the question whether the central bank should be in charge of financial stability and if not, what its relationship with the systemic regulator should be.<sup>134</sup> He points out that the essence of central banking has been the central bank’s capacity to lend, and thus to create liquidity, either to an individual bank in terms of its role of a lender of last resort, or the market as a whole via open market operations. In his opinion it would cause massive complications if liquidity management remained the sole province of the central bank while a separate financial stability authority was to be established without any command over liquidity management.<sup>135</sup> Of course

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<sup>132</sup> Corbo V “Financial stability in a crisis: What is the role of the central bank?” BIS Papers No. 51 (2010) <http://www.bis.org/publ/bppdf/bispap51f.pdf> (accessed 15 October 2016); See also Shirakawa M “Central banking before, during and after the crisis” (24 March 2012) <https://www.bis.org/review/r120329b.pdf> (accessed 2 December 2017); Cukierman “Monetary policy and institutions before, during and after the Global Financial Crisis 2013 (9) *Journal of Financial Stability* 373; Bullock M “Has the way we look at financial stability changed since the Global Financial Crisis?” (14 March 2017) <https://www.rba.gov.au/speeches/2017/sp-ag-2017-03-14.html> (accessed 29 November 2017); In 2009 Michael Taylor, the original author of Twin Peaks (see in 1.9 below) in “Twin Peaks revisited a second chance for regulatory reform” (September 2009) <https://static1.squarespace.com/static/54d620fce4b049bf4cd5be9b/t/55241044e4b03769e017208a/1428426820095/Twin+Peaks+Revisited.pdf> (accessed 27 April 2017) 30 opined that the central bank should have an unambiguous financial stability mandate. And in 2011 he opined in “The Road from ‘Twin Peaks’ – and The Way Back” *Connecticut Insurance Law Journal* Vol 16:1 (2011) <http://www.insurancejournal.org/wp-content/uploads/2011/07/Abstrac-21> (accessed 9 September 2015) 91, that as the British experience shows, there is no plausible alternative to having a central bank with an extensive mandate and the ability to intervene to mitigate a crisis.

<sup>133</sup> Group of Thirty Consultative Group on International Economic and Monetary Affairs Inc – Special Report by Working Group on Financial Supervision “The structure of financial supervision – Approaches and challenges in a global marketplace” (6 October 2008) [http://group30.org/images/uploads/publications/G30\\_StructureFinancialSupervision2008.pdf](http://group30.org/images/uploads/publications/G30_StructureFinancialSupervision2008.pdf) (accessed 1 June 2017), hereinafter Group of Thirty 2008, Recommendation 7 at 64.

<sup>134</sup> Goodhart 2011 146.

<sup>135</sup> Goodhart 2011 147. He points out that the essence of central banking lies in its power to create liquidity, by manipulating its own balance sheet. Goodhart further indicates that the question is often asked whether a central bank that sets interest rates should also manage financial stability. However he opines that “[T]his question is put the wrong way around. The question should be whether a central bank that manages both liquidity and financial stability should also be given the task of setting interest rates”; Edge & Liang 2017 3 also point out that some of the traditional roles of a central bank, like

Goodhart is right. Having regard to the prominent roles generally fulfilled by the central bank it is submitted that there can be no doubt that the central bank with its broad institutional expertise of various aspects of the financial system and macro-economy, its data-gathering powers and its various other roles alluded to above, is the institution best suited to carry out the post GFC financial stability mandate - especially given that, although more comprehensive and expanded, this will not be a new role for central banks – only a more focused and hopefully better delineated and enabled one.<sup>136</sup>

This now raises the question as to whether this financial stability mandate can be translated effectively into legislation within the broader context of an appropriate and enabling model of financial regulation given its general absence pre-GFC from being expressly and comprehensively entrenched in legislation.

## **1.8 Enabling financial stability through an appropriate institutional framework for financial regulation**

It is submitted that the central bank's financial stability mandate cannot be exercised in a vacuum but that it should be exercised within the parameters of an enabling legislative framework for financial regulation that focuses on providing an optimal institutional architecture to facilitate the execution of this crucially important mandate.

As a basic premise Llewellyn states that a well-structured regulatory regime contributes to the efficiency and stability of the financial system.<sup>137</sup> He remarks that while it is universally agreed that the central bank has a major responsibility for maintaining systemic stability “the definition and legal authority for this is often blurred.” He remarks that it is ironic therefore that there is no universal definition and agreement

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maintaining stability in the monetary system and being the lender of last resort in the economy, intersect closely with macroprudential policy responsibilities.

<sup>136</sup> Edey 2013.

<sup>137</sup> Llewellyn D “Institutional Structure of financial regulation and supervision: the basic issues” Paper presented at World Bank Seminar - Aligning Supervisory structures with country needs - Washington DC (6 and 7 June 2006) (accessed 30 May 2017) 5, hereinafter Llewellyn 2006.

about what constitutes financial stability and that in very few countries there is actually legal authority for the central bank to undertake this task.<sup>138</sup>

Llewellyn points out that one dimension of the debate over institutional structure is whether the central bank's functions as payment system supervisor, lender of last resort and its mandate for financial stability can effectively be performed if the central bank is not also the prudential supervisor of the individual financial institutions that make up the financial system. In his opinion there are several dimensions to this issue, including the independence and authority of the central bank, its skills and whether its responsibility for price stability might be compromised by any failures in regulation and supervision of financial institutions in the event that the central bank is also the prudential supervisor.<sup>139</sup>

Arguments in favour of combining the mandates of financial stability and prudential regulation in the central bank are that it may occasion economies of scale<sup>140</sup> as it serves to lower institutional costs and allows sharing of resources such as IT-systems and support services. Synergies may also be generated from economies of scope.<sup>141</sup> The problem however with dumping too many regulatory obligations on the central bank is that it may lead to what has been described as the "Christmas tree effect" by Taylor and Fleming: by on-loading a wide range of miscellaneous functions onto an agency it eventually becomes overburdened by activities divorced from its primary functions and objectives.<sup>142</sup>

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<sup>138</sup> Llewellyn 2006 28.

<sup>139</sup> Llewellyn 2006 6.

<sup>140</sup> Collins Dictionary (undated) <https://www.collinsdictionary.com/dictionary/english/economies-of-scale> (accessed 19 March 2018), hereinafter Collins Dictionary: Economies of scale are the financial advantages that a company gains when it produces large quantities of products.

<sup>141</sup> Collins Dictionary: Economies of scope is a proportionate saving gained by producing two or more distinct goods, when the cost of doing so is less than that of producing each separately.

<sup>142</sup> Taylor M and Fleming A "Integrated Financial Supervision: Lessons from Northern European Experience" Policy Research Working Paper No. WPS 2223 World Bank (September 1999) <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.476.466&rep=rep1&type=pdf> (accessed 31 December 2017) referred to in Llewellyn 2006 23.

The four most prevalent frameworks for financial regulation that existed prior to the 2008 GFC are the institutional or traditional approach, the functional approach, the integrated or single-regulator approach and the Twin Peaks approach.<sup>143</sup> The Group of Thirty completed a seventeen-jurisdiction review of financial regulatory approaches in July 2007. Examples of jurisdictions using one of the four approaches to financial supervision, or a variation thereof, were the Institutional approach in China, Hong Kong and Mexico; the Functional approach in Italy, Brazil, Spain and France; the Integrated approach in the United Kingdom, Canada, Japan, Qatar, Singapore, Switzerland and Germany; and the Twin Peaks approach in Australia, Canada, the Netherlands, Switzerland and Spain.<sup>144</sup>

Schmulow points out that the institutional approach focuses on the form of a legal entity under regulation and subsequently a particular regulator is then assigned to it.<sup>145</sup> With the institutional approach (being a product of the broader 'sectoral' or 'operational' approach), institutions with different legal statuses have thus been permitted over time to engage in similar activities but subject to different requirements set by different regulators. A separate specialist regulator is established for each type of institution. This regulator then supervises all activities undertaken by the institution that falls within the scope of financial regulation undertaken by that regulator, irrespective of the market or sector in which the activities take place.<sup>146</sup> Institutions are

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<sup>143</sup> Schmulow AD "The four methods of financial system regulation: an international comparative survey" 2015 26 *Journal of Banking and Finance Law and Practice* 152, hereinafter Schmulow 2015 no. 1. National Treasury Red Book 2011 29; Killick M "'Twin Peaks' – a new series or a new chimera? An analysis of the proposed new regulatory structure in the UK" 2012 (12) *The Company Lawyer* 366 at 370.

<sup>144</sup> Group of Thirty 2008 28 and 30; Schmulow 2015 no. 1 151; See also Wymeersch E "The Structure of Financial Supervision in Europe: About Single, Twin Peaks and Multiple Financial Supervisors" (2006) [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=946695](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=946695) (accessed 6 July 2017) 1 for a discussion of various approaches to supervision, including the institutional approach, the functional approach and the integrated approach in Europe; See also National Treasury Red Book 2011 29.

<sup>145</sup> Schmulow 2015 no. 1 153.

<sup>146</sup> Godwin A, Guo L and Ramsay I "Is Australia's 'Twin Peaks' System of Financial Regulation a Model for China?" (11 April 2016) CIFR Paper No. 102/2016 <https://ssrn.com/abstract=2763300> (accessed 23 March 2017, hereinafter Godwin et al 2016 at 5 and also: Some commentators refer to the sectoral or operational model as a functional approach, under which each type of business is 'overseen by a separate, "functional" regulator'. With the institutional approach, the institution is usually regulated by one regulator alone, unless it offers more than one product, like banking products and life insurance, in which case it might be regulated by the banking regulator and the insurance regulator. For example, where a financial institution does business in banking products and life insurance, it might be regulated by both the banking regulator and the insurance regulator. In this thesis the words functional model will not be used to refer to the sectoral or operational model.

thus regulated with reference to the sector in which they operate or the products or business that they are involved in, for example banks will be regulated and supervised separately from insurance companies.<sup>147</sup> With the institutional approach, each regulator would be responsible for both prudential and market conduct and consumer protection issues.<sup>148</sup>

The institutional approach to supervision is also the traditional approach, and where it was applied, it was under the most strain to change, due to significant changes in financial markets and players and the blurring of product lines across sectors. The institutional approach is based on a business model that, to a large extent, no longer exists. Many large financial institutions have moved away from businesses that operate in one specific financial area and are involved in a cross-section of products and services. Institutions are inclined to operate along business lines without regard to legal status of the entities in which the activity is situated or recorded for regulatory purposes. Different regulators apply rules and regulations differently. Financial regulation following the institutional approach therefor results in rules and regulations being applied inconsistently. The same or economically similar activities may be conducted by entities that are legally overseen as banks, insurance companies or securities firms, and then may be regulated differently for the same type of activity, for instance applying different capital requirements or customer protection rules. One may therefore argue that in the modern financial system with its micro and macro dimensions this approach to financial regulation has lost its relevance as it is too narrow to ensure financial stability.<sup>149</sup> Schmulow observes that the institutional approach to financial system regulation is heavily fragmented and does not deal very

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<sup>147</sup> National Treasury Red Book 2011 29; Hockett 2015 232: The problem experienced with the model where macroprudential financial regulation is devised between various sectoral regulators, is that it lends itself to sector-specific macroprudential regulation at best and dysfunctional fragmented microprudential regulation at worst. If there are not meaningful coordination and collaboration by sectoral regulators, the problem of convergence will outrun the adaptive capacities of the sectoral regulators. For instance, a securities regulator with no expertise in bank regulation, will be facing bank-like problems that they will not be adequately equipped to regulate. In this way, systemic risks will infiltrate the whole financial system.

<sup>148</sup> Schmulow 2015 no. 1 152 – 154.

<sup>149</sup> Group of Thirty 2008 34 and also: The Institutional Approach potentially suffers from not having a single regulator with a 360-degree overview of a regulated entity's business or of the market as a whole. It also suffers from not having a single regulator that can mandate actions designed to mitigate systemic risk; See also discussion in 4.2 below regarding the move in the Netherlands from the sectoral model, of which the institutional model is a product, to a functional model, reflected in the Twin Peaks model.

well with financial entities with mixed businesses, like a bank that also does insurance business. This approach is also regarded as least capable of dealing with financial conglomerates, where the activities blur the boundaries between different types of financial firms.<sup>150</sup>

Under the functional approach supervisory oversight involves regulating activities across functional, as opposed to legal entity, lines and it is determined by the type of business or transactions or products that is regulated. One firm that engages in multiple types of transactions will thus be subject to multiple regulators. The benefit of this approach is that the regulator will apply consistent rules to the same activity regardless of the entity in which the activity is conducted. Each regulator will supervise the safety and soundness of a specific financial institution as well as the business conduct of that institution. Regulatory arbitrage, which can happen when multiple regulators interpret and enforce the same, or perhaps even inconsistent, rules in different ways, is avoided under this approach. Each regulator may use highly qualified experts who can interpret and apply applicable rules to the same functions across different legal entities. However, in practice it may be extremely difficult to distinguish which type of activity comes within the jurisdiction of a particular regulator, giving rise to disparities in regulatory positions on similar activities.<sup>151</sup>

The functional approach also has some other drawbacks: it can force financial institutions to deal with multiple regulators, which could be costly in terms of time and effort. Furthermore product innovation can be repressed if there is a battle between functional regulators over jurisdiction. Other challenges to the functional approach is that no regulator has sufficient information concerning all the activities of any particular entity or entities to monitor for systemic risk. Addressing systemic risk may require having a single regulator with authority to mandate actions across the entire financial

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<sup>150</sup> Schmulow 2015 no. 1 152 and 154: This is however not always the case, for example in Mexico, where the institutional approach is followed, there are various regulators for different entities as well as a National Commission for the Protection of Financial Services Users that is in charge of protection of consumers of financial services. Its main objectives, according to Schmulow, are to “promote, advise, protect and defend the rights of people who use financial services offered by institutions operating within Mexico”.

<sup>151</sup> Schmulow 2015 no. 1 154; National Treasury Red Book 2011 29.

system. No functional regulator may be in a position to fulfil that role.<sup>152</sup> Schmulow regards another important shortcoming of this model as the threat that safety and soundness may be viewed differently by various regulators. He emphasizes that the types of activities that are regulated has to be definable with sufficient clarity to assign a regulator thereto. Furthermore Schmulow questions whether the functional approach will be able to devote the necessary effort to combat the threat posed by shadow banks.<sup>153</sup> The Group of Thirty has commented that the functional approach to supervision remains quite common and appears to work well, as long as coordination among agencies is achieved and maintained. However, there is a general awareness that this may be a somewhat suboptimal structure. Because of this, a number of jurisdictions moved away from the functional approach toward a Twin Peaks model or to integrated systems.<sup>154</sup>

The integrated model (also referred to as the single regulator or super-regulator model) creates a single mega regulator to regulate both the conduct of business and the prudential soundness of financial institutions.<sup>155</sup> It thus endeavours to address the problems experienced by the institutional and sectoral approaches in the context of the focused holistic view that the regulator has of the institution's business activities.<sup>156</sup> Many regulators and policymakers favour the integrated approach, since the changes in business models of financial institutions and many new financial products occasion a need for reform of the approach to oversight of financial institutions. According to the Group of Thirty, the positives of the integrated approach includes the advantage of a clarity of focus on regulation and supervision without confusion or conflict over jurisdiction as can happen under both the institutional approach and the functional approach. Another significant advantage of this approach is an all-inclusive holistic

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<sup>152</sup> Group of Thirty 2008 13 and 35.

<sup>153</sup> Schmulow AD "Approaches to financial system regulation: An international comparative survey" Centre for International Finance and Regulation (CIFR): Research Working Paper Series No. 053/2015 Project No. E018 (January 2015) [http://apo.org.au/files/Resource/twin\\_peaks\\_the\\_theory\\_-\\_a\\_theoretical\\_analysis\\_0.pdf](http://apo.org.au/files/Resource/twin_peaks_the_theory_-_a_theoretical_analysis_0.pdf) (accessed 14 April 2017), hereinafter Schmulow 2015 no. 2, at 10 and 11. See also Schmulow 2015 no. 1 155.

<sup>154</sup> Group of Thirty 2008 13 and 35.

<sup>155</sup> Schmulow 2015 no. 1 155. Schmulow mentions that the integrated model differs from the Twin Peaks model in that it combines both stability and business conduct oversight, whereas stability and market conduct oversight is separated in the Twin Peaks model.

<sup>156</sup> Godwin et al 2016 6.

view of the regulated entity's business.<sup>157</sup> With this complete supervision, the regulator can more easily assess the risks associated with changing market conditions and regulatory arbitrage, as information about these matters will be collected and monitored by one agency. Hence, oversight is broad as well as deep. This model is thus based on the premise that supervision of financial institutions that are involved in various businesses can be more efficient and cost-effective with a single regulator where the application of rules would be consistent.<sup>158</sup>

Disadvantages of the integrated approach entail inter alia that there is only a single point of failure. If an integrated regulator thus fails to spot an issue, there is no other agency to offer support, no other safety nets. No system of checks and balances exists. Furthermore, in a very large market, an integrated regulator might simply be too large to be managed effectively. The converse is also true, namely that in a large market there may just be too many institutions to be adequately regulated and supervised by one single regulator. This approach can thus be effective and efficient in smaller markets, where oversight of the broad spectrum of financial services can be successfully conducted by one regulator but its effectiveness in large complex market is dubious. The Group of Thirty further points out that this model by definition lacks regulatory competition which, it is submitted, may concentrate too much power in the hands of the regulator without the constraints of competition to incentivise better regulation.<sup>159</sup>

According to Godwin et al a further apparent problem with the integrated model is that vitally different approaches and cultures are needed for proper prudential and conduct of business regulation. They opine that it is doubtful that a single regulator would be able to incorporate all of that. Furthermore a single regulator will find it difficult to focus on these different objectives and rationales of regulation and supervision and might

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<sup>157</sup> Group of Thirty 2008 36.

<sup>158</sup> National Treasury Red Book 2011 29. Schmulow 2015 no. 1 155: This model is often referred to as the "FSA Model", as the former Financial Services Authority in the UK was this model's most prominent example.

<sup>159</sup> Group of Thirty 2008 14, 36 and 37.

find it hard to differentiate between different institutions and businesses.<sup>160</sup> There can thus be conflict between prudential regulation (which, for example, requires “thinking like a banker”) and market conduct regulation (which requires “thinking like a customer”) if both are located within the same powerful agency.<sup>161</sup>

The fourth model, that of Twin Peaks, is functional in nature with the distinction that financial regulation occurs in accordance with two broad regulatory functions, namely market conduct integrity and consumer protection on the one hand, and prudential regulation and financial system stability on the other hand. Each objective is pursued by a separate regulator, thus lending the name “Twin Peaks” to the model.<sup>162</sup>

Given that South Africa has chosen to move to a Twin Peaks Model of Financial Regulation with the enactment of the Financial Sector Regulation Act 9 of 2017, as discussed in more detail in Chapter Two, the general underpinnings of the Twin Peaks approach to financial regulation will now be examined in more particularity.

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<sup>160</sup> Godwin et al 2016 6 and also: This model was implemented in the UK prior to its move to Twin Peaks; See also Schmulow 2015 no. 1 158 - 165 and Schmulow 2015 no. 2 17 - 32 for further insight into regulation according to the integrated approach where the United Kingdom (under the heading ‘The United Kingdom, or Pride before the fall’) is discussed; Hofheimer GA “Evaluating the single financial services regulator question” Filene Research Institute (2009) [https://filene.org/assets/pdf-reports/187\\_Hofheimer\\_Single\\_Regulator.pdf](https://filene.org/assets/pdf-reports/187_Hofheimer_Single_Regulator.pdf) (accessed 23 May 2017) at 12: Regulation is prudential when it is aimed specifically at protecting the financial system as a whole as well as protecting the safety of deposits (and perhaps other liabilities) in individual institutions. When a deposit-taking institution becomes insolvent, it cannot repay its depositors. If it is a large institution, its failure can undermine confidence enough so that the banking system suffers a run on deposits. Therefore, in prudential regulation, the government attempts to protect the financial soundness and solvency of the regulated institutions. Non-prudential rules include regulations about the institution’s business operations and do not ultimately aim to protect the solvency of the financial system. These rules are easier to administer because government authorities do not have to take responsibility for the financial soundness of the organization. These issues include, among others, consumer protection; fraud and financial crimes prevention; credit information services; interest rate policies; limitations on foreign ownership, management, and sources of capital; tax and accounting issues; and a variety of cross-cutting issues surrounding transformations from one institutional type to another.

<sup>161</sup> National Treasury Red Book 2011 29.

<sup>162</sup> Schmulow 2015 no. 1 165. Schmulow 2015 no. 2 32. Godwin et al 2016 6.

## 1.9 The Twin Peaks Model of Financial Regulation

In 1995 Michael Taylor, formerly with the Bank of England and at that time director of a course in financial services regulation at London Guildhall University, in a paper entitled “‘Twin peaks’: A regulatory structure for the new century”<sup>163</sup> advocated an approach to financial regulation that attracted widespread attention amongst financial regulators globally. The Twin Peaks model was stated to be a focused approach to financial regulation, designed to yield greater efficiencies than that produced by a fragmented approach to regulation of the financial system.

Taylor proposed that when financial services are regulated, it should be done with two goals in mind, namely to protect the stability and integrity of the financial system (“systemic protection”) and to ensure that the interests of individual depositors, investors, and policy-holders are protected (“consumer protection”). He indicated that systemic protection implies that prudential measures will be designed to ensure the financial soundness of institutions. Such prudential measures comprise inter alia of capital adequacy and large exposures requirements and measures taken relating to systems and controls and provisioning policies as well as making sure that senior managers possess appropriate levels of experience and skill. As regards consumer protection, Taylor indicated that it is mainly furthered by conduct of business measures to make sure that individual consumers do not suffer from fraudulent actions or incompetence and abuse of market powers by big institutions. Such consumer protection measures consist of rules regarding advertising, marketing and transactions in financial products and also include training of salespeople to meet certain minimum standards of integrity and competence and their subsequent registration as being adequately qualified.<sup>164</sup>

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<sup>163</sup> Michael Taylor “‘Twin peaks’: A regulatory structure for the new century” published by the Centre for the Study of Financial Innovation, 1995 – Financial Service Industry - Issue 20 of DSFI series, hereinafter Taylor 1995. See also Schmulow A “Financial regulatory governance in South Africa: the move towards Twin Peaks” 2017 (25) *African Journal of International and Comparative Law* 393, hereinafter Schmulow 2017, at 394.

<sup>164</sup> Taylor 1995 2 and 3.

Taylor assessed the system of financial services regulation that existed in the UK, pointing out that formerly banks were seen as the essential systemically important establishments. However other non-bank financial businesses also developed systemic problems, for instance security houses, insurance companies, trusts and businesses in the over-the-counter derivatives market.<sup>165</sup> He further pointed out that the “traditional” financial regulatory systems commenced by dividing function and risk with the result that many regulatory bodies over the spectrum of the financial system might have had an interest in the regulation of systemically important businesses, thus creating a fragmented approach to the regulation of these institutions. Taylor noted that this unsatisfactory, fragmented regulatory trend in the financial markets and the structure of financial groups necessitated the formation of a single financial services supervisor with responsibility for the overall financial stability of the financial system as a more efficient approach to financial system regulation.<sup>166</sup> He argued that when financial regulatory systems were initially developed, the banking, securities and insurance companies were not yet interlinked in such unexpected ways as happened subsequently and that this “interlinkage” provided a strong reason for changing the division of regulatory responsibility in order to promote prudential soundness of all the financial entities that are active in a specific financial system (and thus not only of banks).<sup>167</sup>

Taylor thus made a strong case for the transfer of power for monitoring and regulating the financial soundness of the entire financial system to a single office that would be responsible for the protection of the whole financial system from disruption (thus a macroprudential financial stability mandate). In this regard he listed the following four considerations in favour of moving prudential supervision of banking, securities and insurance to the sphere of a single regulatory department:

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<sup>165</sup> Taylor 1995 4.

<sup>166</sup> Taylor 1995 4; Schmulow AD “Twin Peaks: A theoretical analysis” Centre for International Finance and Regulation (CIFR): Research Working Paper Series No. 064/2015 Project No. E018 (1 July 2015) [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2625331](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2625331) (accessed 10 March 2018), hereinafter Schmulow 2015 no. 3 at 11. Godwin et al 2016 5.

<sup>167</sup> Taylor 1995 5.

- (a) a vast spectrum of financial businesses would be considered as systemically important (thus not only banks will have to be closely monitored because of their systemic importance but also other financial entities);
- (b) regulatory requirements that were current at that stage queried the issue of competitive equality between types of financial businesses;
- (c) because of the increase of financial conglomerates, it was crucial to have a view of financial groups as a whole, with the inclusion of the banking, security and insurance sectors; and
- (d) it was necessary to put together all the skills and competences that were needed to supervise sophisticated financial businesses.<sup>168</sup>

Taylor therefore suggested that to ensure efficient financial regulation and supervision a Twin Peaks model comprising of systemic protection, on the one hand, and consumer protection, on the other hand, should be implemented and that these “peaks” should be regulated by two separate bodies, having overlapping staff and governing boards, all answerable to the Treasury. If a conflict arose between the two peak regulators, as he foresaw might occasionally happen, this would be clarified politically at ministerial level in the Treasury.<sup>169</sup>

The traditional Twin Peaks model of financial regulation proposed by Taylor thus has only two “peaks”, namely that of a systemic risk regulator which is integrated in the central bank and that of a market conduct regulator. In this model the systemic risk regulator is (also) accountable for prudential regulation (“safety and soundness”) of all potentially systemic financial institutions and oversight of systemically important payment and settlement systems and thus for the maintenance of financial safety, soundness and solvency of the financial sector. The original Twin Peaks model as proposed by Taylor thus envisaged the central bank to be responsible for overall financial stability and also prudential regulation of financial institutions as a primary measure to achieve or maintain financial stability. The market conduct regulator, on the other hand, is accountable for the conduct of business regulation across all sectors

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<sup>168</sup> Taylor 1995 4.

<sup>169</sup> Taylor 1995 1.

of financial services, like banking, insurance and securities and focuses on the behaviour of financial institutions toward customers in the market.<sup>170</sup>

The Twin Peaks approach thus regulates the financial sector in an all-inclusive way. By establishing separate sector-wide prudential and market conduct supervision, Taylor argued that the focus of the Twin Peaks regulatory approach is balanced between the two peak regulators as each authority is dedicated to its clearly demarcated objective of prudential and market conduct, respectively but both authorities are simultaneously focusing on financial stability.<sup>171</sup>

Taylor argued that the benefits of these “twin peaks” are clear in that this regulatory structure would to a large extent do away with replication and overlap of regulatory actions and would ensure that regulatory bodies with a dedicated purpose will be created; that mechanisms for clearing up of clashes between the regulation of financial services would be encouraged; and that an open and transparent regulatory process would be established. As such the Twin Peaks Model accords with the philosophy of creating greater transparency, efficiency and specific functions of responsibility in the duties of governmental departments.<sup>172</sup>

Taylor’s Twin Peaks approach to financial regulation has since been lauded by many commentators as the most appropriate approach to financial regulation as it reaps the benefits of the integrated approach (regulatory consistency, jurisdictional clarity and informational efficiency), yet also addresses the inherent conflicts between prudential regulation and consumer protection. Twin Peaks is regarded as the optimal means of ensuring that transparency, market integrity, and consumer protection receive sufficient priority.<sup>173</sup> It is stated to be the embodiment of “regulation by objective.” The Group of Thirty pointed out that this approach to financial supervision is becoming

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<sup>170</sup> De Jager 2013 no. 2 508; Group of Thirty 2008 38.

<sup>171</sup> Taylor 1995 13. See also Department of National Treasury in the RSA “Twin Peaks in SA: Response and explanatory document” Dec 2014 accompanying the second draft of the FSR Bill, hereinafter Explanatory document Dec 2014, at 5.

<sup>172</sup> Taylor 1995 16.

<sup>173</sup> National Treasury Red Book 2011 29; Schmulow 2017 396; Godwin et al 2016 6.

more popular as a means of achieving the benefits of the integrated approach with the added distinct emphasis on consumer protection issues, particularly for retail customers. Under this approach, each regulator can hire employees with appropriate expertise for their specific functions. Prudential regulators can employ persons with business and economic expertise while business conduct regulators focus on hiring enforcement-oriented staffs. It is also opined that having the functions of prudential regulation and supervision and market conduct regulation and supervision in separate entities can minimize the conflicts between these two very different disciplines.<sup>174</sup>

Llewellyn regards the advantages of the Twin Peaks model as being that the two regulators responsible for prudential and market conduct regulation respectively, have their own dedicated objectives and clear mandates to which they are exclusively committed; accountability is clear because of the clearly defined objectives and mandates of each regulator; there is no danger that one of the areas of regulation will come to dominate the other; and if conflicts arise between the two areas of supervision they are more likely to be resolved internally without publicity.<sup>175</sup> Schmulow also mentions that the following benefits of the Twin Peaks structure are examples of why structure is important to create effective financial system regulation: the removal of regulatory duplication and overlap; creating regulatory bodies with an exact area of operation; establishing mechanisms for resolving conflicts between the objectives of financial services regulation; and encouraging a regulatory process which is open, transparent and publicly accountable.<sup>176</sup>

Other advantageous features of Twin Peaks are that the existence of separate prudential and market conduct regulators creates a system of checks and balances, thereby avoiding that too much power vests in the hands of a single regulator,<sup>177</sup>

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<sup>174</sup> Group of Thirty 2008 37 and 38.

<sup>175</sup> Llewellyn 2006 28. Schmulow 2015 no. 3 28: The single objective of each regulator minimizes overlap and turf wars between them. He mentions that over time overlap can diminish if clear lines are drawn for responsibilities and if key parties are determined to cooperate.

<sup>176</sup> Schmulow 2017 396 - 397. Schmulow refers to failures under the regulators, APRA and ASIC, in Australia, and opines that those have not been because of a confusion of objectives. He subscribes these failures to a weak enforcement culture, especially in the regulation of market conduct and consumer protection. See further the discussion of the Australian Twin Peaks model in Chapter Three.

<sup>177</sup> National Treasury Red Book 2011 29.

synergies are created by bringing regulators of a particular market together, conglomerates are regulated more consistent and cultural clashes are minimised.<sup>178</sup>

Although the Twin Peaks model has many advantages there are also aspects of this approach to financial regulation which may compromise the effectiveness of the model if left unchecked. Contrary to opinions that Twin Peaks will avoid or lessen regulatory overlap, Di Giorgio and Di Noia remark that compared to the institutional or single regulator approach, a regulatory framework organized by objectives obviously produces a certain degree of multiplication of the controls. Sometimes it may also lead to a lack of certain controls given that the specific assignments of the regulatory responsibilities and powers of the different regulators are not necessarily “univocal and all-inclusive in practice”. Because each financial institution is subject to dual regulation by the prudential and market conduct regulators respectively, it may also be more costly than other regulatory models. Di Giorgio and Di Noia indicate that the regulated financial institutions might also be required to produce several reports for compliance purposes, often containing identical or similar information. At the same time they may also have to justify the same action to a whole set of authorities contemporaneously even though for different reasons. A deficit of controls may also occur whenever the exact areas of responsibility of the regulators are not clearly identifiable in specific instances.<sup>179</sup> Moreover, in order to be effective and to avoid and address the conflict of interest among the different objectives of the Twin Peaks model, Di Giorgio and Di Noia crucially emphasise that this regulatory model needs a coordinating committee participated by the members of all the different regulators and of the central bank.<sup>180</sup>

Thus the roles and responsibilities of each regulator in the Twin Peaks model will have to be carefully defined to avoid duplication of work and jurisdictional overlap. Moreover, separation of prudential and market conduct regulation does not eliminate

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<sup>178</sup> Schmulow 2015 no 3 27 – 28.

<sup>179</sup> Di Giorgio G and Di Noia C 1999 “Should Banking Supervision and monetary policy tasks be given to different agencies?” 1999 (3) *International Finance* 3, hereinafter Di Giorgio & Di Noia 1999, at 14 - 15.

<sup>180</sup> Di Giorgio & Di Noia 1999 15.

the possibility of conflict between them and therefore measures will have to be devised to appropriately deal with such conflict when it arises.<sup>181</sup>

From the aforementioned it is clear that two pertinent challenges that present themselves in the context of the Twin Peaks model are first, whether it is indeed appropriate for the central bank to have both the overall financial stability mandate as well as the mandate for prudential regulation. Second, the effective implementation of this model will necessarily require serious thought to go into devising measures for cooperation and collaboration between the regulators on two levels, namely specifically for purposes of promotion and maintenance of financial stability and then also in the context of the broader objectives of this model of regulation.

With regard to the question whether the central bank should be both the guardian of financial stability as well as the prudential regulator Llewellyn remarks, that as the central bank in the traditional Twin Peak model as proposed by Taylor has responsibility for oversight of the system as a whole and also the stability of the payments system, there are potentially powerful synergies in also having the central bank as prudential regulator; particularly information synergies. Having prudential supervision, oversight of the payments system and monetary policy tasks “under one roof” eases the exchange of information and cooperation and collaboration between the monetary policy and financial stability functions on the one hand and the supervision of institutions on the other. A further argument is that the central bank usually has considerable authority in an economy and this enhances the credibility of regulation and supervision for a central bank who is also the prudential regulator. Also, if conflicts arise between for example monetary policy and prudential regulation then such conflicts are better resolved internally in a central bank as single regulator responsible for systemic and prudential oversight than externally between different regulators.<sup>182</sup>

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<sup>181</sup> National Treasury Red Book 2011 29.

<sup>182</sup> Llewellyn 2006 30.

Schmulow distinguishes between a monopolistic (regulator part of the central bank) and a non-monopolistic regulator (regulator not part of the central bank), also mentioning the benefits of synergy and efficiency as the biggest advantage of the monopolist approach. Therefore he opines that in jurisdictions where there is not a strong tradition of independent regulatory agencies, it could be beneficial to locate the regulator within the central bank, especially if the central bank has a strong tradition of independence.<sup>183</sup> He further opines that a non-monopolistic regulatory approach is more in line with the Basel III Core Principles. Furthermore conflicts of interest between the central bank with a macroprudential focus and a regulator with a microprudential focus, would not be a problem when the regulator is not part of the central bank. The lender of last resort function of the central bank and the monetary policy function would also not be compromised in the non-monopolistic approach.<sup>184</sup>

Arguments against the central bank in the Twin Peaks model being both responsible for overall financial stability as well as prudential regulation and supervision are that it may lead to the concentration of excessive power in a single agency; failures in prudential regulation may compromise the authority of the central bank of its activity; and the possibility exists that the central bank itself may compromise its own monetary policy objectives due to conflict with objectives related to ensuring the safety and soundness of banks.<sup>185</sup>

Llewellyn however significantly remarks: “[I]n practice no bank regulator could or should ever be totally independent of the central bank. The central bank is the monopoly provider of the reserve base and the lender of last resort. Any serious banking problems are bound to lead to calls to the central bank to use its reserve creating powers. Moreover the central bank in its macro-policy operational role, must have a direct concern with the payments and settlement system and the development of monetary aggregates. Any serious problem with the health of the banking system will touch on one or more of these concerns. So there is bound to be, and there must

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<sup>183</sup> Schmulow 2015 no. 3 20.

<sup>184</sup> Schmulow 2015 no. 3 23 - 24.

<sup>185</sup> Llewellyn 2006 31. I.e. by loosening monetary policy to save financial institutions by failure.

be, very close relationships between the bank regulator and the monetary policy authority.”<sup>186</sup>

Interestingly, Llewellyn points out that a higher proportion of central banks in developing countries are responsible for bank supervision than is the case in industrial countries. He states that many of the arguments in favour of the central bank being responsible for bank supervision, notably those relating to economies of scale and independence, apply particularly to developing and emerging market economies.<sup>187</sup>

Llewellyn thus concludes that irrespective of the decision about the regulation and supervision of individual institutions the central bank must necessarily be centrally involved in safety net arrangements;<sup>188</sup> liquidity support; the payments system and maintaining financial stability as a whole. In cases where the central bank is not responsible for prudential regulation and supervision he points out that its responsibility for financial stability nevertheless requires cooperation with and from those agencies which are responsible for such regulation and supervision. He significantly remarks: “This issue cannot be ducked and explicit arrangements are required.”<sup>189</sup>

From the aforementioned it is thus evident that the Twin Peaks model revolves around three main themes namely financial stability, prudential regulation and market conduct regulation. It accords financial stability a prominent position and clearly envisages that both prudential and market conduct regulation will serve the greater objective of systemic stability. Given that different versions of the Twin Peaks model have since been adopted in several jurisdictions inter alia Australia (as pioneering jurisdiction) and the Netherlands (as first adopter of the model in the EU), it would thus be

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<sup>186</sup> Llewellyn 2006 32. According to Llewellyn the bottom line is that banking realities will force there to be considerable coordination and interaction between the senior official dealing with monetary policy and bank supervision.

<sup>187</sup> Llewellyn 2006 38-39.

<sup>188</sup> Safety nets for banks comprise a series of policy arrangements that help stakeholders to avoid or weather loss-causing financial shocks

<sup>189</sup> Llewellyn 2006 35.

necessary to consider what would be the optimal Twin Peaks framework from the perspective of promoting and maintaining financial stability as core regulatory pursuit post the GFC.

### **1.10 Problem statement**

The new regulatory paradigm post GFC which has elevated the importance to promote and maintain financial stability, has also impacted South Africa's approach to financial regulation. South Africa, being a member of the G-20<sup>190</sup> and thus "obliged" to align its approach to financial regulation with international best practice has since 2011 actively embarked on extensive reform of its approach to financial regulation.<sup>191</sup> In this process it has selected the Twin Peaks model of financial regulation as its new regulatory approach and has assigned an explicit, comprehensive and expanded financial stability mandate to the South African Reserve Bank (SARB) as central bank.

It is important to note that the focus of this thesis is not to decide whether the Twin Peaks model of financial regulation is the most appropriate regulatory model for South Africa. This issue is largely irrelevant given that South Africa has already made its choice in this regard with the enactment of the Financial Sector Regulation Act 9 of

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<sup>190</sup> Arner & Taylor 2009 488: The G-20, formed in 1999 in the wake of the Asian financial crisis, comprised of Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States, as well as the European Union and the European Central Bank. In addition, the United Nations, World Bank, International Monetary Fund and Financial Stability Board, among others, were also invited to attend; Arner DW "Adaptation and resilience in global financial regulation" 2011 (89) *North Carolina Law Review* 1579, hereinafter Arner 2011, at 1591 - 1595 indicates that the first leaders' summit of the G-20 countries was held in Washington, D.C., in November 2008. The G-20 focused on the causes of the GFC and began to address financial regulatory reform. During the second summit of the G-20 leaders in London in April 2009 the Financial Stability Forum (FSF) that was established along with the G-20 in 1999, was renamed and reconstituted as the Financial Stability Board (FSB). The G-20 leaders provided the FSB with a mandate to coordinate international financial regulatory initiatives and monitor their implementation. During the Fifth G-20 Leaders' Summit in November 2010 in Seoul, the G-20 announced the adoption of the "core elements of a new financial regulatory framework to transform the global financial system." Specific policies adopted address capital and liquidity standards; systemically important financial institutions (SIFIs) and global SIFIs (G-SIFIs); financial institution resolution; supervisory effectiveness; and implementation; See also G-20 Seoul Summit 2010 "The G-20 Seoul Summit Leaders' Declaration" (11 – 12 November 2010) <http://www.g20.utoronto.ca/2010/g20seoul.html> (accessed 11 March 2018).

<sup>191</sup> As explained in Chapter Two this process started in 2007 but it properly gained momentum in 2011. See par 2.6.

2017. There is no turning back - at least not for the foreseeable future. What now remains to be considered is how this model will serve South Africa in its efforts to promote and maintain financial stability.

The research problem to be investigated is accordingly how the legislative framework and institutional architecture introducing the South African Twin Peaks model of financial regulation has changed the role of the SARB as central bank of South Africa and whether it will serve to augment the role of the SARB in respect of financial stability to such an extent that financial stability in South Africa will potentially be better promoted and maintained under this new regulatory model than it was in the past.

### **1.11 Research objectives**

The objectives of the research are:

- To give an overview of the historical evolution of the role of central banks in general and how it has changed as a result of the new regulatory paradigm that emerged post GFC, elevating the promotion and maintenance of financial stability as core goal of financial regulation and emphasising the role of the central bank as macroprudential supervisor.
- To examine the main approaches to financial regulation with specific focus on the Twin Peaks Model as initially proposed by Michael Taylor.
- To investigate legislation in South Africa (i.e. the Constitution and the SARB Act) regarding the role of SARB in promotion of financial stability prior to the GFC.
- To critically analyse and evaluate framework legislation enacted as a response to the GFC, namely the Financial Sector Regulation Act,<sup>192</sup> (the FSR Act) in terms whereof a Twin Peaks model is introduced in South Africa, in order to eventually address the question as to how the role of the SARB with regard to financial stability has changed and whether this legislation and the institutional

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<sup>192</sup> Act 9 of 2017.

architecture that it put in place provides adequate measures for the SARB to promote and maintain financial stability;

- To do a comparative study on the role of the Australian Reserve Bank in relation to financial stability as it was dealt with in the Twin Peaks model of Financial Regulation in Australia prior to and after the GFC, especially considering that Australia had the foresight, approximately a decade before the 2008 GFC to overhaul their approach to financial regulation by pioneering the Twin Peaks model and to navigate and tweak their Twin Peaks system well before the Crisis.
- To do a comparative study on the role of the Dutch Central Bank in relation to financial stability as it was dealt with in the Twin Peaks model of Financial Regulation in the Netherlands prior to and after the GFC, especially considering that the Twin Peaks system in the Netherlands was implemented at a time when the GFC was imminent and thus the Dutch system had to face the challenges brought about by this worldwide crisis head-on.

## **1.12 Delimitations**

The focus of this thesis is on the changed role of the central bank with regard to the promotion and maintenance of financial stability. Therefore, save to point out some aspects of the role of the central bank pertaining to monetary policy, oversight of the payments and settlement system and supervisor of banks and how these roles interact with financial stability, an in-depth investigation of each of these roles and interactions will not be undertaken. The same applies to the notion of central bank independence. For purposes of this study some reference will be made to central bank independence in order to contextualize the discussion but other than that opinions expressed in this thesis will be based on the assumption that the central bank is independent of undue political interference that may compromise its financial stability mandate.

Although some mention is made where relevant, of the tools of micro- and macroprudential regulation this thesis will not conduct a study into these tools. Some background is provided to enlighten the reader as to the fundamentals of

macroprudential policy and an appropriate macroprudential toolkit but this is merely done in order to foster an appreciation of the magnitude and complexity of the central bank's financial stability mandate and to facilitate an understanding of the regulatory energy that such a mandate requires. Apart from this background information and some peripheral reference to these aspects in later chapters this thesis will not contain a detailed analysis and discussion of these measures. Save for mentioning the aspect of prudential regulation and of conduct of business regulation where appropriate and remarking on some aspects of its role in contributing to the promotion and maintenance of financial stability, the thesis will also not entertain an in-depth study of such regulation and the tools by which same is achieved.

A study of the role of the National Credit Regulator in the South African Twin Peaks model as enabling legal and institutional framework for the promotion and maintenance of financial stability is beyond the scope of this thesis.

### **1.13 Methodology**

The proposed research will include a literature study of books, reports, journal articles, web sites, legislation, draft legislation, media statements and discussion documents. The study is primarily a critical analysis of the South African state of affairs. A comparative study on the relevant aspects will be undertaken comprising of reference to International principles and guidelines where applicable and focusing on the role of the central banks within the Twin Peaks systems of Australia and the Netherlands.

### **1.14 Comparative Jurisdictions**

A comparative study will be undertaken by investigating relevant aspects of the role of the Australian central bank and the Dutch central bank in maintaining and promoting financial stability in the context of the Twin Peaks system of Financial Regulation in

Australia and the Netherlands as well as recent developments regarding the system in these countries.

Australia is renowned for its robust financial system and resilient economy. It has taken a pro-active approach to financial regulation by adopting and pioneering a Twin Peaks system in 1998 in which the Reserve Bank of Australia has the mandate to promote and maintain financial stability. Despite not being as severely affected by the GFC as for example a country such as the USA which was at the epicentre of the Crisis, Australia has never been complacent about financial regulation. The Australian Twin Peaks model has thus continued to evolve post GFC.

The Netherlands moved from a sectoral approach to financial regulation to a functional approach in accordance with the Twin Peaks model in 2007, shortly before the GFC. During the Crisis the Dutch learnt some key lessons especially pertaining to the role of De Nederlandsche Bank (DNB) in promoting and maintaining financial stability. The establishment of the European Central Bank and its development also impacted on how DNB currently approaches its financial stability mandate.

It would therefore be instructive, focusing on the role of the central bank, to compare the Twin Peaks system of financial regulation in Australia and in the Netherlands with South Africa's new Twin Peaks legislation in order to determine whether the Twin Peaks systems in these two jurisdictions can offer any insights to South Africa, specifically in the context of the expanded role of the central bank in promoting and maintaining financial stability.

## **1.15 Outline of chapters**

### **Chapter 1: Introduction and background to the study**

This chapter deals with the evolution of central banking and the main roles of the central bank. It considers the issue of financial stability and macroprudential regulation and how the 2008 GFC became a driver of financial stability as apex objective of financial regulation with the result that microprudential regulation as a core role of a central bank was pushed to the forefront. It supports the notion that central banks are institutionally best placed to effectively execute the mandate for financial stability through sound macroprudential oversight which requires a system-wide surveillance approach. Chapter One further sets out the research statement and objectives of the study, the rationale for the selection of the comparative jurisdiction, the research methodology and contains a roadmap of the thesis in the form of a brief overview of its chapters.

### **Chapter 2: The changing role of the South African Reserve Bank**

This chapter will provide an overview of the regulatory model that prevailed in South Africa pre-Twin Peaks. It will contain an analysis of the history of the SARB before the implementation of the Twin Peaks model and the changing role of the SARB with regard to financial stability. The provisions of various statutes relevant to the role of the SARB as central bank will be considered, such as the Constitution of the Republic of South Africa, 1996, the South African Reserve Bank Act 90 of 1989 (SARB Act) and the Banks Act 94 of 1990.

It will also interrogate the motivation for South Africa's move to a Twin Peaks system of Financial Regulation. The main focus of this chapter will be the comprehensive financial stability mandate that has been assigned to the SARB in the context of the

Twin Peaks architecture that the FSR Act introduces into the South African financial system.

### **Chapter 3: Comparative study: Australia**

Australia is an obvious choice for purposes of comparative research being the first jurisdiction to have adopted the innovative Twin Peaks model of financial regulation. The focus of this chapter will be on the role of the central bank of Australia, the Reserve Bank of Australia (RBA), to assess, from a financial stability perspective, how the Australian Twin Peaks model fared during the GFC and which changes were made to the role of the RBA with specific emphasis on financial stability, in view of lessons learnt during the GFC. Using Australia as comparative jurisdiction will also enable reflection on whether prudential regulation should be removed from the regulatory remit of the central bank that is clothed with an expanded financial stability mandate post GFC.

### **Chapter 4: Comparative study: The Netherlands**

The role of the Dutch central bank, DNB, in the context of the Twin Peaks regime that has been introduced in the Netherlands will be considered with specific focus on financial stability. The purpose is to consider the role of this central bank with regard to maintenance and promotion of financial stability prior to and after the GFC in order to assess whether there are any lessons that South Africa may learn in this regard that can be efficiently applied in line with the notion that “prevention is better than cure.” The role and functions of the SARB will thus eventually be compared with that of a jurisdiction that also evolved from a traditional silo regulation approach. Given the status of Netherlands as an EU Member State the impact of developments in financial regulation on a supranational EU-level on the Dutch Twin Peaks model and specifically the role of DNB as both systemic and prudential supervisor in the Dutch Twin Peaks model, will also be considered.

## **Chapter 5: Conclusion and recommendations**

This final chapter will contain conclusions from which recommendations will be drawn regarding the role of the SARB in promoting and maintaining financial stability in South Africa in the Twin Peaks regime.

## CHAPTER 2

### THE CHANGING ROLE OF THE SOUTH AFRICAN RESERVE BANK

- 2.1 Introduction
  - 2.2 Historical background of financial regulation in South Africa and the South African Reserve Bank as central bank
  - 2.3 Primary objective of the SARB pre-Twin Peaks: price stability
  - 2.4 Other functions and roles of the SARB pre-Twin Peaks
  - 2.5 Cooperation between SARB and other regulators
  - 2.6 Rationale behind the move to a Twin Peaks system of financial regulation in South Africa
  - 2.7 The Financial Sector Regulation Act
  - 2.8 Final remarks
  - 2.9 Conclusion
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#### 2.1 Introduction

In this chapter the changing role of the SARB with regard to the promotion and maintenance of financial stability prior to as well as after South Africa's move towards a Twin Peaks Model of Financial Regulation, will be discussed and analysed. It should be noted that at the time of writing this thesis the Financial Sector Regulation Act (FSR Act)<sup>193</sup> which comprises the first stage of the move towards a Twin Peaks system, has

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<sup>193</sup> Financial Sector Regulation Act, Act 9 of 2017 published in *Government Gazette* no. 41060 volume 626 of 22 August 2017 (Regulation Gazette no. 853) accessible at <http://www.treasury.gov.za/legislation/acts/2017/Act%209%20of%202017%20FinanSectorRegulation.pdf> (accessed 28 August 2017).

been assented to on 21 August 2017 and has been published in the Government Gazette on 22 August 2017. The commencement date of the Act was determined by the Minister of Finance by notice in the Government Gazette as being 1 April 2018.<sup>194</sup>

## **2.2 Historical background of financial regulation in South Africa and the South African Reserve Bank as central bank**

The regulation of the financial sector in South Africa was in the past mainly modelled on countries that it was historically linked to, specifically the United Kingdom and other former British colonies such as Australia and Canada.<sup>195</sup> Pre-Twin Peaks the approach to financial regulation in South Africa was multi-layered with various regulators practising silo regulation in respect of the different roleplayers in the South African financial markets. Pertinent in this pre-Twin Peaks regulatory landscape was the SARB, being the central bank since its inception in 1921, inter alia entrenching its position as a robust prudential regulator of banks.

The SARB is the fourth-oldest central bank outside Europe.<sup>196</sup> It has served as South Africa's central bank since its inception, during which time, as pointed out by De Jager, there were many circumstances affecting, changing and internationalising the banking and financial sector of the country. Factors like South Africa's political liberation, acceptance of a modern Constitution, the fading of boundaries between institutions and a new concept of companies have caused various changes to the legislative framework within which the SARB operates.<sup>197</sup>

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<sup>194</sup> See paragraph 2.6 below.

<sup>195</sup> National Treasury Red Book 2011 28.

<sup>196</sup> Rossouw J "A selective reflection on the institutional development of the South African Reserve Bank since 1921" [https://repository.up.ac.za/bitstream/handle/2263/17079/Rossouw\\_Selective%282011%29.pdf?sequence=1&isAllowed=y](https://repository.up.ac.za/bitstream/handle/2263/17079/Rossouw_Selective%282011%29.pdf?sequence=1&isAllowed=y) 2011(26) Economic History of Developing Regions (accessed 25 February 2016) S3, hereinafter Rossouw 2011, at S3.

<sup>197</sup> De Jager 2006 no. 1 159; See further Malan and Pretorius "The Reserve Bank, Banks and Clearing Houses in South African Law: Part 1" (2001) 13 *SA Merc LJ* 35, hereinafter Malan & Pretorius 2001 no. 1 and also Malan and Pretorius "The Reserve Bank, Banks and Clearing Houses in South African Law: Part 2" (2001) 13 *SA Merc LJ* 163, hereinafter Malan & Pretorius 2001 no. 2.

The SARB was established in Pretoria with the enactment of the Currency and Banking Act 31 of 1920.<sup>198</sup> It is a non-profitable and non-competitive bank that operates like most other central banks in the interest of the general public. The SARB thus has to perform its functions for the benefit of growth in the economy of South Africa and not for the benefit of its shareholders.<sup>199</sup>

In the Currency and Banking Act the SARB was established as a body corporate with a share capital of one million pounds.<sup>200</sup> Initially every bank that did business in the Union of South Africa had to hold shares in the SARB to a nominal value of not less than 5 per cent of its own paid-up capital.<sup>201</sup> In later amendments of the Currency and Banking Act it was determined that banks were no longer required to hold SARB shares.<sup>202</sup>

The Currency and Banking Act was subsequently replaced by the South African Reserve Bank Act 29 of 1944,<sup>203</sup> which Act was later replaced by the South African Reserve Bank Act 90 of 1989 (SARB Act)<sup>204</sup> on 1 Aug 1989.<sup>205</sup> Later, the status of the SARB as central bank of South Africa was given recognition in the Constitution of the

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<sup>198</sup> De Kock G *A history of the South African Reserve Bank (1920 - 52)* (1954), hereinafter De Kock 1954 at 22, 34 and 47, and also: The Currency and Banking Bill was finally passed by the senate on the 10<sup>th</sup> of August 1920 and promulgated on the 17<sup>th</sup> of December 1920. This Act had much in common with the Federal Reserve Act of the United States (as amended up to 1917). The use of the word "Reserve" in the name of the Bank reflects reference to the term "Reserve Bank" that had previously been adopted only in the United States with regard to the Federal Reserve as their central bank. De Jager 2006 no. 1 160: The Currency and Banking Act was amended by Acts 22 of 1923, 26 of 1930, 25 of 1932 and 9 of 1933.

<sup>199</sup> De Jager J "The South African Reserve Bank: Blowing Winds of Change (Part 1)" 2013 *SA Merc LJ* 342, hereinafter De Jager 2013 no.1, at 345.

<sup>200</sup> Section 10(1) Currency and Banking Act.

<sup>201</sup> De Kock 1954 13. De Jager 2006 no. 1 161 and 162: According to De Jager the reason for this provision in the Currency and Banking Act might have been that central-banking principles that was globally accepted at that time in foreign jurisdictions were closely followed in the Currency and Banking Act. The principle that banks in a country should hold shares in the central bank of the country, was thus also followed. The countries that had central banks at the stage when the Currency and Banking Act was written, were countries with different economic structures and non-comparable levels of economic development than South Africa. Therefore it was necessary to amend some of the terms of the Act, like the requirement that banks should hold SARB shares.

<sup>202</sup> De Jager 2006 no.1 162.

<sup>203</sup> Rossouw 2011 S6; See also Verhoef G "The dynamics of South African Banking in the 1980's" 1994 *South African Journal of Economic History: The South African Economy in the 1980's: Special Issue 2* 84: Act 29 of 1944 consolidated the law relating to the SARB and repealed previous legislation relating to it.

<sup>204</sup> The South African Reserve Bank Act, Act 90 of 1989.

<sup>205</sup> Rossouw 2011 S6.

Republic of South Africa (Constitution)<sup>206</sup> when the latter was enacted. In section 223 of the Constitution it was confirmed that the SARB is the central bank of the Republic, regulated in terms of an Act of Parliament. The Constitution further specifies that the powers and functions of the SARB are those “customarily exercised and performed by central banks”, which powers and functions must be determined by an Act of Parliament and must be exercised or performed subject to the conditions prescribed in terms of that Act.<sup>207</sup> The autonomy of the SARB is also entrenched in the Constitution since the bank must, in the pursuit of its primary objective, perform its functions independently and without fear, favour or prejudice.<sup>208</sup> It is however provided that there must nevertheless be regular consultation between the SARB and the Minister of Finance.<sup>209</sup>

The SARB, established as a juristic person, is a creature of statute<sup>210</sup> and must therefore function within the boundaries of the SARB Act and other enabling

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<sup>206</sup> The Constitution of the Republic of South Africa, 1996. The Constitution of the Republic of South Africa was promulgated on 18 December 1996 and commenced on 4 February 1997; Rossouw 2011 S7: Rossouw remarks that the Constitution has to some extent superseded the SARB Act by providing for a central bank with a strong constitutional mandate.

<sup>207</sup> Section 225 of the Constitution.

<sup>208</sup> De Jager 2006 no. 2 284; See also Bekink B and Botha C “The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures: A South African Public-Law Angle of Incidence” 2009 SA *Merc LJ* 74, at 78.

<sup>209</sup> Section 224(2) of the Constitution; Malan & Pretorius 2001 no.1 at 39 remark that central bank independence also involves the monetary and political independence of the central bank. They refer to Oelkers *Das Recht der South African Reserve Bank. Ein Beitrag zum neuen Sudafricanischen Verfassungsrecht* (1999) who defines the concept as the power of the central bank to perform its duties without political, economic and legislative interference, in particular without directives from the government and without being subject to government supervision. Accordingly Malan and Pretorius remark that, in this sense, the autonomy of a central bank is a principle of good government because “elected governments, periodically needing to face their electorates, have an incentive to over-inflate, but independent monetary authorities, having other, more public spirited objectives- can protect them from temptation’ (as per Forder “Central Bank Independence: Reassessing the Measurements” 1999 (33) *Jnl of Economic Issues* 23, at 24). They thus remark that the essence of central bank independence then involves the independence of the central bank to determine monetary policy but point out that maintaining such independence requires continuous effort. It is further to be noted that in *Certification of the Constitution of the Republic of South Africa 1996* 1996 (4) SA 744 (CC) at 825 it was observed by the Constitutional Court that although the requirement of impartiality and independence is restricted to the “primary object” of the SARB, all the powers and functions of the SARB will flow from its primary object. The Constitutional Court was further of the view that the requirement regarding regular consultations between the Minister and SARB did not compromise SARB’s impartiality and independence. Regarding the independence of SARB see also Du Plessis ED “The structure and operation of the South African Reserve Bank and its relation to Government” 1980 *Modern Business Law Review* 86.

<sup>210</sup> De Jager 2013 no. 1 350. The SARB has the status of an independent legal person which may not be liquidated other than by an Act of Parliament; See s 2, 4 and 38 of the SARB Act; In De Jager 2006 no 1 166 he points out that its powers and duties are those laid down in the SARB Act, beyond which the Bank is legally incapable of doing anything. Any act conducted outside its powers is void by law.

legislation. This means that the SARB does not have inherent powers or jurisdiction and that it is not competent for the SARB to act outside the parameters of the SARB Act and other applicable legislation. De Jager points out that this however does not have the effect that the SARB has only the powers that are clearly expressed in the SARB Act or that the powers of the SARB must be interpreted in such a restrictive way that justice is thereby frustrated. Accordingly the authority that empowers the SARB to act, may be implied or express.<sup>211</sup>

The SARB is managed by a board of fourteen directors, consisting of a Governor, three Deputy Governors and three other directors that are appointed by the President of the Republic after consultation with the Minister of Finance and the Board and seven other directors, elected by the shareholders.<sup>212</sup> Of the directors elected by the shareholders, four must be persons who are or have been actively and primarily engaged in commerce or finance; one must have been engaged in agriculture and two must be or have been engaged in industrial pursuits.<sup>213</sup>

The SARB, being a juristic person, has a share capital of R2 million divided into ordinary shares of R1 each and no shareholder may hold more than 10 000 shares.<sup>214</sup> If an existing shareholder does hold more than 10 000 shares his or her voting power is limited to the voting power attached to 10 000 shares.<sup>215</sup> The fact that the SARB is a juristic person that functions independently does however not mean that it can shun accountability. Accordingly the SARB Act contains various measures aimed at ensuring the accountability of the Bank to Parliament. As such the SARB has to furnish certain information to the National Treasury and to Parliament *inter alia* regarding its assets and liabilities, its annual financial statements, and its shareholders.<sup>216</sup> This

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<sup>211</sup> De Jager 2013 no. 2 500. De Jager remarks that the powers specified by the SARB Act were given with a specific objective in mind, and that objective should not be lost because the ancillary powers that are needed to implement it have not been mentioned precisely.

<sup>212</sup> Section 4(1)(a) and (b) of the SARB Act. In terms of section 4(2) the Governor must be a person tested for banking experience.

<sup>213</sup> Section 4(3). See further section 4(4) regarding fit and proper requirements for directors, section 5 regarding tenure and conditions of office, section 7 regarding procedure and quorum, section 8 regarding delegation of powers and section 9 regarding the validity of the Board's decisions and acts.

<sup>214</sup> Section 22(1) of the SARB Act; See also Malan & Pretorius 2001 no. 1 at 36.

<sup>215</sup> Section 23(2) of the SARB Act.

<sup>216</sup> Section 32. When called upon to do so by the National Treasury by notice in writing, it must furnish it within the period specified in such notice, with such further returns as may be specified in the notice.

accountability is further enhanced by regular discussions between the Governor and the Minister of Finance as well as the Governor's periodical appearance before the Parliamentary Standing Committee on Finance to discuss matters relating to the SARB. The Minister also has fairly extensive powers to oversee certain issues regarding the SARB, which includes the powers to make regulations, appoint a director of his or her choice to chair meetings of the Board, and to direct the Bank to comply with any provision of the SARB Act. In addition, the fairly unique private shareholder structure of the Bank affords SARB shareholders the opportunity of calling the Governor and management of the Bank to account at shareholders' meetings. Various publications containing relevant information on the SARB, such as Monetary Policy Committee statements, Governors' Addresses, financial statements and board reports, are designed to keep the general public informed of the operations of the Bank.<sup>217</sup>

Apart from the SARB other regulators in South Africa pre-Twin Peaks included the Financial Services Board that was responsible for insurance regulation and supervision and also supervised fund managers and exchanges, and shared the responsibility for supervision of market intermediaries with the Johannesburg Stock Exchange (JSE). The JSE supervised listed companies while the Department of Trade and Industry supervised unlisted companies. The National Credit Regulator, established in terms of the National Credit Act,<sup>218</sup> oversaw lending and reported to the Department of Trade and Industry. South Africa decided upon a single regulator approach to financial regulation after the Melamet Commission in 1993,<sup>219</sup> but this change was never implemented and the silo'd sectoral approach to regulation prevailed.<sup>220</sup>

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<sup>217</sup> De Jager 2006 no.2 290.

<sup>218</sup> Act 34 of 2005.

<sup>219</sup> Melamet Commission *Report of the committee of inquiry into the feasibility of a holistic approach for financial supervision of financial institutions, financial services and deposit-taking institutions* (1993); Botha E and Makina D "Financial Regulation And Supervision: Theory And Practice In South Africa" 2011 (10) *International Business and Economics Research Journal* 27 at 32: The Melamet Commission, was chaired by Judge David Melamet, and recommended a single regulator model for supervision of the financial system in South Africa.

<sup>220</sup> Rajendaran D "Approaches to Financial Regulation and the Case of South Africa" IFMR Finance Foundation (6 March 2012) <http://www.ifmr.co.in/blog/2012/03/06/approaches-to-financial-regulation-and-the-case-of-south-africa/> (accessed 7 June 2017), hereinafter Rajendaran 2012: Following the Melamet Commission, South Africa planned to move towards a single regulator approach to be in line

### 2.3 Primary objective of the SARB pre-Twin Peaks: price stability

In 1989 the primary objective of the SARB, as later also confirmed in section 224(1) of the Constitution, was embodied in legislation for the first time.<sup>221</sup> In terms of section 3 of the SARB Act the primary objective of the SARB was stated to be the protection of the value of the currency of the Republic in the interest of balanced and sustainable economic growth in the Republic. The SARB thus had the responsibility for implementing monetary policy aimed at price stability.<sup>222</sup>

De Jager remarks that inasmuch as the public is influenced by monetary concerns and the economy, central banks are globally regarded as bodies that fulfil a role that has to benefit the public as a whole. Therefore the regulation of monetary issues is not necessarily one and the same as the realisation of profits.<sup>223</sup> The SARB had to conduct its business likewise in the public interest only, without considering or pursuing any profit motive. Consequently the ultimate goal that the executive of the SARB had to pursue, was not the maximisation of profit, but the protection of the value of the currency to the benefit of the general public.<sup>224</sup>

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with developments in European countries whose financial systems are similar, although the regulatory system has remained functional and partially integrated and thus the suggestion of the Melamet Commission was not implemented.

<sup>221</sup> Schoombie "The Stals era of monetary policy in South Africa" 2003 *South African Journal of Economic History: The South African Economy in the 1990's* 31, at 33.

<sup>222</sup> Address by Mboweni, Governor of the South African Reserve Bank at the Council for Businesswomen Pretoria 14 March 2000 "The role of the South African Reserve Bank in the economy" <https://www.bis.org/review/r000321a.pdf> (accessed 31 December 2017). See also De Jager 2006 no. 2 274-283; De Jager 2013 no. 1 344 and 357.

<sup>223</sup> De Jager 2006 no.1 163.

<sup>224</sup> De Jager 2006 no.1 164; *South African Reserve Bank v Public Protector and Others* (Case number 43769/17) [2017] ZAGPPHC 443; [2017] 4 All SA 269 (GP); 2017 (6) SA 198 (GP) (15 August 2017); See also City Press "Reserve Bank's urgent court application against Public Protector" (27 June 2017) <http://city-press.news24.com/News/reserve-banks-urgent-court-application-against-public-protector-20170627> (accessed 1 July 2017): The Public Protector's recommendation in June 2017 that a process be initiated by the Portfolio Committee on Justice and Correctional Services to change the Constitution "in pursuit of improving socioeconomic conditions of the citizens of the Republic" and to remove the reference in the Constitution to "protect the value of the currency" has been set aside by the North Gauteng High Court in Pretoria on 15 August 2017; Mail and Guardian "SA Reserve Bank wins court bid against Public Protector" (15 August 2017) <https://mg.co.za/article/2017-08-15-sa-reserve-bank-wins-court-bid-against-public-protector> (accessed 30 August 2017): The Judge found that the Public

In order to achieve its primary objective of price stability, the SARB conducted monetary policy within an inflation-targeting framework in terms of which it endeavoured to maintain the consumer-price index inflation, adjusted to provide for interest costs on mortgages (CPIX) within a designated target range. The SARB thus followed a market-oriented approach which is common in many other countries with established financial markets.<sup>225</sup> With regard to the implementation of monetary policy the SARB was vested with instrument independence only, as its primary objective was set in legislation and its target was determined by government.<sup>226</sup>

With regard to the value of the currency the SARB maintained a floating exchange rate policy in terms of which no exchange targets are set and value of the currency is determined by the market. This means that the determination of the appropriateness of the exchange rate requires an implicit judgment on what the equilibrium rate or fair value of the currency may be at any given point in time. The challenge then posed by exchange rate changes entails ascertaining whether the change in the value of the currency constitutes a valid change from the equilibrium or whether it constitutes a divergence from the equilibrium which can result in either an over-or under-valuation of the currency.<sup>227</sup>

The Monetary Policy Committee of the SARB was responsible for ensuring the formulation of monetary policy. It met at regular intervals and published a statement on the monetary-policy stance of the SARB after each meeting.<sup>228</sup>

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Protector's remedial action violated the doctrine of separation of powers because it instructed parliament to act and was therefore unconstitutional.

<sup>225</sup> De Jager 2006 no. 1 164.

<sup>226</sup> De Jager 2006 no. 2 284-285. De Jager remarks that although instrument autonomy may be perceived as a lesser degree of autonomy, it has proven sufficient to provide the general public with the assurance that the implementation of monetary policy will not be manipulated by the government.

<sup>227</sup> De Jager 2006 no. 1 165; See also C Stals "Monetary Policy and Inflation Targets" address at the AGM of the South Africa/Canada Chamber of Business, Johannesburg, 2 May 1996.

<sup>228</sup> De Jager 2006 no. 2 288.

## **2.4 Other functions and roles of the SARB pre-Twin Peaks**

In the pre-Twin Peaks dispensation the SARB, in addition to its mandate for price stability, also had other powers, functions and duties in terms of the SARB Act and fulfilled the traditional central bank roles of supervisor of banks, overseer of the payments, clearing and settlement system, acting as lender of last resort, and also had the responsibility for the maintenance of financial stability, as will be discussed in more detail below.

### **2.4.1 General**

In terms of section 10 of the SARB Act the SARB *inter alia* had the following powers and duties, some of which might have had an influence on financial stability and/or might have contributed to financial stability:

“(a) make banknotes or cause banknotes to be made; coin coins or cause coins to be coined; issue banknotes and coins, or cause banknotes and coins to be issued for use in the Republic; make or cause to be made, banknotes to be issued for use in another State, and coin, or cause to be coined, coins for use in another State; and destroy banknotes and coins or cause them to be destroyed;

(b) with the object of making banknotes or coining coins, and with any object incidental thereto, form companies and take up shares in such companies;

(c) perform such functions, implement such rules and procedures and, in general, take such steps as may be necessary to establish, conduct, monitor and regulate and supervise payment, clearing or settlement systems; form or take up shares or acquire an interest in, any company or other juristic person that provides services or facilities for or associated with the utilization of any such payment clearing or settlement systems; perform the functions assigned to the SARB by or under any law for the regulation of such payment, clearing or settlement systems and participate in such payment, clearing or settlement systems;

(d) acquire shares in a limited company if the Board is of the opinion that any such acquisition will be conducive to the attainment of any of the objects of the SARB Act;

- (e) accept money on deposit, allow interest on any deposit or portion thereof and collect money for other persons;
- (f) grant loans and advances;<sup>229</sup>
- (g) buy, sell or re-discount bills of exchange drawn or promissory notes issued for commercial, industrial or agricultural purposes, or exchequer bills<sup>230</sup> of the Government of the Republic or the government of another country, or securities of a local authority in the Republic;
- (h) buy, sell or deal in financial instruments and, in accordance with the provisions of any law regulating the safe deposit of securities, hold such financial instruments in safe custody, or cause such financial instruments to be held in safe custody on behalf of other persons;
- (i) issue its own interest-bearing securities for purposes of monetary policy and buy, sell, discount or re-discount, or grant loans or advances against, such securities;
- (j) subject to the provisions of section 13(a) and (b), enter into repurchase agreements with any institution in respect of interest bearing securities or such other securities as the SARB may determine;
- (k) buy, sell or deal in precious metals and hold in safe custody for other persons gold, securities and other articles of value;
- (l) buy and sell foreign currencies;
- (m) buy, sell, accept or deal in special drawing rights;
- (n) open credits and issue guarantees;
- (o) effect transfers in accordance with generally accepted banking practice, and sell drafts drawn on its own branches and correspondents;
- (p) establish branches or appoint agents and correspondents in or outside the Republic;
- (q) open accounts in foreign countries and act as agent or correspondent of any bank carrying on business in or outside the Republic;
- (r) make arrangements or enter into agreements with any institution in a foreign country to borrow, in such manner, at such rate of interest and subject to such other

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<sup>229</sup> See more with regard to the proviso to section 10(f) in paragraph 2.4.4 below to the effect that unsecured loans and advances may only be granted to the government of the Republic or to a company formed in terms of section 10(b) or, with the approval of the Board, to any company in which the SARB has acquired shares in accordance with section 10(d) or to officers or employees of SARB.

<sup>230</sup>Exchequer bills (undated) <https://www.merriam-webster.com/dictionary/exchequer%20bill> (accessed 2 December 2016): an exchequer bill is a former British short-time bill of credit or promissory note issued by governmental authority and bearing interest.

terms and conditions as the SARB may deem fit, any foreign currency which it may consider expedient to acquire;

(s) perform such other functions of bankers and financial agents *as central banks customarily may perform*;<sup>231</sup>

(t) lend or advance money on security of a mortgage of immovable property or of a notarial or other bond or a cession thereof, to any officer or employee or former officer or employee of the SARB for the purpose of enabling such person to acquire a dwelling of his own;

(u) acquire immovable property required by the SARB for business purposes or for the purpose of providing a dwelling for any officer of the Bank, and sell, dispose of, donate or otherwise alienate any such immovable property; and

(v) perform the functions relating to banking supervision assigned to it by the Banks Act 94 of 1990 and the Mutual Banks Act 124 of 1993.”

The SARB was further authorised to announce the rates at which it would discount or re-discount the various classes of bills, promissory notes and other securities from time to time.<sup>232</sup>

#### **2.4.2 The SARB as supervisor of Banks**

The SARB has acted as supervisor of banks since 24 April 1987 focusing on prudential soundness of banks.<sup>233</sup>

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<sup>231</sup> Author's emphasis.

<sup>232</sup> Section 10(2) of the SARB Act. South African Reserve Bank webpage (undated) <https://www.resbank.co.za/Research/Rates/Pages/CurrentMarketRates.aspx> (accessed 26 November 2017): The current market rates for various products are published on the SARB's website from time to time. The repo rate is also published as such. The repo rate is the rate at which the SARB lends money to banks. The prime lending rate, which is the interest charged by banks to clients, is linked to the repo rate, and is 3.5% higher than the repo rate. The repo rate is set and reviewed at meetings of the Monetary Policy Committee of the SARB. The repo rate is thus an important outcome of decisions taken in the implementation of the monetary policy of the SARB.

<sup>233</sup> Mbuya JC *The pillars of banking* (2008) 215: In 1985 the Bank Supervision Department was created in the SARB to monitor the foreign activities of South African banks. The functions of the department were expanded in 1986 to include supervision of domestic activities of all banks. The Bank Supervision Department began its work on 1 October 1996 and the responsibility for the supervision of banks and building societies (that have later been transformed into either banks or mutual banks) was officially transferred from the Department of Finance to the SARB on 24 April 1987.

The main powers and functioning of the SARB as banking supervisor were set out in the Banks Act<sup>234</sup> together with the Regulations relating to banks made in terms of section 90 of the Banks Act.<sup>235</sup> Before the passing of the Banks Act, banks were divided into different classes such as merchant banks, commercial banks and discount houses. This classification disappeared with the promulgation of the Banks Act when deposit-taking establishments were all “tarred with the same brush”.<sup>236</sup>

The purpose of the Banks Act 94 of 1990 is to provide for the management and control of the business of banks as public companies taking deposits from the public. As such it provides the legal framework for supervising the financial soundness and stability of individual banks and the investments of depositors.<sup>237</sup> Pre-Twin Peaks the SARB exercised its authority to supervise and regulate banks through the Registrar of Banks and the Office for Banks, as determined in the Banks Act.<sup>238</sup> Section 3 of the Banks Act established the Office for Banks, as a department of the SARB, namely the Bank Supervision Department (BSD),<sup>239</sup> headed by the Registrar of Banks. The BSD had the responsibility to promote the soundness of the banking system and by doing so, to contribute to financial stability, although it is to be noted that the Banks Act did not make any explicit mention of financial stability in this context. Banking supervision by the BSD was risk-based, with specific attention to compliance with regulatory and supervisory standards as expressed by international standard-setting bodies such as the Basel Committee on Banking Supervision and the Financial Stability Board (FSB).<sup>240</sup> In terms of section 4(1) of the Banks Act the Registrar of Banks was

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<sup>234</sup> The Banks Act, Act 94 of 1990.

<sup>235</sup> Regulations relating to Banks issued in terms of section 90 of the Banks Act, 1990, published in Government Gazette no. 34838 of 15 December 2011 accessible at: [http://www.gov.za/files/34838\\_rg9644\\_gon1033a.pdf](http://www.gov.za/files/34838_rg9644_gon1033a.pdf) (accessed 15 June 2016).

<sup>236</sup> Malan & Pretorius 2001 no.1 35.

<sup>237</sup> Malan & Pretorius 2001 no.1 47.

<sup>238</sup> International Monetary Fund Country Report No. 14/340 *South Africa Financial System Stability Assessment* (3 December 2014) <https://www.imf.org/external/pubs/ft/scr/2014/cr14340.pdf> (accessed 15 June 2016), hereinafter IMF 14/340, at 55.

<sup>239</sup> De Jager 2013 no. 2 506.

<sup>240</sup> SARB *Bank Supervision Department Annual Report 2011 (2012)* <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/5048/01%20Annual%20Report%202011.pdf> (accessed 12 December 2017) 1 and also: The mission of the BSD as stated in the Annual Report, is to promote the soundness of the banking system and contribute to financial stability; De Jager 2006 no.2 284. De Jager 2013 no.2 507.

designated by the SARB, with the approval of the Minister of Finance, from among its employees. Four Deputy Registrars could be designated by the SARB, with the approval of the Minister of Finance.<sup>241</sup> The Registrar and Deputy Registrars functioned under the control of the SARB.<sup>242</sup> When the Registrar exercised a function in terms of the Banks Act it could thus be said that it was the SARB that exercised such function because although the BSD was a separate department within SARB, it was not a separate juristic person from SARB.

It is important to note that the SARB's pre-Twin Peaks role as supervisor of banks entailed mainly prudential regulation and that neither the SARB nor any other entity exercised dedicated oversight of the business conduct of banks. Prudential regulation of banks by the SARB included regulation relating to minimum share capital and unimpaired reserve funds requirements that banks must comply with. Banks whose business did not include trading in financial instruments were required to ensure that the sum of its primary and secondary capital and its unimpaired reserve funds in the Republic did not at any time amount to less than R250 000 000.<sup>243</sup> Banks that did trade in financial instruments were required to manage their affairs in such a way that the sum of their primary and secondary capital, their primary and secondary unimpaired reserve funds and their tertiary capital in the Republic at no time amounted to less than R250 000 000.<sup>244</sup>

As supervisor of banks the SARB was inter alia responsible for registration and licensing of banks;<sup>245</sup> and oversaw their compliance with corporate governance

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<sup>241</sup> Section 4(2) of the Banks Act.

<sup>242</sup> De Jager 2013 no. 2 506. Section 4 of the Banks Act provides that the SARB shall, subject to the approval of the Minister of Finance, designate an officer or employee in its service as Registrar of Banks and that the Registrar is obliged to perform, under the control of SARB and in accordance with the directions by SARB from time to time, the functions assigned to the Registrar under the SARB Act.

<sup>243</sup> Section 70(2)(a) Banks Act.

<sup>244</sup> Section 70(2A)(a) Banks Act. In terms of Section 70A it is further provided that, notwithstanding the provisions of section 70(2), (2A) and (2B), a controlling company shall manage its affairs in such a way that subject to the provisions of section 70A(2), the sum of the capital and reserve funds of the banking group structured under such controlling company does not at any time amount to less than the amounts of the required capital and reserve funds determined in respect of the respective entities constituting such banking group, in accordance with the rules and regulations of the relevant regulator responsible for the supervision of the banking group.

<sup>245</sup> Sections 11 to 35.

requirements,<sup>246</sup> audit compliance<sup>247</sup> and risk compliance<sup>248</sup> as prescribed by the Banks Act. The SARB had wide enforcement powers and could, for example, employ inspectors to carry out inspections of the affairs of banks.<sup>249</sup> It could also order the inspection of persons, partnerships, close corporations, companies or other juristic persons that were not registered as a bank under the Banks Act but which de facto carried on the business of a bank or mutual bank. Keeping banks under continuous supervisory surveillance and being clothed with wide investigative powers put the SARB, as banking supervisor, in a prime position to detect vulnerabilities that threatened system stability and to take swift regulatory action to address such problems. Notably, in terms of section 69 of the Bank's Act the SARB was also empowered to appoint a curator for a failing bank with the intent to manage and restore such bank to economic viability.<sup>250</sup> Finally, it needs to be pointed out that although there were some bank failures in South Africa it can by no means be regarded as a jurisdiction with an elaborate history of bank failures.<sup>251</sup>

### **2.4.3 The SARB as supervisor of the payments, clearing and settlement system**

In accordance with the National Payment System Act 78 of 1998 as amended in 2004 by the National Payment System Amendment Act 22 of 2004, the SARB was

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<sup>246</sup> Section 60B.

<sup>247</sup> Section 61 – 64.

<sup>248</sup> Section 64A.

<sup>249</sup> Section 11. Section 11(2): The provisions of the Inspection of Financial Institutions Act 38 of 1984, except section 2 and 7 thereof, apply mutatis mutandis in respect of an inspection carried out in terms of section 11(1) of the SARB Act.

<sup>250</sup> It should however be noted that the process of curatorship underwent some radical changes with the Banks Amendment Act 3 of 2015 that was occasioned by the rescue of African Bank that collapsed in August 2014. As a result of the Banks Amendment Act 2015 the process of curatorship was aligned with international trends to separate a failing bank into a "good bank" (consisting of good asset and performing loans, etc) and a "bad bank" (consisting of non-performing loans and other bad debts). The purpose of curatorship was thus amended so that it is not solely geared at restoring the viability of the whole business of the failing bank as used to be the case prior to the amendments; See further Van Heerden "The Rescue of African Bank: a Step Forward in Banking Regulation in South Africa" 2017 *Journal of International Banking Law and Regulation* 350, at 350 - 358.

<sup>251</sup> Notably no truly systemic banks have failed. A few smaller bank failures that occurred since 1990 are that of Alpha Bank Ltd (1990); Cape Investment Bank Ltd and Pretoria Bank (1991-1992); Sechold Bank and Prima Bank (1993); The African Bank Ltd (1995); Community Bank (1996); Islamic Bank Ltd (1997-1998); FBC Fidelity Bank Ltd (1999); Regal Treasury Bank Ltd; Saambou Bank Ltd and New Republic Bank Ltd (2002); Regal Bank Ltd (2004).

appointed as overseer of the South African payments and settlement system. As such the SARB was responsible for the monitoring, regulation and supervision of the safety and soundness of the payment, clearing and settlement system. The SARB was assisted and enabled to adequately oversee the affairs of the National Payment System by a payment-system management body styled by the Payment Association of South Africa (PASA), which body was responsible for the organisation, management and regulation of its members in the National Payment System. In the execution of its duties with regards to the payment system, the SARB was at all times in a position to monitor the payment and settlement system by means of access to information pertaining to individual banks.<sup>252</sup>

#### **2.4.4 The SARB as Lender of Last Resort**

De Jager points out that generally central banks are reluctant to publish much information in instances where they extend lender of last resort assistance to a bank for fear that it may trigger a loss of confidence in that bank and a subsequent bank panic. The rationale behind not having a fixed set of rules indicating when the central bank's lender of last resort assistance will be invoked is to reduce moral hazard by banks who would otherwise take excessive risks knowing that they are covered if they fail and hence to instil more market discipline.<sup>253</sup> The SARB is one of the central banks worldwide in respect of which scant information regarding its lender of last resort assistance is available in the public domain since neither the Constitution nor the SARB Act deals with this function. According to De Jager the SARB was however totally familiar with this role in the pre-Twin Peaks era and was therefore capable of

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<sup>252</sup> De Jager 2006 no. 2 277. The National Payment System Act, Act 78 of 1998 enables the SARB to perform the functions as provided for in section 10(1)(c)(i) of the SARB Act, namely perform such functions, implement such rules and procedures and, in general, take such steps as may be necessary to establish, conduct, monitor, regulate and supervise payment, clearing or settlement systems; See further the South African Reserve Bank – The National Payment System Framework and Strategy Vision 2015 (2015) [https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem\(NPS\)/Documents/Overview/Vision2015.pdf](https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NPS)/Documents/Overview/Vision2015.pdf) (accessed 31 December 2017); See also Lawack V in Sharrock (ed) *The Law of Banking and Payment in South Africa* (2016) Chapter 3 par 3.3.2.

<sup>253</sup> See also paragraph 1.2 above on moral hazard as well as paragraph 1.3.2 on the central bank as lender of last resort.

providing stabilizing financial support to a bank or banks whenever exceptional circumstances justified such central bank assistance.<sup>254</sup>

De Jager further points out that in general, with regard to loans, the SARB Act in section 10(f)(i) determined that unsecured loans and advances could be granted by the SARB only

(a) to Government;

(b) to a company formed in terms of the Companies Act, for purposes of manufacturing banknotes or coins;

(c) with the approval of its board, to any company formed in terms of the Companies Act in which SARB has acquired shares, if in the opinion of the board the acquisition of the company was conducive to the attainment of any objects of the SARB Act; or

(d) to an officer or employee of the SARB for purposes of purchasing a dwelling or a motor vehicle.<sup>255</sup>

He remarks that it is therefore evident that potential lender of last resort assistance by the SARB to banks had to be in the form of secured loans or advances, unless the shares in the relevant Bank were taken over by the SARB in circumstances as envisaged in (c) above. Generally, since the SARB was a non-profit institution with a public interest role, lender of last resort-assistance by the SARB in the pre-Twin Peaks dispensation involved use of taxpayers' money.<sup>256</sup> This use of taxpayer's money to bail-out failing banks was occasioned by the fact that in the pre-Twin Peaks era South Africa did not have an explicit deposit insurance system.<sup>257</sup>

#### **2.4.5 The role of the SARB in respect of financial stability**

As pointed out in Chapter One, financial stability is at best a "fuzzy" concept and navigating this role of the SARB in the pre-Twin Peaks dispensation is quite a challenging exercise. This is mainly because neither the Constitution nor the SARB

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<sup>254</sup> De Jager 2010 234 -235.

<sup>255</sup> See *South African Reserve Bank v Public Protector and Others* where one of the allegations was that SARB has granted an unsecured loan to ABSA Bank Ltd (the successor of Bankorp), contrary to the provisions of the SARB Act.

<sup>256</sup> De Jager 2010 236-237.

<sup>257</sup> De Jager 2010 244. South Africa will however be moving to an explicit deposit insurance system in the near future. See IMF 8/349 8 and also paragraphs 2.6 and 2.7.11 below.

Act makes any specific mention of the SARB's role with regard to financial stability. Thus no comprehensive legislative framework existed pre-Twin Peaks to explain the exact nature or parameters of this role. At most one could deduce that it would be covered by the provision in section 10(1)(s) of the SARB Act that the SARB may "perform such other functions of bankers ... as central banks customarily may perform" which is wide enough to include the traditional financial stability role of central banks. It thus appears that the SARB's role with respect to financial stability was, for the larger part of the time period prior to South Africa's move to Twin Peaks, mainly an implied role inherent in the SARB's factual role as the central bank of South Africa.

Although scant information exists about the SARB's financial stability mandate pre-Twin Peaks it is clear that, even without a comprehensive legal framework facilitating this mandate, SARB accepted over the years that it was responsible for the maintenance of financial stability in the country and de facto exercised this role.<sup>258</sup> This role gained further momentum when the implicit responsibility of the SARB for monitoring macro-economic risks was confirmed in a letter by the Minister of Finance to the Governor of SARB on 16 February 2010.<sup>259</sup> Despite the absence of an

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<sup>258</sup> South African Reserve Bank – Research (undated) <https://www.resbank.co.za/Research/Pages/Research-Home.aspx> (accessed 29 March 2018): The SARB's research outputs are coordinated by the Research Department. The aim of the Department is to support economic policy formulation by providing accurate economic information and well-considered research and recommendations. The Department's roles include research on sources of data, methodological research, identification of economic and social interrelationships, estimation and simulation of economic behaviour, analysis of short-term developments and problems, structural, trend and in-depth research as well as collecting domestic and international economic information.

<sup>259</sup> De Jager 2013 no. 2 499; See further for the letter by the Minister of Finance: South African Reserve Bank Publications – Quarterly Bulletin no 255 (19 March 2010) <https://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-b7dfb1bedb4&sarblast=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=3638> (accessed 29 June 2017); Schinasi GJ - Responsibility of central banks for stability in financial markets - IMF Working Paper No. 03/121 (June 2003) <https://www.imf.org/external/pubs/cat/longres.aspx?sk=16526.0> (accessed 9 January 2017) 7 - 8: There are several reasons why central banks have a natural role in ensuring financial stability. First, the central bank is the only provider of the means of payment and of immediate liquidity. Secondly, it is the role of the central bank to ensure the smooth functioning of the national payment system. Problems at one bank may cascade through the payment system and perhaps lead to bottlenecks in payment and the possibility of a widespread domino effect. Third, the banking system is key in the transmission mechanism through which monetary policy affects the economy. To the extent that the banking system is experiencing distress, it will be more difficult for central bankers to do whatever they think necessary to achieve their monetary objectives. Central banks therefore have a natural interest in sound financial institutions and stable financial markets. Finally, there is an explicit link between monetary stability and financial stability. When financial instability occurs, trust and confidence breaks down. When this happens, there is usually a rush to obtain liquidity. If this process is allowed to continue, there is the potential for a sharp contraction in monetary aggregates that could ultimately lead to a decline in economic activity.

appropriate facilitating legal framework further developments followed: a dedicated Financial Stability Department (FSD) was established within the SARB in 2001. In 2011 the FSD was merged with the BSD mainly for data reasons. In 2014 the FSD was re-established as a separate department given the future expansion of the Banks' mandate to include an explicit responsibility for financial stability. In its 2014/2015 *Annual Report* the SARB inter alia stated with regard to its de facto financial stability mandate: "Although the bank's financial stability mandate is distinct from its price stability mandate, careful consideration should continuously be given to the interaction between these two objectives. This coordination is facilitated by a degree of cross membership between the SARB's monetary policy and its financial stability committee structures."<sup>260</sup>

Other initiatives in the context of its implied and de facto financial stability mandate (which as indicated, was later formally recognised in the open letter by the Minister of Finance alluded to above but not expressly captured in legislation) included the hosting of a biennial financial stability conference that commenced in October 2006.<sup>261</sup> At the 2010 SARB conference on financial stability Singh notably indicated that "[T]he SARB through the BSD is responsible for banking regulation and supervision and *also for financial stability*. She pertinently stated that the mission of the BSD was "to promote the soundness of the banking system and to *minimise systemic risk* through

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<sup>260</sup> SARB *Annual Report* 2014/2015 – Report on financial stability (2014/2015) [http://www.financialresults.co.za/2015/reservebank\\_2015/financial-stability.php](http://www.financialresults.co.za/2015/reservebank_2015/financial-stability.php) (accessed 12 December 2017).

<sup>261</sup> 2006: South African Reserve Bank Conference "Macroeconomic Policy Challenges for South Africa" (22 – 24 October 2006) – first for SA and according to the Governor TT Mboweni, they planned to make it a biennial occasion. Publication detail for conference: <https://www.resbank.co.za/Publications/Detail-Item-View/Pages/Publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblast=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=56> (accessed 15 December 2017).

2008: Late October 2008, after outbreak of the global economic crisis (referred to by the Governor Gill Marcus in the 2010 Conference Proceedings);

2010: Monetary Policy and Financial Stability in the Post-crisis Era (South African Reserve Bank Conference Series 2010) 90<sup>th</sup> Anniversary-3<sup>rd</sup> biennial conference hosted by the Reserve Bank 4 to 5 November 2010 <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/4908/Confproceeding2010.pdf>;

2015: Research conference on financial stability: Developments, Challenges and Policy Responses 25 November 2015 <https://www.resbank.co.za/Research/Pages/Research-Conference-on-Financial-Stability.aspx>;

2016: Sixth Biennial conference: South Africa's Monetary Policy and Financial Stability Challenges in the Context of Emerging Market Vulnerabilities: 27 – 28 October 2016 <https://www.resbank.co.za/Research/Pages/Biennial-Conference-2016.aspx>.

the effective and efficient application of international regulatory and supervisory standards.<sup>262</sup>

Since March 2004 SARB has also published a Financial Stability Review, covering periods of six months at a time.

## 2.5 Cooperation between SARB and other regulators

As alluded to in Chapter One, effective execution of the mandate for financial stability by necessary implication requires collaboration by the central bank with other entities, such as the various financial regulators and organs of state whose actions have an impact on the financial system. In the pre-Twin Peaks era section 4(3) of the Banks Act provided the framework for cooperation and collaboration as it permitted the Registrar of Banks to enter into written cooperation arrangements including memoranda of understanding (MOUs) with any supervisor or other person or institution as the Registrar deemed fit,<sup>263</sup> although the permitted scope of such agreements were limited to supervisory matters.<sup>264</sup> The BSD and the South African Financial Services Board thus signed a MOU in December 1998 for coordination and liaison between them. They also converged on a regular basis to discuss systemic issues. The MOU provided for shared cooperation in supervision, exchange of information, and directions for shared supervision of financial conglomerates like banks, mutual banks and financial institutions under the jurisdiction of the Financial Services Board.<sup>265</sup>

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<sup>262</sup> Author's emphasis. Singh Y "The emerging new architecture of financial regulation: A response to Charles Goodhart" Conference Proceedings 69 (4 - 5 November 2010) <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/4908/Confproceeding2010.pdf> (accessed 10 December 2017).

<sup>263</sup> Section 4(3) Banks Act.

<sup>264</sup> IMF 14/340 24.

<sup>265</sup> International Monetary Fund Country Report No. 15/53 *South Africa Financial Sector Assessment Program Financial Safety Net, Bank Resolution, and Crisis Management Framework – Technical Note* (February 2015) <https://www.imf.org/external/pubs/ft/scr/2015/cr1553.pdf> (accessed 7 March 2017) 11, hereinafter IMF 15/53, at 12; See also South African Reserve Bank Webpage – Publication and Notices - Publication detail (8 December 1998) <https://www.resbank.co.za/Publications/Detail-Item-View/Pages/Publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblast=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=4452> (accessed 29 March 2018): The Memorandum of understanding between the Financial Services Board and the BSD in the SARB that was signed on 8 December 1998, sets out an arrangement between the two parties regarding mutual assistance and

Furthermore section 89 of the Banks Act permitted the sharing of information by the Registrar of Banks with fellow regulators, provided that the Registrar was satisfied that the information was essential for the proper performance of a function under any law by the fellow regulator.<sup>266</sup>

It is however to be noted that none of the above cooperation and collaboration measures as provided for in the Banks Act was stated to be specifically for purposes of maintaining financial stability.

## **2.6 Rationale behind the move to a Twin Peaks system of financial regulation in South Africa**

As pointed out in Chapter One it is widely acknowledged that the concept of financial stability is vague and difficult to define.<sup>267</sup> A material difficulty with the concept of financial stability in the South African context was that financial stability was not specifically mentioned as an objective of the SARB nor mentioned or defined in any pre-Twin Peaks legislation. It is however clear that through the combination of its various traditional roles, inter alia in implementing monetary policy, overseeing the payments and settlement system, acting as lender of last resort and as supervisor of the safety and soundness of banks, the SARB as central bank has always de facto executed an implied financial stability mandate which was made more public through various initiatives in the 2000s such as establishing the FSD, hosting biennial conferences on financial stability; addressing the issue of financial stability in its annual reports, issuing financial stability reviews and affirming this mandate in the 2010 open letter by the Minister of Finance. However it is unfortunately also true that whilst the SARB acknowledged its financial stability mandate and in recent years appeared to

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exchange of information between them and with other authorities where appropriate and co-ordination of the supervision of financial conglomerates involving banks and other financial institutions.

<sup>266</sup> IMF 15/53 12.

<sup>267</sup> De Jager 2013 no. 2 495.

have pursued it more actively, pre-Twin Peaks its primary goal was that of pursuing price stability and its financial stability mandate did not feature as prominently.

Things slowly started to change in 2007 when the South African National Treasury launched a formal review of the financial sector regulation.<sup>268</sup> The scope of this review was subsequently expanded in 2008 after the GFC erupted.<sup>269</sup> Although South Africa weathered the GFC quite well and was less affected than many other countries like the US, the indirect impact of one million job losses, declining house prices, less manufacturing production, shrinking of the mining sector and the slowdown of growth was devastating.<sup>270</sup> The GFC thus illuminated the pressing need for countries across the globe to assess what lessons could be learnt from the Crisis and which areas of financial regulation needed reform.

In its review of the South African financial system National Treasury pointed out that the South African financial services industry functions in an international environment where there is significant interconnectedness between financial institutions and a crisis in one economy can spread to another at speed as a result of contagion.<sup>271</sup> This position increased the risk of financial instability and heightened the need for appropriate supervision of the financial sector. Accordingly Treasury indicated that the 2008 GFC, being a watershed event in the context of financial regulation, emphasized

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<sup>268</sup> The review of the regulation of the financial sector was also prompted by various calls in South Africa for financial sector reform; See also Financial Sector Charter Annual Review *Report on the transformation of the financial sector in South Africa* (2006) <https://www.fscharter.co.za/pdf/reports-and-reviews/2006-Annual-Report-on-Transformation.pdf> (accessed 29 March 2018) 8: The Financial Sector Charter was a sectoral charter which was the negotiated outcome of a process whereby members of the financial sector, government, social partners and other stakeholders agreed to sector transformation through a formal course of action; See also Parliamentary Monitoring Group “Financial Sector Regulation Bill and financial implications: National Treasury briefing” (3 February 2017) <https://pmg.org.za/committee-meeting/23913/> (accessed 29 March 2018) 1: The Chairperson noted that the Financial Sector Regulation Bill was initiated in 2007, at a time when the financial crisis was experienced, and this had influenced the performance of the financial sector in South Africa also. It was recognised that there was a need to strengthen the regulation of the financial sector.

<sup>269</sup> National Treasury Red Book 2011 2 and also: The policy document provided a review of the key challenges in the financial sector that were addressed, namely financial stability, consumer protection and financial inclusion.

<sup>270</sup> Rena R and Msoni M “Global Financial Crises and its impact on the South African Economy: A further Update” (2014) *Journal of Economics* <http://www.tandfonline.com/doi/abs/10.1080/09765239.2014.11884980> (accessed 31 December 2017).

<sup>271</sup> For more on bank runs and contagion see also Schmulow 2015 no. 2, at 14 -17.

the need for better coordination of monetary and fiscal policies in financial regulation as well as the need to focus on prevention and management of systemic risks.<sup>272</sup>

Notably the International Monetary Fund (IMF) and the World Bank performed a Financial Sector Assessment Program (FSAP) of South Africa as G-20-member, in 2008 in terms whereof they conducted a joint assessment of the South African financial system.<sup>273</sup>The main findings from the IMF team were that although South Africa had a modern and effective financial regulatory framework that had weathered the GFC without major problems, it nevertheless needed reform that would focus on and strengthen both prudential and market conduct supervision and regulatory powers.<sup>274</sup> The main recommendations in the 2008 FSAP Report regarding financial stability was that emerging risks have to be closely monitored and that an early warning analysis has to be conducted. It was also suggested that there has to be an enhanced focus on banking system risks, including that of household credit and bank liquidity and funding risks. Other suggestions were that Basel II<sup>275</sup> has to be implemented proactively to ensure adequate buffers in banks to cope with risks associated with lending to highly leveraged borrowers, including loans for residential mortgages. It was suggested that a crisis simulation exercise has to be undertaken to evaluate response capabilities to systemic stress in the financial sector and that further strengthening procedures for addressing banking problems should be implemented as well as that South Africa needed a well-designed deposit insurance system.<sup>276</sup>

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<sup>272</sup> National Treasury Red Book 2011 5.

<sup>273</sup> International Monetary Fund Country Report No. 08/349 *South Africa: Financial System Stability Assessment, Including Report on the Observance of Standards and Codes on the following topic: Securities Regulation* (October 2008) <https://www.imf.org/external/pubs/ft/scr/2008/cr08349.pdf> (accessed 7 June 2017), hereinafter IMF 8/349. The main author of this report was S. Kal Wajid with substantial contributions from the FSAP team.

<sup>274</sup> Rajendaran 2012. IMF 8/349 1: FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been established to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their flexibility to macro-economic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud; Schmulow 2017 at 401: Schmulow pointed out that the problem with the regulatory structure in South Africa was emphasised, "with a degree of disapproval", by the FSAP Report.

<sup>275</sup> Arner 2011 1600: Basel II, which was finalized in June 2004, proposed new risk measurement methods that instituted higher capital requirements on banks with riskier assets. Alford 2005 267: Basel II incorporated a three-pillar structure consisting of minimum capital requirements, supervisory review and market discipline.

<sup>276</sup> IMF 8/349 8.

It was also recommended in the 2008 FSAP Report that coordination and information exchange among regulators and policymakers should be strengthened and that gaps and overlaps should be minimized and responsibilities should be clearly outlined. It was suggested that the Financial Services Board (as it then was) should develop standards for corporate governance, risk management, and internal controls and harmonize its risk-based models for the different sectors.<sup>277</sup>

Although the financial sector in South Africa had withstood the 2008 GFC relatively successfully, it was thus clear that some important changes were necessary and therefore the South African government at the 2010 Seoul Summit of the G-20, undertook to rethink the fragmented domestic system of financial regulation and committed itself to the global financial reform agenda in order to strengthen financial stability in South Africa.<sup>278</sup> The changes in financial regulation that occurred in South Africa was therefore not so much a knee-jerk reaction in response to the GFC but rather a matter of carrying through of a review that Treasury had already intended to undertake pre-GFC and that South Africa committed itself to more seriously post GFC in alignment with international trends in financial regulation that emerged in the post GFC landscape.

The South African National Treasury subsequently gave momentum to the reform of financial sector regulation in South Africa by issuing a policy paper entitled “A safer financial sector to serve South Africa better” in February 2011.<sup>279</sup> This document,

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<sup>277</sup> IMF 8/349 8.

<sup>278</sup> De Jager 2013 no. 2 498; The G-20 Seoul Summit Leaders' Declaration (12 November 2010) <http://www.g20.utoronto.ca/2010/g20seoul.html> (accessed 26 November 2017) in Arner 2011 1595: This declaration by the G-20 leaders, outlined a new stage of international financial regulation and commitment to previously implemented rules. South Africa, being a member of the G-20, was part of the leaders who identified a range of regulatory issues that would have to be subjected to reform. The G-20 leaders committed to a new financial regulatory framework to transform the global financial system.

<sup>279</sup> National Treasury Red Book 2011. Rajendran 2012: In order to address the shortcomings identified by the IMF in 2008, the government issued the National Treasury Policy Document (A safer financial sector to serve South Africa Better) in February 2011 that set out proposals for strengthening the financial regulatory system. The core of the policy was the adoption of the Twin Peaks model of financial regulation in South Africa. It was in part recognition of the fact that there was a global shift from the single regulator model to the Twin Peaks model after the crisis.

commonly known as the Red Book, considered the lessons learnt from the GFC and assessed the structure and characteristics of South Africa's financial sector for gaps and weaknesses. The Red Book voiced the realization that there were inadequacies in the prevailing system of microprudential supervision of individual institutions in the financial sector occasioned inter alia by the risks for financial instability emanating from interconnections between different establishments in the concentrated South African financial sector. In line with global developments the need was expressed for a macroprudential approach to financial regulation in South Africa in pursuit of financial stability.<sup>280</sup> After considering other approaches to financial regulation such as the institutional approach, the functional approach, the single-regulator or integrated approach and the Twin Peaks approach,<sup>281</sup> National Treasury identified the Twin Peaks model of financial regulation as the appropriate regulatory approach that South Africa should embrace in future to provide the legal and institutional framework and broader context for implementing the various regulatory changes that had to be made.<sup>282</sup>

Following the approval in July 2011 of a shift to an “expanded” Twin Peaks model of financial regulation which included the SARB as an “extra peak” with an express financial stability mandate, a detailed follow-up document was published by the Treasury on 1 February 2013, entitled “Implementing a Twin Peaks model of financial regulation in South Africa”, also known as the Roadmap.<sup>283</sup> This document set out the process going forward, and highlighted important policy choices in the area of prudential and market conduct supervision.

The gist of the South African model as proposed by Treasury was that the financial sector would be made safer (and thus more stable) through a comprehensive financial stability framework, backed by a stronger prudential and market conduct framework,

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<sup>280</sup> De Jager 2013 no. 2 499.

<sup>281</sup> See paragraph 1.8 above.

<sup>282</sup> Explanatory document Dec 2014 6; National Treasury Red Book 2011 29.

<sup>283</sup> Department of National Treasury in the RSA “Implementing a twin peaks model of financial regulation in South Africa.” Published for public comment by the Financial Regulatory Reform Steering Committee on 1 February 2013 <http://www.treasury.gov.za/twinpeaks/20131211%20-%20Item%203%20Roadmap.pdf> (accessed 29 June 2016), hereinafter Roadmap 2013.

each located in a separate regulator. Treasury pointed out that the Twin Peaks system of regulation recognises that the two objectives of financial soundness and treating customers fairly are better done by two regulators, dedicated to each objective as this minimises regulatory arbitrage due to conflicting objectives as often happens where one regulator is tasked to oversee prudential as well as market conduct of financial institutions, being the case under the then prevailing system of silo financial regulation.<sup>284</sup> The South African Twin Peaks model notably excises bank supervision from the remit of the SARB and thus does away with the BSD situated in the SARB as regulator of banks and establishes a separate juristic person, located within the SARB, as prudential regulator. It further replaces the current Financial Services Board with a new market conduct regulator, the Financial Sector Conduct Authority.<sup>285</sup> It also gives these two peaks each a system-wide regulatory remit covering all financial institutions that are engaged in the financial system. The Prudential Authority (PA) is the entity responsible for prudential supervision of the wider spectrum of regulated financial institutions, such as banks and all non-bank financial institutions, including long-term and short-term insurers and pension funds. The Financial Sector Conduct Authority (FSCA), as market conduct authority, is responsible for protecting consumers of financial services and promoting confidence in the South African financial system by regulating and supervising the market conduct of financial services providers, including banks (having been previously virtually unsupervised in this context), insurers, financial advisers, financial intermediaries, investment institutions and the broader financial markets.<sup>286</sup> The functions of the PA and the FSCA with regards to medical schemes will be exercised by the Council for Medical Schemes with the concurrence of the PA and the FSCA until 31 March 2021.<sup>287</sup>

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<sup>284</sup> Explanatory document Dec 2014 8.

<sup>285</sup> Explanatory document Dec 2014 8: It was envisaged that the Financial Services Board would be restructured to serve as the market conduct authority but in later drafts of the Financial Sector Regulation Bill and finally in the FSR Act, discussed below, the establishment of a new market conduct authority, the Financial Sector Conduct Authority (FSCA), was introduced.

<sup>286</sup> De Jager 2013 no. 2 509. Explanatory Document Dec 2014 10: The industry-specific legislation that is currently valid, will still remain in place and will be revised over time. However, with the creation of the new regulators, the responsibility for the existing Acts will change. For example, the responsible authority for the prudentially-focused provisions of the Banks Act and prudential aspects of the Long-term and Short-term Insurance Acts will shift from the Registrar of Banks and Registrars of Long-term and Short-term Insurance to the PA. For most other pieces of legislation, the primary responsibility for the law will shift to the FSCA. The authority responsible for the legislation will also become the licensing authority for financial institutions licensed or authorised in terms of that law.

<sup>287</sup> See note 302 below with regards to this determination subject to section 291(4) of the FSR Act.

Apart from having the responsibility for prudential regulation of banks taken away from the SARB and entrusted to the PA, the SARB in the South African Twin Peaks model retains its other traditional roles as discussed above. However the role of the SARB as central bank in relation to financial stability is changed significantly: under the new Twin Peaks system of financial regulation the mandate of the SARB is expanded to include *promoting, maintaining and restoring* of financial stability and its oversight of systemic macroprudential aspects of the financial system is expanded by establishing a comprehensive legal framework for macroprudential supervision.<sup>288</sup> This amplified and express mandate includes the obligation to identify systemic risks in the financial system, monitoring and analysing market and other financial and economic factors that may increase systemic risks and result in systemic crises, formulating and implementing appropriate policies, and assessing how these policies may impact on the financial system. It further includes dealing specifically with systemically important financial institutions (SIFI or “Too-Big-To-Fail”) in order to reduce the incidence of using tax-payer funds to bail out failing financial institutions. The SARB does however not have a *carte blanche* as to how it will exercise its financial stability mandate but must exercise this mandate within a policy framework agreed with the Minister of Finance.<sup>289</sup>

It is to be noted that the Financial Stability Board (FSB), as international standard setting body, published a *Peer Review of South Africa Report* on 5 February 2013 whilst South Africa was in the process of putting measures in place for the move to Twin Peaks.<sup>290</sup> The FSB welcomed the planned reforms and agreed that a shift to a Twin Peaks model of financial regulation would provide a good opportunity for South

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<sup>288</sup> Author’s emphasis.

<sup>289</sup> Explanatory document Dec 2014 7. See also section 11(2) (a) FSR Act.

<sup>290</sup> Financial Stability Board *Peer Review of South Africa* (5 February 2013) [http://www.fsb.org/wp-content/uploads/r\\_130205.pdf](http://www.fsb.org/wp-content/uploads/r_130205.pdf) (accessed 17 July 2017), hereinafter referred to as FSB Peer Review 2013, at 9: After South Africa underwent the FSAP assessment update in 2008 it was followed in 2010 by detailed assessments of the Basel Committee on Banking Supervision’s *Core Principles for Effective Banking Supervision*, the International Association of Insurance Supervisors’ *Insurance Core Principles*, and the International Organization of Securities Commissions’ (IOSCO) *Principles and Objectives of Securities Regulation*. As part of the commitment of South Africa as an FSB member jurisdiction to undergo an FSAP assessment, South Africa also has to undergo a peer review 2 - 3 years following the FSAP to complement that cycle and therefor volunteered to undertake a country peer review in 2012.

Africa to streamline regulatory responsibilities and elevate the importance of market conduct regulation, which has historically played a less prominent role in certain financial sub-sectors (notably also in the banking sector). It was remarked that since prudential supervision would be the responsibility of a separate body in the Twin Peaks model that would oversee not only banks but various other financial institutions, this would also help to improve oversight of financial conglomerates that dominated the South African financial system. The FSB stated that while the reforms did not seem to reduce the overall complexity in terms of the number of agencies involved in regulation and supervision in South Africa, they did provide more clarity in the assignment of responsibilities and the concentration of related expertise.<sup>291</sup> The FSB Peer Review Report further pointed out that there was general consensus that the SARB would be best placed to perform the macroprudential analysis function, but stated that it was also clear that the SARB could not be the sole custodian of financial system stability and that all other financial regulators had to take into account the financial stability implications of their actions.<sup>292</sup>

The first stage of South Africa's move towards a Twin Peaks system of financial regulation is encapsulated in the Financial Sector Regulation Act, 9 of 2017, designed to put the Twin Peaks architecture in place. This Act was preceded by a formidable number of drafts in an attempt to refine the proposed regulatory model. After the first draft of the Financial Sector Regulation Bill (FSR Bill) was published,<sup>293</sup> close to 300 pages of comments were received on the draft Bill, and various communications between stakeholders followed. Early in 2014 National Treasury published the second draft of the FSR Bill<sup>294</sup> as a revised version of the first draft of the Bill for further public consultation. National Treasury summarised some of the responses and comments from stakeholder engagements with members of the public and various government departments received on the first draft of the FSR Bill. It gave detailed explanations of

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<sup>291</sup> FSB Peer Review 2013 5.

<sup>292</sup> FSB Peer Review 2013 16.

<sup>293</sup> The FSR Bill – first published for public comment in December 2013.

<sup>294</sup> The second draft of the Financial Sector Regulation Bill, hereinafter referred to as FSR 2014; See also Media Statement by National Treasury on 11 December 2014, Pretoria – TWIN PEAKS: Second draft of FSR Bill and draft Market Conduct Policy Framework discussion document published for comment and Department of National Treasury in the RSA “Financial Sector Regulation Bill 2013 Implementing Twin Peaks – Phase 1” January 2014 [http://www.treasury.gov.za/twinpeaks/2014128%20\(Workshops\)%20v4%20Twin%20peaks%20presentation.pdf](http://www.treasury.gov.za/twinpeaks/2014128%20(Workshops)%20v4%20Twin%20peaks%20presentation.pdf) (accessed 29 June 2016).

the proposals in the document that accompanied the second draft of the FSR Bill, entitled “Twin Peaks in SA: Response and explanatory document”.<sup>295</sup> The introduction of Twin Peaks in South Africa gained further momentum when the Revised (Third) Draft of the FSR Bill<sup>296</sup> was tabled in parliament on 27 October 2015.<sup>297</sup> This draft underwent yet a further revision in July 2016.<sup>298</sup> On 21 October 2016 a comparison of the revisions with the July 2016 version of the Bill was published<sup>299</sup> and on 6 December 2016 the National Assembly voted on the Bill.<sup>300</sup> Eventually on 21 August 2017, more than six years after publication of the Red Book, the President signed the Financial Sector Regulation Act, Act 9 of 2017 (hereinafter referred to as the FSR Act) into law.<sup>301</sup> National Treasury issued a Notice on 24 August 2017 regarding the implementation of the FSR Act, indicating that the Minister of Finance would determine the commencement date of the Act by notice in the Government Gazette.<sup>302</sup> The

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<sup>295</sup> Explanatory document Dec 2014 4.

<sup>296</sup> Financial Sector Regulation Bill, 2015 available at <http://www.treasury.gov.za/twinpeaks/Financial%20Sector%20Regulation%20Bill%20tabled%2027%20October%202015.pdf> (accessed 9 November 2015); See also Media Statement by National Treasury on 27 October 2015, Pretoria – Tabling of Financial Sector Regulation Bill to give effect to Twin Peaks reform [http://www.treasury.gov.za/comm\\_media/press/2105/2015102701%20-%20Twin%20Peaks%20Reform.pdf](http://www.treasury.gov.za/comm_media/press/2105/2015102701%20-%20Twin%20Peaks%20Reform.pdf) (accessed 9 Nov 2015).

<sup>297</sup> National Treasury’s responses to issues raised during the public consultation period on the tabled draft FSR Bill (B 34-2015) (comment period: November 2015 – May 2016) [http://www.treasury.gov.za/twinpeaks/NT%20Responses%20to%20issues%20raised%20during%20the%20SCOF%20public%20consultation%20process%20\(21-07-2016%20\).pdf](http://www.treasury.gov.za/twinpeaks/NT%20Responses%20to%20issues%20raised%20during%20the%20SCOF%20public%20consultation%20process%20(21-07-2016%20).pdf) (accessed 20 November 2016), hereinafter National Treasury Responses 2016.

<sup>298</sup> FSR July 2016 available at <http://www.treasury.gov.za/twinpeaks/Comparison%20of%20proposed%20revised%20bill%20with%20tabled%20version%20of%20Bill%20July%202016.pdf> (accessed 1 August 2016).

<sup>299</sup> Financial Sector Regulation Bill Comparison of Revisions with July 2016 version of the Bill on 21 October 2016 available at <http://www.treasury.gov.za/twinpeaks/FSR%20Bill%20comparison%20of%20revisions%20with%20July%202016%20version.pdf> (accessed 6 December 2016).

<sup>300</sup> Financial Sector Regulation Bill, as voted on by the National Assembly on 6 December 2016 available at [http://www.treasury.gov.za/twinpeaks/FSR%20Bill%20as%20voted%20in%20NA%20b%2034b%20-2015%20\(financial%20sector%20regulation\).pdf](http://www.treasury.gov.za/twinpeaks/FSR%20Bill%20as%20voted%20in%20NA%20b%2034b%20-2015%20(financial%20sector%20regulation).pdf) (accessed 10 December 2016), hereinafter FSR 2016; An erratum was published on 6 December 2017: Erratum: Financial Sector Regulation Bill as voted on by the National Assembly on 6 December 2016 <http://www.treasury.gov.za/twinpeaks/2016%2012%2009%20Erratum%20Publication%20of%20tabled%20FSR%20Bill.pdf> (accessed 23 December 2016). On 22 June 2017 the FSR Bill was passed by the National Assembly: Financial Sector Regulation Bill passed by the National Assembly on 22 June 2017 (B-34D-2015) <http://www.treasury.gov.za/twinpeaks/FSRB%20D%20Bill%20as%20passed%20by%20Parliament.pdf> (accessed 30 June 2017).

<sup>301</sup> Financial Sector Regulation Act, Act 9 of 2017 published in *Government Gazette* no. 41060 volume 626 of 22 August 2017 (Regulation Gazette no. 853) <http://www.treasury.gov.za/legislation/acts/2017/Act%209%20of%202017%20FinanSectorRegulation.pdf> (accessed 28 August 2017) 1, hereinafter referred to as FSR Act.

<sup>302</sup> Section 305 of the FSR Act. Notice by Department of National Treasury “Implementation of the Financial Sector Regulation Act, Act 9 of 2017” (24 August 2017) <http://www.treasury.gov.za/twinpeaks/Implementation%20of%20the%20Financial%20Sector%20Regulation%20Act.pdf> (accessed 28 August 2017) and also: The National Treasury has been working together with the SARB and the Financial Services Board on the implementation of the Act and transitional arrangements. See also

commencement date of the Act was determined by the Minister of Finance by notice in the Government Gazette on 29 March 2018 as being 1 April 2018.<sup>303</sup>

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Draft Regulations published for public comment in terms of sections 61(4) and 304 of the Financial Sector Regulation Act, 2017 in *Government Gazette* no. 41340 volume 630 of 18 December 2017 (Regulation Gazette No. 10789) accessible at <http://www.treasury.gov.za/twinpeaks/Government%20Gazette-%20Invitation%20of%20comments%20on%20the%20draft%20Financial%20Sector%20Regulations.pdf>. See also Commencement of amendments to Financial Markets Act, 2012, as contained in the Financial Sector Regulation Act, 2017, was published in *Government Gazette* no. 41433 volume 632 of 9 February 2018 (Regulation Gazette no. 10802 – National Treasury notice 99 of 2018) accessible at [https://www.greengazette.co.za/notices/financial-sector-regulation-act-9-2017-commencement-of-amendments-to-financial-markets-act-2012-as-contained-in-financial-sector-regulation-act-2017\\_20180209-GGR-41433-00099.pdf](https://www.greengazette.co.za/notices/financial-sector-regulation-act-9-2017-commencement-of-amendments-to-financial-markets-act-2012-as-contained-in-financial-sector-regulation-act-2017_20180209-GGR-41433-00099.pdf) (accessed 27 March 2018) 127. See also Insurance regulations in terms of section 291 of the FSR Act published for comment in *Government Gazette* no. 41523 volume 633 of 23 March 2018 (National Treasury Notice number 357 in terms of the Short-term Insurance Act, 1998 and National Treasury Notice number 358 in terms of the Long-term Insurance Act, 1998) [http://www.treasury.gov.za/twinpeaks/Annexure%20A\\_Insurance%20Regulations%20for%20Comment\\_%20Gazette%20No\\_41523.pdf](http://www.treasury.gov.za/twinpeaks/Annexure%20A_Insurance%20Regulations%20for%20Comment_%20Gazette%20No_41523.pdf) (accessed 1 April 2018) 4 and 12; With regards to medical schemes see also determination in terms of section 291 of the FSR Act (23 March 2018) <http://www.treasury.gov.za/twinpeaks/Determination%20in%20terms%20of%20s%2020291%20of%20FSR%20Act.pdf> (accessed 1 April 2018): The Minister of Finance has determined in terms of section 291(1) of the FSR Act that until 31 March 2021 the functions of the PA in relation to medical schemes and the associated powers and duties of the PA in terms of the Act must be exercised by the Council for Medical Schemes instead of the PA, but with the concurrence of the PA, subject to section 291(4) of the Act; and (b) in terms of section 291(2) of the Act, determined that until 31 March 2021, the functions of the FSCA in relation to medical schemes and the associated powers and duties of the FSCA in terms of the Act must be exercised by the Council for Medical Schemes instead of the FSCA, but with the concurrence of the FSCA, subject to section 291(4) of the Act.

<sup>303</sup> Commencement of Financial Sector Regulation Act, 2017 published in *Government Gazette* no. 41549 volume 633 of 29 March 2018 (National Treasury Notice 169 of 2018) <http://www.treasury.gov.za/twinpeaks/Commencement%20of%20Financial%20Sector%20Regulation%20Act%202017.pdf> (accessed 1 April 2018): The following provisions of the FSR Act took effect on 29 March 2017, namely section 1, chapter 7 (sections 97 – 110), sections 288, 301(4), 304 and schedule 1. The following provisions of the FSR Act took effect on 1 April 2018: Sections 2 – 10, chapter 2 (sections 11 – 31), chapter 3 (sections 32 – 55), chapter 4 (sections 56 to 75), sections 76 – 82, 87 – 89, 91 – 96, 111(1)(a) and (2) to (7), 112 – 128, chapter 9 (sections 129 – 140), chapter 10 (sections 141 – 156), chapter 13 (sections 167 – 173), chapter 15 (sections 218 – 236), sections 250 – 255, 265 – 268, 271 – 282, 284 – 286, 289, 291 – 300, 301(1), (3) and (5) and 303 and schedule 2. Section 283 took effect on 1 April 2018 in respect of the PA and the FSCA and on 1 October 2018 in respect of the Ombud Council. The following provisions of the FSR Act will take effect on 1 October 2018: Section 90, chapter 14 (sections 175 – 217), sections 270 and 301(2), (6) and (7). Chapter 11 (sections 157 – 159) will take effect on 1 January 2019. Chapter 12 (sections 160 – 166) will take effect on 1 March 2019. Section 111(1)(b) and chapter 16 (sections 237 – 249) and section 302 will take effect on 1 April 2019. Section 290 took effect as follows: With regards to the Insolvency Act, Act 24 of 1936 and the Policy Board for Financial Services and Regulation Act, Act 141 of 1993 (the latter will be repealed) on 29 March 2018; with regards to all the other Acts mentioned in schedule 4, on 1 April 2018, with the exception of the Financial Intelligence Centre Act, Act 38 of 2001 that took effect on 7 May 2018 and certain sections of the Pension Funds Act, Act 24 of 1956, as well as certain sections of the Financial Advisory and Intermediary Services Act, Act 37 of 2002 and the Financial Services Ombud Schemes Act, Act 37 of 2004 (the latter will be repealed) and the National Credit Act, Act 34 of 2005 and certain items of the Co-operative Banks Act, Act 40 of 2007 that will take effect on 1 October 2018. See also Press Release of the National Treasury “New Twin Peaks Regulators established” (29 March 2018) [http://www.treasury.gov.za/twinpeaks/Press%20release%20Twin%20Peaks%20implementation%20March2018\\_FINAL.pdf](http://www.treasury.gov.za/twinpeaks/Press%20release%20Twin%20Peaks%20implementation%20March2018_FINAL.pdf) (accessed 1 April 2018).

## 2.7 The Financial Sector Regulation Act

### 2.7.1 Introduction

Section 7 of the FSR Act provides that the object of the Act is to achieve a stable financial system that works in the interests of financial customers, and supports balanced and sustainable economic growth in the Republic, by establishing, in conjunction with the other financial sector laws, *a regulatory and supervisory framework that promotes financial stability*<sup>304</sup>; the safety and soundness of financial institutions; the fair treatment and protection of financial customers; the efficiency and integrity of the financial system; the prevention of financial crime; financial inclusion; transformation of the financial sector and confidence in the financial system.<sup>305</sup>

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<sup>304</sup> Author's emphasis.

<sup>305</sup> Explanatory Summary of the Financial Sector Regulation Bill 2015 published in *Government Gazette* no. 39127 volume 749 on 21 August 2015 [http://www.gov.za/sites/www.gov.za/files/39127\\_gon749.pdf](http://www.gov.za/sites/www.gov.za/files/39127_gon749.pdf) (accessed 29 June 2016) 26 in terms of Rule 241(1)(c) of the Rules of the National Assembly. See also the preamble of the FSR Act for a more extensive summary of the matters dealt with in the Act; Section 7(1) of the FSR Act states that the object of the Act will be achieved by:

- Conferring on the Reserve Bank the mandate to protect and enhance financial stability, and if a systemic event has adversely affected financial stability, to restore and maintain financial stability;
- Establishing the Financial Sector Conduct Authority and the PA to supervise and regulate the provision of financial products and financial services;
- Ensuring cooperation, collaboration, co-ordination and consistency between the Financial Sector Conduct Authority, the PA, the National Credit Regulator, the Reserve Bank and other organs of the state;
- Protecting the interests of customers acquiring or using financial products and financial services by ensuring that financial institutions treats customers fairly and providing financial customers with financial education programs;
- Providing for the regulation of significant owners of financial institutions and creating a framework for the supervision of financial conglomerates;
- Ensuring a consistent and standardised approach to financial regulation, by establishing harmonised systems of licensing, supervision, complaints resolution, enforcement and review mechanisms;
- Providing for procedural matters such as information sharing arrangements, information gathering and for supervisory on-site inspections and investigations into the affairs of a financial institution;
- Providing financial sector regulators with enforcement powers, establishing the Financial Services Tribunal to hear reviews of decisions made in terms of the financial sector laws, and for the imposition of administrative penalties and related orders;
- Establishing the Financial Sector Ombud Schemes Regulatory Council to provide for the regulation of ombud schemes.

The FSR Act has a broad scope of application and generally applies to “financial institutions” rendering financial services<sup>306</sup> and providing financial products<sup>307</sup> in the South African financial system.<sup>308</sup> For purposes of the Act “financial institution” means a financial product provider; a financial service provider; a market infrastructure;<sup>309</sup> a holding company of a financial conglomerate; or a person licensed or required to be licensed in terms of a financial sector law.<sup>310</sup>

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<sup>306</sup> Section 3 of FSR Act: 3(1) In this Act— “financial service” means—

(a) any of the following activities conducted in the Republic in relation to a financial product, a foreign financial product, a financial instrument, or a foreign financial instrument: (i) Offering, promoting, marketing or distributing; (ii) providing advice, recommendations or guidance; (iii) operating or managing; or (iv) providing administration services;

(b) dealing or making a market in the Republic in a financial product, a foreign financial product, a financial instrument or a foreign financial instrument;

(c) a payment service;

(d) securities services;

(e) an intermediary service as defined in section 1(1) of the Financial Advisory and Intermediary Services Act;

(f) a service related to the buying and selling of foreign exchange;

(g) a service related to the provision of credit, including a debt collection service, but excluding the services of (i) a debt counsellor registered in terms of section 44 of the National Credit Act who provides the services of a debt counsellor as contemplated in that Act; (ii) a payment distribution agent as defined in section 1 of the National Credit Act; or (iii) an alternative dispute resolution agent, as defined in section 1 of the National Credit Act;

(h) a service provided to a financial institution through an outsourcing arrangement;

(i) any other service provided by a financial institution, being a service regulated by a specific financial sector law; and

(j) a service designated by the Regulations for this section as a financial service.

(2) A service provided by a market infrastructure is not a financial service unless designated by Regulations in terms of subsection (3).

<sup>307</sup> Section 2 of FSR Act: 2(1) In this Act—“financial product” means—

(a) a participatory interest in a collective investment scheme;

(b) a long-term policy as defined in section 1(1) of the Long-term Insurance Act;

(c) a short-term policy as defined in section 1(1) of the Short-term Insurance Act;

(d) a benefit provided by— (i) a pension fund organisation, as defined in section 1(1) of the Pension Funds Act, to a member of the organisation by virtue of membership; or (ii) a friendly society, as defined in section 1(1) of the Friendly Societies Act, to a member of the society by virtue of membership;

(e) a deposit as defined in section 1(1) of the Banks Act;

(f) a health service benefit provided by a medical scheme as defined in section 1(1) of the Medical Schemes Act;

(g) except for Chapter 4 and section 106, the provision of credit provided in terms of a credit agreement regulated in terms of the National Credit Act;

(h) a warranty, guarantee or other credit support arrangement as provided for in a financial sector law;

(i) a facility or arrangement designated by Regulations for this section as a financial product; and

(j) a facility or arrangement that includes one or more of the financial products referred to in paragraphs (a) to (i).

<sup>308</sup> In terms of section 1(1) of FSR Act “financial system” is defined as meaning the system of institutions and markets through which financial products, financial instruments and financial services are provided and traded, and includes the operation of a market infrastructure and a payment system.

<sup>309</sup> A “market infrastructure” for purposes of the FSR Act means each of the following, as they are defined in section 1(1) of the Financial Markets Act: (a) A central counterparty; (b) a central securities depository; (c) a clearing house; (d) an exchange; and (e) a trade repository;

<sup>310</sup> Section 1(1) of the FSR Act.

## **2.7.2 The SARB's Financial Stability Mandate in terms of the FSR Act**

### **(a) Introduction**

As indicated, the 2008 GFC was a financial meltdown of global proportions that highlighted the threat of systemic risk to financial systems with the result that since the GFC the regulatory focus has entered a new paradigm that concentrates extensively on the promotion and maintenance of stability in financial markets. This is also the main focus of the FSR Act which describes the concept of “financial stability” to mean that:<sup>311</sup>

(a) financial institutions generally provide financial products and financial services, and market infrastructures generally perform their functions and duties in terms of financial sector laws, without interruption;

(b) financial institutions are capable of continuing to provide financial products and financial services, and market infrastructures are capable of continuing to perform their functions and duties in terms of financial sector laws, without interruption despite changes in economic circumstances; and

(c) there is general confidence in the ability of financial institutions to continue to provide financial products and financial services, and the ability of market infrastructures to continue to perform their functions and duties in terms of financial sector laws, without interruption despite changes in economic circumstances.<sup>312</sup>

The FSR Act assigns an overall financial stability mandate to the SARB, encompassing various powers and functions entrenched in this framework legislation and requiring broad collaboration by various bodies. This expanded financial stability mandate is a pronounced and comprehensive mandate that not only requires the SARB to monitor the financial system closely and act pre-emptively to prevent

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<sup>311</sup> Section 1 read with section 4 of FSR Act.

<sup>312</sup> It is important to note that section 4(2) expressly provides that a reference to “maintaining” financial stability includes, where financial stability has been adversely affected, a reference to “restoring” financial stability.

disruption of financial stability and, if such disruption occurs despite SARB's efforts to prevent it, to then manage such situation in an attempt to eventually restore financial stability.

Notably this expanded financial stability mandate has to be exercised by the SARB in the broader context of the Twin Peaks model hence the FSR Act creates a legislative and institutional framework dedicated specifically to facilitate the effective execution of such mandate but also provides a broader framework enabling the effective implementation of the complete Twin Peaks model of financial regulation in which the SARB plays a pivotal stabilizing role. In view thereof one has to gauge the SARB's "new" comprehensive financial stability mandate first by looking at those provisions that focus specifically on enabling the SARB's financial stability mandate per se. Second it has to be considered how, within the broader framework of the Twin Peaks model, this mandate is assimilated into the fabric of the Twin Peaks model.

The FSR Act also creates a structural network comprising of various committees dedicated to facilitating decisions on financial stability issues and otherwise facilitating interagency coordination. In exercising its financial stability mandate the SARB will primarily be supported by the Financial Stability Oversight Committee (FSOC)<sup>313</sup> established in terms of section 20 of the Act and the Financial Sector Contingency Forum (FSCF)<sup>314</sup> established in terms of section 25 of the Act. On a broader Twin Peaks-level the Act has created dedicated bodies such as the Financial System Council of Regulators (section 79)<sup>315</sup> and the Financial Sector Inter Ministerial Council (section 83)<sup>316</sup> to facilitate the proper implementation of the comprehensive Twin Peaks model in South Africa. The Act provides for extensive cooperation between the SARB and the other financial sector regulators such as the Prudential Authority (PA), the Financial Sector Conduct Authority (FSCA) that each have a mandate to "assist" in the maintenance of financial stability as well as the National Credit Regulator (NCR)

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<sup>313</sup> See discussion of the FSOC in paragraph 2.7.8 below.

<sup>314</sup> See discussion of the FSCF in paragraph 2.7.9 below.

<sup>315</sup> See discussion of the Financial System Council of Regulators in paragraph 2.7.13 (c) below.

<sup>316</sup> See discussion of the Financial Sector Inter Ministerial Council in paragraph 2.7.13 (d) below.

and the Financial Intelligence Centre (FIC).<sup>317</sup> Provision is also made for cooperation and collaboration between the SARB and other organs of state<sup>318</sup> in the context of maintaining financial stability.<sup>319</sup>

Crucially the SARB's stability mandate as per the FSR Act, requires it not only to keep the scales of financial stability hanging in balance but to actively *promote* financial stability in South Africa. In order to comprehend the changed role of the SARB and scope of this mandate and exactly how it is envisaged to be exercised, the various provisions of the FSR Act relevant to the SARB's mandate will be unpacked and critically analysed below.

#### **(b) The parameters of the SARB's financial stability mandate**

Section 11 of the FSR Act articulates the SARB's new "additional primary mandate", namely that the SARB is responsible for "protecting and enhancing" financial stability and if a systemic event<sup>320</sup> has occurred or is imminent, the SARB has the responsibility for "restoring and maintaining" financial stability in the South African financial system. This is clearly a broader, multi-layered mandate than merely stating that the SARB is responsible for "maintaining" financial stability being the description given to the SARB's implied financial stability mandate in the pre-Twin Peaks era. The words "protecting", "enhancing", "restoring" and "maintaining" are not defined in the FSR Act and thus have to be afforded their ordinary grammatical interpretation adjusted to fit the context in which they appear in the Act. As indicated by the Oxford Dictionary "protect" means to "keep safe from harm or injury". "Enhance" means "an increase or

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<sup>317</sup> See discussion of the cooperation and collaboration between financial sector regulators and the SARB in paragraph 2.7.13 (a) below.

<sup>318</sup> Section 1 of the FSR Act read with section 239 of the Constitution: "organ of state" means any department of state or administration in the national, provincial or local sphere of government; or any other functionary or institution exercising a power or performing a function in terms of the Constitution or a provincial constitution or exercising a public power or performing a public function in terms of any legislation, but does not include a court or a judicial officer.

<sup>319</sup> See discussion of the cooperation and collaboration with and by other organs of state in paragraph 2.7.13 (b) below.

<sup>320</sup> See also 2.7.3 hereof for definition and discussion of determination of systemic events.

improvement in quality, value or extent”. “Restore” means “a return to a normal state of health...or strength, the action or process of regaining possession or control of something”. “Maintain” means to cause or enable (a situation) to continue”.<sup>321</sup> It must also be noted that section 4(2) of the Act provides that a reference in the Act to “maintaining” financial stability includes, where financial stability has been adversely affected, a reference to restoring financial stability.

It also has to be noted that section 3 of the SARB Act has been amended to the effect that the price stability objective of the SARB now has to share the podium as primary objective with the SARB’s financial stability mandate.<sup>322</sup> Section 3 of the SARB Act is now split into two subsections: the new section 3(1) contains the price stability mandate verbatim as it was previously expressed as the (sole) primary objective of the SARB when section 3 was still a single standalone section; and the new section 3(2) adds the “additional” primary objective of financial stability. That this financial stability mandate is not merely an add-on of lesser importance than the SARB’s monetary policy mandate is clear from the fact that the title of section three “Primary objective” has not been amended. Thus the SARB now has two primary objectives, one relating to price stability and the other to financial stability.

This broadly worded mandate in the FSR Act extends the SARB’s responsibility in that it must not only generally maintain financial stability as was previously the case but is now obliged to actively promote and guard such stability; to enable a better “quality” of financial stability, to restore stability where it has been disrupted and to ensure that it is maintained.

The SARB’s financial stability mandate as imposed by the FSR Act entails a close liaison with the Minister of Finance. Not only is the Minister of Finance responsible for

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<sup>321</sup> Definitions as provided in the Oxford Dictionary (2017) <https://oxforddictionaries.com> (accessed 12 December 2017).

<sup>322</sup> This amendment took effect on 1 April 2018. See more on Notice on Commencement of FSR Act in note 304 above.

the administration of the FSR Act,<sup>323</sup> but in fulfilling its financial stability mandate the SARB is required to act within a policy framework agreed between the Minister of Finance and the Governor of the SARB<sup>324</sup> - thus mandating extensive collaboration between the SARB and National Treasury. The SARB may further utilise any power vested in it as South Africa's central bank or conferred on it in terms of the FSR Act or any other legislation.<sup>325</sup> This broadly worded provision obviously inter alia refers to the SARB's roles and powers in relation to monetary policy, oversight of the payments system, lender of last resort and its other functions as stated in the Constitution, SARB Act and Banks Act with the exclusion of powers related specifically to its former role as supervisor of banks (which function has now been transferred to the PA). It is further to be noted that in exercising its financial stability mandate the SARB is expressly obliged to have regard to, amongst other matters, the roles and functions of other organs of state exercising powers that affect aspects of the economy.<sup>326</sup> The FSR Act thus envisages that the SARB will take an integrated approach to the exercise of its financial stability mandate, operating within the parameters of a clear policy framework and taking cognisance of the potential impact that actions by other organs of state (and the regulators under their control) may have on the promotion and maintenance of financial stability.

### **(c) Monitoring of risks by SARB**

As a first step in exercising its financial stability mandate SARB is required to monitor and keep under review strengths and weaknesses of the financial system; and *any*<sup>327</sup> risks to financial stability, and the nature and extent of those risks, including risks that systemic events will occur and *any*<sup>328</sup> other risks contemplated in matters raised by members of the FSOC<sup>329</sup> or reported to the SARB by a financial sector regulator.<sup>330</sup>

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<sup>323</sup> Section 8.

<sup>324</sup> Section 11(2)(a).

<sup>325</sup> Section 11(2)(b).

<sup>326</sup> Section 11(2)(c).

<sup>327</sup> Author's emphasis.

<sup>328</sup> Author's emphasis.

<sup>329</sup> See the discussion on this committee in paragraph 2.7.8 below.

<sup>330</sup> Section 12(a).

This is a continuing duty, covering systemic risk as well as non-systemic risk, which requires in-depth scrutiny of the operations of the various financial institutions that participate in the financial system as well as surveillance of developments within the broader macro-economy. In essence the SARB has to keep a look-out for *any* risks to financial stability hence this is a broad mandate which requires SARB to not only focus on risks of great magnitude such as the risk that a systemic event may occur but requires that it should also be vigilant of smaller apparently non-systemic risks that may build up, and, if left unchecked, may eventually morph into systemic events that can weaken or erode the stability of the financial system.

The FSR Act underwrites a pro-active approach to dealing with risk in the financial system: if the SARB identifies any risks to financial stability it is obliged to take steps to mitigate such risks. These steps include (but are not limited to) advising the financial sector regulators and any other organ of state of steps to be taken by such regulator or organ of state to mitigate the risks to financial stability identified by SARB.<sup>331</sup> The power to dictate to organs of state and other financial regulators how they should conduct themselves in the event of risks to financial stability having been detected by the SARB is clearly an important crisis management power afforded to the SARB.<sup>332</sup>

As indicated in Chapter One, the financial system has especially in the last few decades seen a spate of international standards and guidelines being churned out by international standard setting bodies such as the Basel Committee and the Financial Services Board in an attempt to align and improve financial regulation in the interests of global financial stability. Especially in the context of the emphasis on financial stability post GFC, as also infused into the FSR Act, measures such as capital reserve and liquid asset requirements and so forth imposed by the Basel Accords were created specifically to make financial institutions more resilient and South Africa being a

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<sup>331</sup> Section 12(b).

<sup>332</sup> The implication appears to be that these risks would be emanating from areas in which these organs of state or regulators are involved or that may impact on such areas.

member of the G-20 is required to observe these principles.<sup>333</sup> Accordingly the FSR Act requires the SARB, in the exercise of its financial stability mandate, to regularly assess the observance of principles in the Republic developed by international standard setting bodies, and reporting its findings to the financial sector regulators and the Minister of Finance. In doing so it must have regard to the circumstances and context within the Republic.<sup>334</sup> It is thus apparent that in order for the SARB to exercise its financial stability mandate effectively it has to have the cooperation of the other role-players in the financial system towards observing international standards and promoting and maintaining a stable financial sector in South Africa. As indicated in par 2.7.13 below, such cooperation is extensively catered for by the FSR Act.

#### **(d) The Financial Stability Review**

The SARB is *inter alia* held accountable for the due and continuous exercise of its financial stability mandate by the requirement in section 13 of the FSR Act that it must at least, every six months make an assessment of the stability of the financial system in the form of a financial stability review<sup>335</sup> (focusing exclusively on financial stability as opposed to broader mandates) that is required to be published for public notification and input. As indicated in the first part of this chapter the SARB has for a considerable number of years prior to the move towards Twin Peaks issued a financial stability review twice a year - so this is not a new obligation but it is indeed a more pronounced obligation indicating exactly what is expected to be covered in the review. The SARB is required to address a closed list of important issues in every financial stability review, namely:<sup>336</sup> the SARB's assessment of financial stability in the period under review; its identification and assessment of the risks to financial stability in at least the next 12 months; an overview of steps taken by it and the financial sector regulators to identify and manage risks, weaknesses and disruptions in the financial system in the period under review and that are envisaged to be taken during at least the next 12 months;

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<sup>333</sup> Gohari & Woody 2015 417 – 418.

<sup>334</sup> Section 12(c).

<sup>335</sup> Section 13(1).

<sup>336</sup> Section 13(2).

and an overview of recommendations made by SARB and the FSOC during the period under review and progress made in implementing those recommendations.

The financial stability review thus entails that the SARB will exercise both a current as well as a forward-looking “surveillance” approach. It not only has to take responsibility for dealing with current risks to financial stability but also has to be pro-active in terms of pre-empting, preventing and otherwise mitigating future risks. As in the pre-Twin Peaks dispensation the financial stability review will, in accordance with the SARB’s “leaning forward” approach to keeping the public informed, serve as a source of information for the public with regard to issues that are relevant in the context of financial system stability.<sup>337</sup>

The FSR Act also entrenches other obligations of SARB in the context of the financial stability review. As such the Act expressly provides that information which, if published, may materially increase the possibility of a systemic event, only needs to be published in a financial stability review after the risk of a systemic event subsides, or has been addressed.<sup>338</sup> Obviously this provision was enacted to prevent the financial stability review report itself from becoming a trigger or conduit for the occurrence of a systemic event as a result of publishing sensitive information that may for instance trigger a “bank run” that can propagate contagion and create a severe liquidity crisis in the financial system. The SARB is also required to follow a consultative process prior to publication of the financial stability review. In this regard it is required to submit a copy of each review to the Minister of Finance and the FSOC and to allow them at last two weeks to comment thereon, should they wish to do so. Only thereafter may the review be published, with SARB being obliged to take into

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<sup>337</sup> Bradlow D "The role of central banks is changing. What South Africans should look out for" (28 August 2016) <http://theconversation.com/the-role-of-central-banks-is-changing-what-south-africans-should-look-out-for-64447> (accessed 15 December 2017): Central bank governors have started using what is known as forward guidance. This means that they are becoming more transparent, using public statements to inform the public about their views on interest rates and how these might change over time.

<sup>338</sup> Section 13(3).

account any comments by the Minister of Finance and the FSOC before the review is published and a copy of the review is tabled in Parliament.<sup>339</sup>

The need to involve the FSOC in the financial stability review, is evident from the requirement that the financial stability review specifically has to set out an overview of recommendations by the FSOC during the period under review. Through the involvement of the FSOC in financial stability reviews, the input of various bodies together with the SARB are obtained, since the members of the FSOC include not only the Governor of SARB and the Deputy Governor for financial stability but also the CEO of the PA, the Commissioner of the FSCA, the Chief Executive Officer of the NCR, the Director-General of the National Treasury and the Director of the Financial Intelligence Centre.<sup>340</sup>

### **2.7.3 Determination of Systemic events**

As explained in Chapter One, systemic events are events that have the potential to trigger the collapse of a whole financial system and accordingly they pose the most significant threats to financial stability. In order for the SARB to know when its mandate to restore financial stability, as contemplated in section 11(1)(b) is triggered it is therefore imperative to have some guidance in the Twin Peaks legislation as to what can be considered to be a systemic event. In section 1 of the FSR Act “systemic event” is accordingly defined as “an event or circumstance, including one that occurs or arises outside the Republic, that may reasonably be expected to have a substantial adverse effect on the financial system or on economic activity in the Republic, including an event or circumstance that leads to a loss of confidence that operators of, or participants in, payment systems, settlement systems or financial markets, or financial institutions, are able to continue to provide financial products or financial services”.

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<sup>339</sup> Section 13(4)(a) and (b) and (c).

<sup>340</sup> See also section 22(1) regarding membership of the FSOC and further discussion of FSOC in 2.7.8 hereof.

It is submitted that one of the most significant powers assigned to the SARB in the context of financial stability is its power to determine that certain events qualify as systemic events. This designation creates the basis for ex ante emergency and stabilizing intervention by the SARB as lender of last resort and also ex post crisis management by the SARB. In terms of section 14(1) of the FSR Act the Governor may, after having consulted the Minister of Finance, determine that a specified event or circumstance, or a specified combination of events or circumstances, is a systemic event<sup>341</sup> and that a specified systemic event has occurred or is imminent.<sup>342</sup> Before making such a determination the Governor may also consult the FSOC.<sup>343</sup> Although this obligation is phrased in discretionary terms it is submitted that it can be expected that the Governor will as a matter of course consult the FSOC before such determination. It is important to note that a determination that an event or circumstance, or combination of events or circumstances constitutes a systemic event may be made regardless of whether or not the event or circumstances or combination of events or circumstances has already arisen, thus conferring on the Governor a pre-emptive crisis management power.<sup>344</sup> In those instances where a systemic event has already occurred the SARB will, in accordance with its financial stability mandate, take measures to manage and mitigate the effects of such systemic event. Where however the systemic event is merely imminent but has not yet occurred, the SARB's stabilizing powers can be applied pro-actively prior to the actual occurrence of the said event, in order to put measures in place to mitigate the risks associated with the imminent systemic event on an ex ante basis.

Notably, the FSR Act seeks to facilitate engagement between the SARB and National Treasury on a continuous basis as the SARB's ability to restore or maintain financial stability will also involve access to government funds and accordingly the Act provides that subsequent to the determination that a specific event constitutes a "systemic event" the Governor is obliged to notify the Minister of Finance of same.<sup>345</sup> The Governor is further required to keep the determination that an event is systemic, under

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<sup>341</sup> Section 14(1).

<sup>342</sup> Section 14(4).

<sup>343</sup> Section 14(2).

<sup>344</sup> Section 14(3).

<sup>345</sup> Section 14(5)(a).

review.<sup>346</sup> Keeping the event under review will enable the SARB to timeously invoke the necessary measures proportionate to the size and complexity of the event. Flexibility is built into this power to designate systemic events in that the Governor may at any time, after having consulted the Minister of Finance, amend or revoke a determination in writing and notify the Minister accordingly.<sup>347</sup> In view of the cooperation and collaboration of the financial sector regulators that are pivotal to the SARB's ability to promote and maintain financial stability, the SARB must also notify the financial sector regulators of such a determination or the revocation or amendment thereof.<sup>348</sup> One would have expected that the SARB would be obliged to also inform the relevant organs of state and thus the absence of reference to these organs of state appears to be an oversight that needs to be addressed.

The SARB must, in respect of a determination that an event or circumstance or combination of events or circumstances constitute a systemic event or that a systemic event is imminent or has occurred, and any amendment or revocation of such a determination, table the determination, or the amendment or revocation of the determination, in Parliament; and publish the determination, or the amendment or revocation of the determination, on the SARB's website.<sup>349</sup> This appears to be an appropriate provision in instances where the systemic event is of such a nature that it does not require immediate emergency intervention. However in the latter instance this process is cumbersome and may hamper the measures required to deal with the event in the interests of restoring or maintaining financial stability.

#### **2.7.4 Functions of SARB in relation to systemic events**

The true test of the SARB's ability to effectively and efficiently fulfil its financial stability mandate and whether such execution is comprehensively facilitated by the legislative and institutional framework created by the FSR Act, will become apparent when a

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<sup>346</sup> Section 14(5)(b).

<sup>347</sup> Section 14(5)(c) and (d).

<sup>348</sup> Section 14(6).

<sup>349</sup> Section 14(7)(a) and (b).

systemic event threatens to erode the maintenance of financial stability despite the SARB's endeavours to carefully promote and guard the maintenance of such stability. In this context the powers bestowed on the SARB in relation to systemic events and constraints on these powers are crucially important.

It has been pointed out above that the functions of the SARB in relation to systemic events in terms of the FSR Act are both of an *ex ante* and an *ex post* nature: on a proactive level it must take all reasonable steps to prevent systemic events from occurring and if a systemic event has occurred or is imminent, it must respond by mitigating without delay the adverse effects of the event on financial stability and managing the systemic event and its effects.<sup>350</sup> When the SARB acts as such, it is obliged by the FSR Act to have regard to the need to minimise adverse effects on financial stability and economic activity and to protect, as appropriate, financial customers and contain the cost to the Republic of the systemic event and the steps taken.<sup>351</sup> The need to contain the cost to the Republic of the systemic event will clearly impact directly on how the SARB seeks to use its powers as lender of last resort in its attempts to deal with systemic events.

It is thus evident that the SARB does not have a *carte blanche* to deal with systemic events as it wishes and that it can also not take a *cards-against-the chest* approach but has to operate within a framework that secures its accountability. The SARB will also have to conduct some sort of cost-benefit analysis with respect to each instance of systemic event in order to determine whether for example, what extent of lender of last resort–assistance is justified in a given situation. In the context of dealing with systemic events it is thus submitted that the adage that “the ends will have to justify the means” will be applicable.

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<sup>350</sup> Section 15(1).

<sup>351</sup> Section 15(2).

## 2.7.5 Information to the Minister

The Minister of Finance is responsible for the administration of the FSR Act and accordingly plays a central role, albeit somewhat behind the scenes in the sense that the exact nature and extent of his involvement in the context of financial stability is not laid out specifically in the FSR Act.<sup>352</sup> Nevertheless, in it is quite inconceivable that fiscal funds will in future not still be used to some considerable extent to deal with systemic events. In view of the close ties between the SARB and National Treasury in the context of promotion and maintenance of financial stability, SARB not only has to ensure that the Minister is notified of the determination of a systemic event as provided for in section 14(5) but the Governor is further obliged to ensure that the Minister is kept informed of the event and any steps taken or proposed to manage the systemic event and its effects.<sup>353</sup> In executing its financial stability mandate the SARB can also not dip into government funds without obtaining the Minister's approval. Accordingly SARB may not, except with the Minister's approval, take any step in terms of section 15 in relation to a systemic event that will or is likely to bind the National Revenue Fund to any expenditure (thus to tie it to a "bail-out"); have a material impact on the cost of borrowing for the National Revenue Fund; or create a future financial commitment or a contingent liability for the National Revenue Fund.<sup>354</sup> It appears that this provision also speaks directly to the global regulatory trend to move away from a culture where bail-outs of "Too-Big-To-Fail" financial institutions, and hence moral hazard through excessive risk-taking by these institutions, were condoned, to a post GFC culture of condemning bail-outs and underwriting the principle that shareholders and directors should curb their risk appetite by being held accountable to contribute in the event that giant institutions encounter financial distress.<sup>355</sup>

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<sup>352</sup> Section 8 and 11(2)(a).

<sup>353</sup> Section 16 (1).

<sup>354</sup> Section 16 (2) (a) - (c).

<sup>355</sup> See also Chapter One paragraph 1.1 on bail-ins and bail-outs.

## 2.7.6 Responsibilities of Financial Regulators

Although the responsibility for financial stability has been entrusted to the SARB in the FSR Act, it has already been alluded to above that the maintenance and promotion of financial stability is clearly not something that the SARB will be able to achieve completely on its own and absent assistance by other role-players in the financial sector. However such cooperation and collaboration will not necessarily occur automatically and it is submitted that the best way to ensure that it occurs is thus to statutorily mandate the desired cooperation and collaboration; i.e. lay such obligation down in hard law. Such cooperation is pivotally important especially in the context of sharing information that is vital to the promotion and maintenance of financial stability, especially in times of crisis.

Accordingly it is provided that if the Governor has determined that a systemic event has occurred or is imminent, each financial sector regulator (the PA, FSCA, the NCR and the FIC) *must* provide the SARB with any information in their possession which may be relevant for the SARB to manage the systemic event or the effects thereof.<sup>356</sup> The Financial Regulators also have to consult the SARB *before* exercising any of their powers in a way that may compromise steps taken in terms of section 15 to manage the systemic event or the effects thereof.<sup>357</sup> If the SARB deems it unsuitable that a regulator takes specific actions that could compromise financial stability, it can issue a directive to the said regulator requiring it to refrain from taking such action.<sup>358</sup>

In order to ensure cooperation by other regulators, the SARB as central bank has to be empowered with the necessary tools to enforce the required compliance. As is evident from the aforementioned the SARB's financial stability mandate, powers and functions are accordingly supported by a well-stocked regulatory toolkit, comprising of powers to extract information from regulators and organs of state, directing them to

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<sup>356</sup> Section 17(a). Author's emphasis.

<sup>357</sup> Section 17(b). See also 2.7.3 above and section 14(6) where it is stated that the SARB must notify the financial sector regulators of the determination of an event as a systemic event.

<sup>358</sup> Section 18.

act in a certain manner and sanctioning them for non-compliance. In order to enable the effective execution of its financial stability mandate the Governor may direct a financial sector regulator to provide the SARB with information that the SARB or the Governor needs for exercising their power in terms of section 14 and 15.<sup>359</sup> If the Governor has determined that a systemic event has occurred or is imminent, the Governor may in writing, direct a financial sector regulator to assist the SARB in complying with section 15 by acting in accordance with the directive when exercising its powers.<sup>360</sup> A directive may include directions aimed at supporting the restructuring, resolution or winding up of any financial institution; preventing or reducing the spread of risk, weakness or disruption through the financial system; or increasing the resilience of financial institutions to risk, weakness or disruption.<sup>361</sup> The aforementioned “interventions” do not constitute a closed list and it is submitted that, where appropriate, the SARB will also be able to invoke the other powers that it customarily has as a central bank that emanate from its roles with regard to monetary policy, overseer of the payments system and lender of last resort and/or any other powers that it has in terms of other relevant legislation such as the SARB Act. Given that bank supervision has been removed from its remit it is submitted it will be able to, for example, under the power to increase the resilience of financial institutions, direct the PA to ensure compliance by financial institutions with increased reserve and liquidity and other prudential requirements that may enhance their resilience.

### **2.7.7 Exercise of powers by other organs of state**

Apart from the various regulators mentioned above, other organs of state may also take decisions or engage in conduct that may threaten or compromise financial stability, and especially where they are in “control” of certain financial supervisors such as for instance the Department of Trade and Industry under whose jurisdiction the National Credit Regulator falls, it is probable that such instances may occur. Thus it

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<sup>359</sup> Section 18(1).

<sup>360</sup> Section 18(2)(a). SARB Macroprudential Policy document 2016 7: The Governor of the SARB may direct financial sector regulators, in writing, to provide the SARB with information and to assist the SARB in meeting its financial stability responsibilities by acting in accordance with the directive when exercising their powers.

<sup>361</sup> Section 18(2)(b).

is important to also keep a check on these organs and to mandate their cooperation and collaboration in promoting and maintaining financial stability. Accordingly the FSR Act is also prescriptive about the role of other organs of state in the context of financial stability: if the Governor has determined in terms of section 14(4) that a systemic event has occurred or is imminent, an organ of state exercising powers in respect of a part of the financial system may not, without the approval of the Minister of Finance, acting in consultation with the Cabinet member responsible for that organ of state, exercise its powers in a way that is inconsistent with a decision or steps taken by the Governor or the SARB in terms of the FSR Act to manage that systemic event or its effects.<sup>362</sup> Section 19(2) entails that if the Minister and the Cabinet member responsible for the organ of state cannot agree on the exercising of the powers of the organ of state, the Cabinet will have to take a decision on it.<sup>363</sup>

### **2.7.8 The Financial Stability Oversight Committee**

Although the Governor of the SARB is designated as the key person to give effect to the SARB's financial stability mandate, it is clear that this mandate is of such critical and comprehensive magnitude that its fulfilment will involve the assistance of many persons with expert knowledge of the condition, functioning and intricacies of the financial system. Thus, whatever actions the Governor undertakes in executing the SARB's financial stability mandate, these actions will by necessary implication be informed by decisions taken subsequent to deliberations at layered, expert committee levels. The Financial Stability Oversight Committee (FSOC) is the apex committee, established in terms of section 20 of the FSR Act, to support the SARB when it performs its functions in relation to financial stability. This committee is also tasked with facilitating cooperation and collaboration between, and co-ordination of action among, the financial sector regulators and the SARB in respect of matters relating to financial stability.<sup>364</sup>

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<sup>362</sup> Section 19(1). This provision does not apply to financial sector regulators (section 19 (3)).

<sup>363</sup> In terms of section 19(2) any unresolved issues between the Minister and that Cabinet member must be referred to Cabinet.

<sup>364</sup> Section 20 of FSR Act.

The FSOC, which must meet at least every six months,<sup>365</sup> consists of the Governor (aptly as chairperson), Deputy Governor responsible for financial stability matters, the Chief Executive Officer of the PA, the Commissioner of the FSCA, the Chief Executive Officer of the NCR, the Director-General of the National Treasury, the Director of the FIC and a maximum of three additional persons appointed by the Governor.<sup>366</sup> The expertise of the persons on the committee is thus located not only in their qualifications but also in the fact that they will be the heads of the relevant regulators and that the head of National Treasury who will have to foot the bill for expenses occasioned by steps to promote financial stability also serves on this committee. Being in such positions of power it can be assumed that the members of the FSOC will be fully informed of any developments within their respective regulatory jurisdictions that may be relevant to financial stability.

The functions of the FSOC are to serve as a forum for representatives of the SARB and the financial sector regulators to be informed and to exchange views about their respective activities regarding financial stability; to make recommendations to the Governor on the designation of systemically important financial institutions (SIFIs); to advise the Minister and the SARB on steps to be taken to promote, protect or maintain, or to manage or prevent risks to, financial stability and on matters relating to crisis management and prevention; to make recommendations to other organs of state regarding steps that are appropriate for them to take to assist in promoting, protecting or maintaining, or managing or preventing risks to financial stability and any other function conferred on it in terms of applicable legislation.<sup>367</sup> It is thus a very focused committee dedicated specifically to enabling the effective execution of the SARB's financial stability mandate. Notably no provision is made in the FSR Act for the Governor to override or veto decisions taken by the FSOC.

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<sup>365</sup> Section 24(1). The Governor however has the discretion in terms of section 24(2) to convene a meeting of the FSOC at any time and is obliged to convene such a meeting if requested to do so by the Chief Executive Officer of the PA, the Commissioner of the Financial Sector Conduct Authority or the Chief Executive Officer of the NCR.

<sup>366</sup> Section 22. In accordance with section 23(1) the SARB is obliged to provide administrative support and other resources, including financial resources, for the effective functioning of the FSOC. The basis on which the Governor may appoint the three additional members is however not stated in the FSR Act.

<sup>367</sup> Section 21.

From the aforementioned it however appears that the FSOC is the actual forum where the main decisions regarding the exercise of the SARB's financial stability mandate will be taken and that the Governor will be acting largely in accordance with decisions taken by this Committee, which in turn will rely on information provided to it by the Financial Sector Contingency Forum, discussed below. By creating such a forum for representatives of the SARB and the financial sector regulators, the FSOC will contribute to cooperation and collaboration between these entities, although it is not as much a coordinating committee.

### **2.7.9 The Financial Sector Contingency Forum**

In terms of the layered advisory approach that the FSR Act takes with regard to the actions that will eventually be undertaken by SARB in the execution of its financial stability mandate, the Act provides for a Financial Sector Contingency Forum (FSCF) to be established by the Governor.<sup>368</sup> This forum, which must meet at least every six months, is composed of at least eight members including, as chairperson, the Deputy Governor designated by the Governor and also representatives of each financial sector regulator, such representatives of other organs of state as the chairperson may determine and representatives of the financial sector industry bodies and any other person as determined by the chairperson.<sup>369</sup> The open-endedness of the provision that the FSCF will be chaired by the Deputy Governor designated by the Governor may have the implication that the same Deputy Governor will not always necessarily chair this committee. From the fact that no specific mention is made of the heads of the various regulators and organs of state such as Treasury one can infer that the "representatives" that will be sitting on the FSCF will be persons other than those heads but who also deal with issues that may be relevant to financial stability. The flexibility that is given to the chairperson of the FSCF in appointing members to the FSCF will also mean that this committee will have more of an ad hoc rotating nature

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<sup>368</sup> Section 25(1).

<sup>369</sup> Section 25(3) and (4). In terms of section 25(6) the SARB must provide the administrative support and other resources, including financial resources, for the effective functioning of the FSCF.

and not have the type of permanent nature that the FSOC will have. It is submitted that it can further be assumed that who exactly sits on this committee at any given time will depend on the type of risk to financial stability at that stage.

The primary objective of the FSCF is to assist the FSOC with the identification of potential risks that systemic events will occur; and the co-ordination of appropriate plans, mechanisms and structures to mitigate those risks.<sup>370</sup> It is submitted that the FSCF will be the committee where the “work” relating to financial stability will be done as opposed to the FSOC where the ultimate “decisions” pertaining to financial stability will be taken. Viewed from this perspective it is submitted that there need not be any fear of overlap or duplication in the functions of these two committees - each has a clear mandate: the one as supporting, information-feeding forum and the other as the forum where the ultimate power in relation to decisions on financial stability will be wielded.

#### **2.7.10 Roles of financial sector regulators and other organs of state in maintaining financial stability**

As indicated in more detail below, it is written into the objectives of both the PA and the FSCA that they have to “assist” the SARB in maintaining (and thus also restoring) financial stability.<sup>371</sup> Notably these objectives do not state that the regulators have to assist in “protecting and enhancing” financial stability although it is submitted that the nature of the regulation that they undertake will inevitably serve the purpose of also promoting or enhancing financial stability. Section 26(1)(a) of the FSR Act however explicitly states that the financial sector regulators<sup>372</sup> *must* cooperate with the Reserve Bank, *and with each other*,<sup>373</sup> to “maintain, protect and enhance financial stability.” Thus not only do the regulators have to cooperate with the SARB in relation to the maintenance, protection and enhancement of financial stability but the FSR Act

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<sup>370</sup> Section 25(2).

<sup>371</sup> Section 33(d) and 57(c) respectively.

<sup>372</sup> The definition for financial regulators in respect of section 26 includes the PA, the FSCA the NCR and the FIC.

<sup>373</sup> Author’s emphasis.

formally obliges them to cooperate with each other. This would mean that if one regulator, say for example the PA, is privy to information that the FSCA would need to be apprised of in order for the FSCA to be able to properly assist the SARB as mandated by section 26 read with section 57(1)(a) then the FSCA will be able to rely on section 26(1)(a) to extract the necessary information from the PA.

Section 26 further provides that the financial sector regulators must provide such assistance and information to the SARB and the FSOC to maintain or restore financial stability, as the latter two establishments may reasonably request.<sup>374</sup> Here again it is to be noted that this obligation, apart from the fact that it concerns assistance and information to the SARB and also the FSOC (which is not part of SARB but merely serves as a committee enabling ultimate decisions on financial stability) is more qualified than that in section 26(1)(a), namely that it has to be for purposes of maintaining or restoring financial stability only and also, the request for the information must be reasonable. This however raises the question as to the exact nature of the FSOC's mandate given that this subsection refers only to maintenance and restoration of financial stability and not to protection or enhancement thereof.

The financial sector regulators are further obliged to promptly report to the SARB any matter of which they become aware that poses or may pose a risk to financial stability; and must further gather information from, or about, financial institutions that concerns financial stability.<sup>375</sup> The SARB is not entitled to proceed about its financial stability mandate in a dictatorial fashion and has no discretion to disregard information that it may deem irrelevant but is obliged, when exercising its powers in terms of Chapter 2, to take into account *any* views expressed and *any* information reported by the financial sector regulators as well as *any* recommendations of the FSOC.<sup>376</sup> This latter part of section 26(2) thus reinforces the combined power of the FSOC as the ultimate decision-taker on financial stability matters. It also illuminates the significance of the

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<sup>374</sup> Section 26(1)(b).

<sup>375</sup> Section 26(1)(c) and (d).

<sup>376</sup> Section 26(2). Author's emphasis. See also 2.7.13 below with regards to memoranda of understanding relating to financial stability.

views of the financial regulators for purposes of promoting and maintaining financial stability.

### **2.7.11 Designation of Systemically Important Financial Institutions**

One of the key lessons from the 2008 GFC is that large, complex and heavily interconnected financial institutions should be closely monitored for build-up of systemic risk and that in principle no institution should be allowed to become “Too-Big-To-Fail”.<sup>377</sup> The FSR Act gives recognition to this lesson by providing that the Governor may by written notice designate a financial institution as a “systemically important financial institution” (SIFI),<sup>378</sup> inter alia subjecting it to heightened prudential regulation<sup>379</sup> and increasing its loss absorbency capacity and requiring the SARB’s concurrence in its rescue or resolution should it fall into distress.<sup>380</sup> This power to designate and regulate SIFIs is a significant new power afforded to the SARB in the context of financial stability.

A comprehensive consultative process is prescribed for the execution of the SARB’s powers to designate SIFIs. Before designating a financial institution as a SIFI, the Governor must give the FSOC notice of the proposed designation together with a statement of the reasons why the designation is proposed and it must invite the FSOC to provide advice on the proposal within a specified reasonable period.<sup>381</sup> If after considering the Committee’s advice, the Governor decides to designate the financial institution as a SIFI he has to invite the financial institution to make submissions on the matter, and give it a reasonable period to do so.<sup>382</sup> In deciding whether to designate

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<sup>377</sup> See paragraph 1.5 above on “Too-Big-To-Fail” financial institutions.

<sup>378</sup> Section 29(1)(a).

<sup>379</sup> Section 30(1).

<sup>380</sup> Section 31.

<sup>381</sup> Section 29(2)(a).

<sup>382</sup> Section 29(2)(b).

a financial institution as a SIFI, the Governor must take into account at least the following factors:<sup>383</sup>

- (a) the size of the financial institution;
- (b) the complexity of the financial institution and its business affairs;
- (c) the interconnectedness of the institution with other financial institutions within or outside the Republic;
- (d) whether there are readily available substitutes for the financial products and financial services or market infrastructure that the financial institution provides;
- (e) recommendations of the FSOC;
- (f) submissions made by or for the institution; and
- (g) any other matters that may be prescribed by Regulation.

The occurrence of, or imminence of, a systemic event can however influence the designation process in the sense that the Governor, given that time may be of the essence, can deviate from strict compliance with the designation process. Accordingly if the Governor has determined (in terms of section 14(4)) that a systemic event has occurred or is imminent, he may as an emergency measure, designate a financial institution as a SIFI without complying, or complying fully, with the process set out in section 29(2) or (3).<sup>384</sup> Where the Governor designates a financial institution without complying, or complying fully, with the process set out in section 29(2) or (3), the financial institution concerned may then make submissions on its designation as SIFI to the Governor within 30 days *after* being notified of the designation, thus *ex post* designation.<sup>385</sup> The Governor is obliged to consider any such submissions and, by notice to the financial institution, may either confirm or revoke the designation.<sup>386</sup>

In line with the global trend post GFC to move from a culture of “bail-out” to a culture of “bail-in” it is expressly stated that the designation of a financial institution as a SIFI

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<sup>383</sup> Section 29(3). See also on set of principles that were developed for domestic systemically important banks: Bank for International Settlements – Basel Committee on Banking Supervision “A framework for dealing with domestic systemically important banks” (October 2012) <https://www.bis.org/publ/bcbs233.pdf> (accessed 31 December 2017).

<sup>384</sup> Section 29(4)(a).

<sup>385</sup> Section 29(4) (b).

<sup>386</sup> Section 29(4)(c).

does not imply, or entitle the financial institution to, a guarantee or any form of credit or other support from any organ of state.<sup>387</sup> This provision also attempts to minimize the moral hazard that is prevalent in situations where large, complex and heavily interconnected financial institutions do not have the incentive to curb their risk appetite and risky behaviour as they are cushioned by the “safety net” of a guaranteed bail-out due to their indispensable role in a specific financial system.

SIFI designation is however not necessarily permanent as it may for instance happen that a large, interconnected financial institution divests itself of significant parts of its business and as a result becomes less systemically important. Thus it is provided that the Governor may, in writing, revoke a designation made in terms of this section.<sup>388</sup>

The rationale behind designation as a SIFI is to enable the SARB and the other financial regulators to monitor large, complex and heavily interconnected institutions that may cause systemic risk to the financial system more closely so that it can step in timeously when the business structure and activities of the SIFI threatens financial stability. However it must also be appreciated that since the South African Twin Peaks model clearly underwrites a pro-active approach to the promotion and maintenance of financial stability it aims at implementing pro-active measures to prevent SIFIs from disrupting financial stability in the first place. Accordingly being designated as a SIFI results in the application of heightened prudential measures to the designated institution to mitigate the risk that systemic events may occur. Hence the SARB may, after consulting the PA, direct the PA to impose, either through prudential standards or regulator’s directives, requirements applicable to one or more SIFI or to such institutions generally in relation to any of the following matters:<sup>389</sup>

(a) solvency matters and capital requirements, which may include requirements in relation to counter-cyclical capital buffers;<sup>390</sup>

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<sup>387</sup> Section 29(5).

<sup>388</sup> Section 29(6). A designation, and the revocation of a designation, in terms of this section must be published (section 29(7)).

<sup>389</sup> Section 30(1).

<sup>390</sup> Section 30(1)(a). Gohari & Woody 2015 409 – 410: Gohari and Woody proposed in 2015 that requirements in relation to countercyclical buffers is a form of macroprudential regulation. Countercyclical buffers provide for constraints on capital during periods of rapid credit growth in order to prevent or mitigate the build-up of risk in the system.

- (b) leverage ratios;<sup>391</sup>
- (c) liquidity;<sup>392</sup>
- (d) organizational structures;<sup>393</sup>
- (e) risk management arrangements;<sup>394</sup>
- (f) sectoral and geographical exposures;<sup>395</sup>
- (g) required statistical returns;<sup>396</sup>
- (h) recovery and resolution planning;<sup>397</sup> and
- (i) any other matter in respect of which a prudential standard or regulator’s directive may be made.<sup>398</sup>

In view of their systemic importance the failure of SIFIs should in the first place be prevented, which is what the legislature seeks to achieve by providing for the increased prudential regulation of SIFIs. However, should it happen that a SIFI encounters financial distress the SARB, given its power to designate SIFIs and more specifically its financial stability mandate,<sup>399</sup> will have to be engaged in the process of “rescuing” the SIFI or if it cannot be rescued, to facilitate its orderly resolution in a way that will not threaten financial stability.

Accordingly none of the following steps may be taken in relation to a SIFI or a SIFI within a financial conglomerate without the concurrence of the SARB:<sup>400</sup> suspending or varying or cancelling a licence issued to that SIFI; adopting a special resolution to

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<sup>391</sup> Section 30(1)(b). A leverage ratio is meant to evaluate a company’s debt levels. The most common leverage ratios are the debt-to-total-assets ratio (which is a company’s total debt divided by its total assets) (Debt-to-total-assets Ratio = Total Debt / Total Assets) and the debt-to-equity ratio (which is a measure of the relationship between the capital contributed by creditors and the capital contributed by owners) (Debt-to-Equity Ratio = Total Debt/Total Equity). In order to reduce potential risks when the extension of credit becomes higher, setting conservative leverage ratios will limit credit extensions to a more sensible level; SARB Macroprudential Policy document 2016 17: The indicator for maximum leverage ratios is total assets to bank equity. At 19: The leverage ratio would typically be tightened during upswings and relaxed during a downturn of the credit cycle.

<sup>392</sup> Section 30(1)(c).

<sup>393</sup> Section 30(1)(d).

<sup>394</sup> Section 30(1)(e).

<sup>395</sup> Section 30(1)(f).

<sup>396</sup> Section 30(1)(g).

<sup>397</sup> Section 30(1)(h).

<sup>398</sup> Section 30(1)(i).

<sup>399</sup> See also Strengthening resolution framework 2015 10 where it is envisaged that SARB will be the resolution authority for financial institutions in terms of the reformed approach to financial institutions as set out in the policy document.

<sup>400</sup> Section 31(1)(a) to (h).

wind up the SIFI voluntarily; applying to a court for an order that the SIFI be wound up; appointing an administrator, trustee or curator for the SIFI; placing the SIFI under business rescue or adopting a business rescue plan for the SIFI; entering into an agreement for amalgamation or merger of the SIFI with another company and entering into a compromise arrangement with the creditors of the SIFI. Taking any of the aforementioned steps without the concurrence of the SARB will lead to such step being void.<sup>401</sup>

Some final remarks on SIFI resolution is apt to contextualize the aforementioned provisions of section 31: The regulatory sentiment post GFC is that systems should be in place for the orderly resolution of insolvent SIFIs so as to minimize disruption to the financial system and to attempt to preserve the critical functions of the SIFI insofar as it is possible. The Financial Stability Board has consequently issued the “Key Attributes of Effective Resolution Regimes for Financial Institutions” (KAs) in 2011.<sup>402</sup> The KAs sets out twelve principles to be contained in resolution regimes in order to facilitate the orderly resolution of SIFIs.<sup>403</sup> The KAs inter alia require jurisdictions to have a privately funded depositor protection fund in place or, alternatively, arrangements to recover any public costs from the private sector ex-post the resolution of SIFIs.<sup>404</sup> South Africa has declared its intention to adopt such a regime in due course and although this aspect is beyond the scope of the thesis, it needs to be pointed out that, once entrenched in legislation, such an orderly resolution regime will significantly impact the manner in which SIFIs will be resolved.<sup>405</sup> It is further to be noted that South

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<sup>401</sup> Section 31(2).

<sup>402</sup> Financial Stability Board “Key attributes of effective resolution regimes for financial institutions” (October 2011) [http://www.fsb.org/wp-content/uploads/r\\_111104cc.pdf](http://www.fsb.org/wp-content/uploads/r_111104cc.pdf) (accessed 14 December 2017); These Key Attributes (KAs) were updated in 2014: Financial Stability Board “Key attributes of effective resolution regimes for financial institutions” (October 2014) <http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/> (accessed 14 December 2017): The preamble to the KAs states that an objective of an effective resolution regime is to make feasible the resolution of financial institutions without causing severe systemic disruption and also without exposing taxpayers to loss, while protecting vital economic functions through mechanisms that makes it possible for shareholders and secured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims.

<sup>403</sup> These principles relate to the following matters: scope; resolution authority; resolution powers; setting-off, collateralisation and segregation of client assets; safeguards, funding of firms in resolution; legal framework conditions for cross-border cooperation; crisis management groups; institution specific cross border cooperation agreements; recovery and resolution planning and finally, access to information and information sharing.

<sup>404</sup> KAs at 21.

<sup>405</sup> Strengthening resolution framework 2015.

Africa will also in due course be moving from a system of implicit deposit insurance to a system of explicit deposit insurance and that having an explicit deposit insurance system will also play a significant role in facilitating the orderly resolution of SIFIs.<sup>406</sup>

## **2.7.12 The role of the Prudential Authority and the Financial Sector Conduct Authority (the twin peaks) in the context of financial stability**

### **(a) The Prudential Authority**

The changed role of the SARB in relation to the promotion and maintenance of financial stability cannot be considered in isolation given that it will operate as central bank within a Twin Peaks model where the regulatory and supervisory work undertaken by the PA and FSCA as newly established peak regulators are specifically designed to also assist in promoting and maintaining financial stability. A comprehensive discussion of the role of the PA is beyond the scope of this thesis hence the discussion on the PA hereinafter will be limited to those aspects that are relevant to its contribution in the context of financial stability.

As indicated, a unique feature of the South African Twin Peaks model is that it excises bank supervision from the remit of the SARB and does away with the BSD which, pre-Twin Peaks, was a department within the SARB, responsible for supervising banks. In its place the FSR Act introduces the PA that is responsible for executing the now much

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<sup>406</sup> See the document from the National Treasury where the design features of a deposit guarantee scheme is discussed referred to as Strengthening resolution framework 2015 32: An explicit system of deposit insurance refers to the instrument through which the banking system guarantees that funds deposited by the public in a bank are independent of solvency and liquidity conditions of the bank itself and it therefore, exists to provide a mechanism to ensure a pre-planned, orderly and efficient provision of protection rather than an unprepared scrambling of funds, haphazard policy decisions made under pressure and/or disorderly and non-transparent compensation arrangements; See also South African Reserve Bank – Financial Stability Department “Designing a deposit insurance scheme for South Africa - a discussion paper” (May 2017) <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/7818/DIS%20paper.pdf> (accessed 17 December 2017).

broader, system-wide mandate of prudential regulation of financial institutions and not merely of banks (as was the prudential remit of the BSD under the previous regulatory dispensation). Chapter 3 of the Act (sections 32 to 55) provides for the establishment, governance, staff, resources and financial management of the PA.

It is further to be noted that unlike in the previous dispensation where the BSD was a department that was part of the SARB itself, the PA will be a separate juristic person but that it will be operating within the administration of the SARB.<sup>407</sup> It will be located within the SARB and will also receive all its administrative support from the SARB but will be a separate entity thus signifying that it has operational independence. The PA will be governed by a Prudential Committee headed by a Chief Executive Officer who will be a Deputy Governor of the SARB.<sup>408</sup> The fact that the PA will be headed by a Deputy Governor of the SARB was obviously motivated by two considerations: one, such Governor would have the required expertise in prudential regulation given the SARB's previous mandate as the prudential regulator of banks. The second consideration appears to be to ease cooperation and collaboration and specifically information-sharing between the PA and SARB - it is vital that there must be open lines of communication between the SARB and PA, especially in times of crisis. It is nevertheless clear that the SARB and the PA will have very close ties given the fact that the PA will be located in the same building as the SARB and the SARB will have input in the regulatory direction of the PA via the Deputy Governor who must serve as

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<sup>407</sup> Section 32. The PA is not a public entity in terms of the Public Finance Management Act 1 of 1999 (section 32(3)).

<sup>408</sup> In section 1(1) of the FSR Act, the "Chief Executive Officer" is defined as the Chief Executive Officer of the PA appointed in terms of section 36(1), and includes a person acting as the Chief Executive Officer. Section 36(1) requires the Governor, with the concurrence of the Minister, to appoint a Deputy Governor who has appropriate expertise in the financial sector, other than the Deputy Governor responsible for financial stability, as the Chief Executive Officer of the PA. The Chief Executive Officer is responsible for the day-to-day management and administration of the PA (section 37(1)(a)) and subject to section 42(b), must perform the functions of the PA including exercising the powers and carrying out the duties associated with those functions. When acting as such, the Chief Executive Officer must implement the policies and strategies adopted by the Prudential Committee (section 37(2)). The Chief Executive Officer will hold office for a term no longer than five years, as the Governor may determine and is at the expiry of that term, eligible for re-appointment for one further term (section 38 (1)(a) and (b)). The Prudential Committee is established for the PA by section 41(1) of the FSR Act and consists of the Governor, the Chief Executive Officer and the other Deputy Governors (section 41 (2)). This Committee must generally oversee the management and administration of the PA to ensure that it is efficient and effective and act for the PA in various matters. The Prudential Committee must meet as often as necessary for the performance of its functions (section 43(1)(a)). See further sections 50 to 55 regarding the staffing, resources and financial management of the PA.

CEO of the PA. It is thus likely that the SARB will be able to exert considerable influence on the PA, which influence in some instances will be converted to mandatory compliance in the event that it relates to financial stability, for example insofar as prudential regulations of SIFIs are concerned.<sup>409</sup> This decision to keep the PA in the same building as the SARB was, apart from the regulatory synergies that it will likely generate, probably motivated by the economies of scale it would present in the form of shared IT-systems and other resources which cost saving is an important consideration for South Africa as an emerging economy. Another likely reason for this arrangement is that it was probably done after heeding the remarks of Goodhart at the 2010 Financial Stability Conference held by SARB when he stated that “it is not good that the central bank does everything”. He pointed out that disadvantages would be that it would raise concerns about the ability of the Governor and Board to manage such a huge and diverse body. It would also increase reputational risk if the SARB still had the responsibility for prudential supervision in addition to its extended financial stability mandate given the conflicts of interest that may arise in this context.<sup>410</sup> Goodhart thus suggested that “[P]erhaps the best approach might be a supervisory body connected with the central bank, but physically separate with a different remuneration scale, with an overlapping Board or policy Committee, both chaired by the Governor and with some common members”.<sup>411</sup> Hence the prudential regulator in the South African Twin Peaks model is a separate juristic person, although not as suggested by Goodhart “physically separate”, from the SARB.

The objectives of the PA are to promote and enhance the safety and soundness of financial institutions that provide financial products and securities services; to promote and enhance the safety and soundness of market infrastructures; to protect financial customers against the risk that those financial institutions may fail to meet their obligations; and to assist in “maintaining” financial stability.<sup>412</sup> In order to achieve its

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<sup>409</sup> As indicated in par 2.7.11 above section 30 of the FSR Act empowers the SARB to give directions to the SARB relating to prudential regulation and supervision of SIFIs.

<sup>410</sup> Goodhart C “Monetary policy and financial stability in the post-crisis era” South African Reserve Bank Conference Series (2010) <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/4908/Confproceeding2010.pdf> (accessed 7 December 2017), hereinafter Goodhart SARB Conference 2010, at 43 - 33.

<sup>411</sup> Goodhart SARB Conference 2010 44.

<sup>412</sup> Section 33.

objective, the PA must regulate and supervise financial institutions (not merely banks) and cooperate with and assist the SARB, the FSOC, the FSCA, the NCR, the FIC and the Council for Medical Schemes.<sup>413</sup>

The PA must also support sustainable competition in the provision of financial products and financial services, including through cooperating and collaborating with the Competition Commission.<sup>414</sup> It must further support financial inclusion<sup>415</sup> and is tasked to regularly review the perimeter and scope of financial sector regulation, and to take steps to mitigate risks identified to the achievement of its objective or the effective performance of its functions.<sup>416</sup> Additionally it is required to conduct and publish research relevant to its objective.<sup>417</sup>

The PA's tasks are not confined to those set out in the FSR Act but it must also perform any other function conferred on it in terms of any other provision of the FSR Act or other legislation.<sup>418</sup> The PA will thus be carrying out the functions previously assigned to the BSD in terms of the Banks Act but just on a much broader system-wide scale which would for instance include prudential regulation of insurance companies and pension funds. The FSR Act accordingly amends the Banks Act to inter alia provide that banks will now be regulated by the PA (and not the BSD as was previously the case).<sup>419</sup> Given that the FSR Act is merely the first stage that implements the architecture for the South African Twin Peaks model it is envisaged that in due course further changes will be made to existing sectoral legislation to give effect to this new

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<sup>413</sup> Section 34(1)(a) and (b). See also section 26 regarding collaboration between the financial regulators and SARB as discussed in paragraph 2.7.13 (a) below.

<sup>414</sup> Section 34(1)(d). The PA's duty in this context is merely the support of competition, not the active promotion thereof. Thus it appears that the PA will have to consider how its actions may impede competition between financial institutions, for instance by mandating compliance with for instance capital reserve requirements or imposing fees for licensing.

<sup>415</sup> Section 34(1)(e). Likewise it is to be noted that the PA must support and not actively engage in facilitating financial inclusion. Again this would mean that the PA should at least consider whether some of the prudential requirements it imposes on financial institutions may compromise access to financial products and services by consumers.

<sup>416</sup> Section 34(1)(f).

<sup>417</sup> Section 34(1)(g).

<sup>418</sup> Section 34(2).

<sup>419</sup> See Schedule 4 of the FSR Act which amends section 1 of the Banks Act 94 of 1990 as follows: "(a) by the insertion in subsection (1) after the definition of 'allocated capital and reserve funds' of the following definition: 'Authority' means the Prudential Authority established in terms of section 32 of the Financial Sector Regulation Act."

model of financial regulation hence it can be expected that the Banks Act will be significantly amended or even consolidated with other legislation in future.<sup>420</sup>

The PA must perform its functions without fear, favour or prejudice<sup>421</sup> and is given quite wide powers to enable it to achieve its supervisory objectives: it may do anything else reasonably necessary to achieve its objective,<sup>422</sup> including cooperating with its counterparts in other jurisdictions; and participating in relevant international regulatory, supervisory, financial stability and standard setting bodies.<sup>423</sup> When performing its functions, the PA is obliged to take into account the need for a primarily pre-emptive, outcomes focused and risk-based approach, and to prioritise the use of its resources in accordance with the significance of risks to the achievement of its objective.<sup>424</sup> It must also to the extent practicable, have regard to international regulatory and supervisory standards set by international standard setting bodies and is, aptly, required to have regard to circumstances prevailing in the Republic.<sup>425</sup> The PA has a microprudential mandate in terms whereof it must consider the individual safety and soundness of financial institutions, and since it has to have regard to circumstances prevailing in the country and regulate and supervise financial institutions on a system wide basis, it also has a macroprudential mandate.

Although a detailed discussion of the PA's regulatory toolkit is beyond the scope of this thesis it should be noted that the PA is provided with wide enforcement powers in order to ensure that it achieves its regulatory objectives. In addition to being the licensing authority for the entities that it supervises,<sup>426</sup> the PA has an extensive

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<sup>420</sup> Currently the FSR Act provides for certain amendments to and repeals of existing laws in Schedule 4 but it is envisaged that further changes to existing legislation will take place in future. See also Roadmap 2013 75: The second phase of the implementation of the Twin Peaks model, after the legislation in the first phase has been tabled in Parliament, will consist of harmonising specific financial sector legislative, regulatory and supervisory systems and frameworks.

<sup>421</sup> Section 34(5).

<sup>422</sup> Section 34(3).

<sup>423</sup> Section 34(3)(a) and (b).

<sup>424</sup> Section 34(4)(a).

<sup>425</sup> Section 34(4)(b). These will for instance include observance of the requirements of the Basel Accords and the Basel Core Principles for Effective Banking Supervision but will also extend to other international standards such as the International Association of Insurance Supervisors' Insurance Core Principles and the International Organization of Securities Commissions' (IOSCO) Principles and Objectives of Securities Regulation.

<sup>426</sup> Chapter 8 of the FSR Act deals with licensing. See specifically sections 111-128.

regulatory toolkit which comprises of the power to issue standards and directives, to gather information, to conduct supervisory on-site inspections, to conduct investigations if it reasonably suspects that a financial sector law has been or is being contravened or might be contravened and to apply for a warrant to aid the conduct of such investigation.<sup>427</sup> Also included in this toolkit is the power to issue guidance notices<sup>428</sup> and interpretation rulings;<sup>429</sup> to enter into enforceable undertakings;<sup>430</sup> to institute proceedings in a high court to ensure compliance with a financial sector law;<sup>431</sup> to make an order for debarment of a natural person;<sup>432</sup> and to enter into a leniency agreement.<sup>433</sup> The FSR Act also provides the PA with regulatory powers pertaining to significant owners of financial institutions, including the power to make standards or issue directives, to such significant owners.<sup>434</sup> The PA may also

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<sup>427</sup> Section 129 -139 as contained in Chapter 9 deals with information-gathering, supervisory on-site inspections and investigations. Section 129 sets out the application and interpretation of this Chapter and section 130 addresses the aspect of legal professional privilege. Section 134 deals with the appointment of investigators; section 135 indicates the grounds for the exercise of the power of investigation and section 136 deals with the details of the powers of investigators to question persons and to require the production of documents or other items. The powers of investigators to enter and search premises is set out in section 137 whilst the authority and grounds for applying for a search warrant is set out in section 138. Section 139 further contains provisions relating to interference with investigations.

<sup>428</sup> Section 141. As indicated in section 141(2) a guidance notice is a non-binding notice issued for information purposes.

<sup>429</sup> Section 142. As indicated in section 142(1), an interpretation ruling is a statement published by a regulator regarding the interpretation or application of a specified provision of an applicable financial sector law, in circumstances as specified in the statement.

<sup>430</sup> Section 151. A person may give a written undertaking to the PA concerning that person's future conduct in relation to a matter regulated by a financial sector law, and that undertaking then becomes enforceable upon its acceptance.

<sup>431</sup> Section 152.

<sup>432</sup> Section 153. Debarment orders can be made if a person has contravened a financial sector law in a material way; materially contravened an accepted enforceable undertaking; attempted, or conspired with, aided, abetted, induced, incited or procured another person to materially contravene a financial sector law or materially contravened a financial sector law of a foreign country that corresponds to a South African financial sector law. The effect (as per section 153(2)) of a debarment order is that the debarred person is prohibited, for a specified period, from providing, or being involved in the provision of, specified financial products or services or acting as a key person of a financial institution or providing specified services to a financial institution.

<sup>433</sup> Section 156. Such an agreement entails that in exchange for a person's cooperation in an investigation or in proceedings that contravene or may contravene a financial sector law, the PA may enter into a leniency agreement with such person to the effect that, subject to that person's cooperation and compliance with certain requirements, the PA will not impose an administrative penalty on that person with respect to its engagement in prohibited conduct. The use of leniency agreements, especially in competition law, has proven to be a very effective enforcement tool with significant value in detecting and deterring prohibited behaviour. See further Sutherland and Kemp *Competition law of South Africa* (Service Issue 19) par 8.4.

<sup>434</sup> Section 157-159. A significant owner is described in section 157(1) as a person who "directly or indirectly, alone or together with a related or inter-related person, has the ability to control or influence materially the business or strategy of the financial institution. The rationale behind heightened regulation and supervision of significant owners is a mechanism aimed at putting regulatory authorities in a position to proactively monitor and manage systemic risks and events in the financial services industry

designate members of a group of companies as a financial conglomerate for purposes of facilitating supervision of the conglomerate.<sup>435</sup> Such designation inter alia alleviates the regulatory burden of the PA who can then regulate the conglomerate via its holding company.<sup>436</sup> Finally, the Act also empowers the PA to impose an administrative penalty on a person who has contravened a relevant financial sector law for which the PA is responsible or who has contravened an enforceable undertaking that was accepted by the PA.<sup>437</sup>

The significant role of particularly standards and directives in the context of the promotion and maintenance of financial stability merit a few further remarks. Simply put, standards lay down certain minimum requirements that financial institutions must comply with and directives are used to enforce compliance with standards. As per section 105 prudential standards are aimed at ensuring the safety and soundness of financial institutions and reducing the risk that those financial institutions and key persons engage in conduct that amounts to, or contributes to, financial crime and, importantly, these standards should also be aimed at assisting in maintaining financial stability.<sup>438</sup> A financial sector regulator may however not make a standard aimed at assisting in maintaining financial stability without the concurrence of the SARB.<sup>439</sup> This is obviously because the SARB is responsible for protecting and enhancing financial stability and has to have the final say on any aspect relating to financial stability.<sup>440</sup>

Prudential standards may be made on various matters:<sup>441</sup> it may include financial requirements in relation to capital adequacy, minimum liquidity and minimum asset

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that could develop because of control that shareholders have over a financial institution's business, so as to safeguard investors and the financial system as a whole, as mentioned in National Treasury Responses 2016 55 - 68 by reviewers.

<sup>435</sup> Section 160.

<sup>436</sup> See section 162(1) read with section 162(3) regarding the power of the PA to require the holding company of a financial conglomerate to be licensed.

<sup>437</sup> See section 167. The precise manner in which the administrative penalty must be calculated is not prescribed in the Act. However section 167(2) lists the matters to which consideration must be given when deciding on an appropriate penalty. Notably these matters include the effect of the conduct on financial stability and the effect of the proposed penalty on financial stability.

<sup>438</sup> Section 105 (2).

<sup>439</sup> Section 109(2).

<sup>440</sup> The PA is granted the responsibility to assist in maintaining financial stability in section 33(d) and the FSCA in section 57 (c).

<sup>441</sup> Section 105(3)(a) to (d).

quality, matters on which a regulatory instrument may be made by the PA in terms of a specific financial sector law, matters that may in terms of any other provision of the FSR Act be regulated by prudential standards, prudential matters relating to SIFIs, including matters regarding capital, leverage, liquidity and organisational structure and recovery and resolution plans<sup>442</sup> and any other matter that is appropriate and necessary for achieving any of the aims set out in section 105(2). Section 108 sets out additional matters in respect of which prudential standards may be made by the PA.<sup>443</sup> The PA and the FSCA may also make joint standards on any matter in respect of which either of them have the power to make a standard.<sup>444</sup>

In accordance with section 143(1) the PA may issue a written directive to a financial institution that provides a financial product or securities services, or that is a market infrastructure or a key person of a financial institution, requiring that action be taken as specified in the directive. Such a directive may also be issued to a holding company of a financial conglomerate.<sup>445</sup> This may be done if the financial institution is conducting its business in an improper or financially unsound way, resulting in a risk that the financial institution may not be able to comply with its obligations or if the financial institution has contravened or is likely to contravene a financial sector law for which the PA is the responsible authority or has not complied with an enforceable undertaking accepted by the PA or is involved or likely to be involved in financial crime or is causing or contributing to instability in the financial system, or is likely to do so.<sup>446</sup>

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<sup>442</sup> Section 30.

<sup>443</sup> In terms of section 108 these additional matters include the following: fit and proper requirements; governance; the appointment, duties and responsibilities, remuneration, reward, incentive schemes and suspension and dismissal of governing bodies and their substructures and also in respect of key persons; the operation and operational requirements for financial institutions; financial management; risk management and internal control requirements; the control functions of financial institutions, including the outsourcing of control functions; record-keeping and data management by financial institutions and representatives; reporting by financial institutions and representatives to a financial sector regulator; outsourcing by financial institutions; insurance arrangements, including reinsurance of financial institutions; the amalgamation, merger, acquisition, disposal and dissolution of financial institutions; recovery, resolution and business continuity of financial institutions; requirements for identifying and managing conflicts of interest; and requirements for the safekeeping of assets, including requirements pertaining to the approval and supervision of nominees and custodians.

<sup>444</sup> Section 107.

<sup>445</sup> Section 143(2).

<sup>446</sup> Section 143(1)(b)(i) and (ii). See also section 143(2) regarding the circumstances in which a directive may be issued to a holding company, which are substantially similar to the circumstances set out in section 143(1). It is to be noted that the PA may not issue a directive to a financial institution relating to

Notably a prudential directive must be aimed at achieving the objective of the PA set out in section 33.<sup>447</sup> It may also be aimed at ensuring that the financial institution or the directed person complies with an enforceable undertaking that was accepted by the PA or to stop the financial institution or holding company of a financial conglomerate from contravening applicable financial sector laws or reducing the risks of such contraventions; or to stop it from being involved in financial crime or reducing the risk that it may be so involved. Directives may also be issued to reduce the risk that a systemic event may occur or to remedy the effects of a contravention of a financial sector law or involvement in financial crime.<sup>448</sup>

Action that may be specified in such a directive includes that the financial institution cease to offer or provide a specific financial product - or that it is required to modify a specific financial product or the terms on which it is provided - or that it remove a person from a specified position or function or that the financial institution is prohibited from paying a dividend or a specified bonus or performance payment - or that the financial institution is prohibited from entering into a specific transaction or undertaking a specific obligation, contingent or otherwise or that the financial institution remedy the effects of a contravention of a financial sector law.<sup>449</sup>

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financial stability unless it has been directed by the SARB to do so or with concurrence of the SARB (section 143(4)).

<sup>447</sup> Section 143(3). Section 33 provides that the objective of the PA is to promote and enhance the safety and soundness of financial institutions that provide financial products and securities services; to promote and enhance the safety and soundness of market infrastructures; to protect financial customers against the risk that those financial institutions may fail to meet their obligations; and to assist in maintaining financial stability.

<sup>448</sup> Section 14 (3)(a) to (f).

<sup>449</sup> Section 143(5)(a) to (e). In addition to its power to issue regulator's directives, if a person is engaging or proposing to engage in conduct that contravenes a financial sector law for which the PA is the responsible authority the PA may issue a written directive to that person require him or her to cease engaging in, or not to engage in, the specified conduct (section 143(6)).

## **(b) The Financial Sector Conduct Authority**

Under the FSR Act a separate juristic person, the Financial Sector Conduct Authority (FSCA), is established as market conduct authority.<sup>450</sup> As indicated, one of the lessons learnt from the GFC is the need for prudential regulation to be appropriately supported by market conduct regulation given that it is possible for financial institutions to be prudentially safe and sound but to pose significant risk to the financial system as a result of inappropriate market conduct behaviour. Accordingly the FSR Act gives effect to this lesson by establishing the FSCA as a separate “peak” but with the clear understanding, as set out in section 26, that there should be extensive and dedicated cooperation and collaboration between the FSCA and PA and the SARB in order to “maintain, protect and enhance” financial stability in the Republic. A comprehensive discussion of the role of the FSCA is however beyond the scope of this thesis hence the discussion on the FSCA hereinafter will be limited to those aspects that are relevant to its contribution in the context of financial stability.

In terms of section 57 of the FSR Act the objectives of the FSCA are to enhance and support the efficiency and integrity of financial markets; to protect financial customers by promoting their fair treatment by financial institutions and by providing financial customers and potential financial customers with financial education programs, and otherwise promoting financial literacy and the ability of financial customers and potential financial customers to make sound financial decisions and, importantly, to assist in maintaining financial stability.<sup>451</sup> Again it is to be noted that the objectives of the FSCA makes mention only of its obligation to assist in “maintaining” financial stability whereas section 26(1)(a) as discussed in paragraph 2.7.10 above, hints at a broader objective that also includes protecting and enhancing financial stability.

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<sup>450</sup> Section 56(1). Section 56(2): The FSCA is a national public entity for purposes of the Public Finance Management Act 1 of 1999.

<sup>451</sup> Section 57(a) to (c).

The FSCA is managed by an Executive Committee, established in terms of section 60 of the FSR Act, consisting of the Commissioner of the FSCA and several Deputy Commissioners.<sup>452</sup> Unlike with the PA, the SARB has no representation on the executive committee of the FSCA. The objectives of the FSCA are to regulate and supervise the conduct of financial institutions; to cooperate with and assist, the SARB, FSO, PA, NCR and FIC, as required by the FSR Act; to cooperate with the Council for Medical Schemes in the handling of matters of mutual interest; to promote sustainable competition in the provision of financial products and services, including through cooperating and collaborating with the Competition Commission; to promote financial inclusion; to regularly review the perimeter and scope of financial sector regulation and take steps to mitigate risks identified to the achievement of its objective or the effective performance of its functions; to administer the collection of levies and the distribution of amounts received in respect of levies; to conduct and publish research relevant to its objective; to monitor the extent to which the financial system is delivering fair outcomes for consumers;<sup>453</sup> and to formulate and implement strategies and programs for financial education of the general public.<sup>454</sup>

The functions of the FSCA further include a catch-all provision that the FSCA, like the PA, may do “anything else” reasonably necessary to achieve its objective, including cooperating with its counterparts in other jurisdictions and participating in relevant international regulatory, supervisory, financial stability and standard setting bodies.<sup>455</sup> It is thus submitted that the FSCA’s mandate also has macro-dimensions, because the FSCA has to survey the whole financial system for compliance by the broad range of financial institutions with proper business conduct practices.

In addition to its licensing powers as set out in Chapter Eight of the FSR Act, the FSCA also has an extensive regulatory toolkit, comprising tools that are largely similar to

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<sup>452</sup> See section 60(3) regarding the functions of this committee, which must meet as often as necessary to perform its functions. See also section 70 for the provisions governing its regulatory strategy.

<sup>453</sup> Section 58(1)(i): Here the focus is on the fairness and appropriateness of financial products and financial services and the extent to which they meet the needs and reasonable expectations of financial customers.

<sup>454</sup> Section 58(1)(a) to (j).

<sup>455</sup> Section 58(4).

those of the PA, as discussed above in paragraph 2.7.12 (a). As such the FSCA may make conduct standards;<sup>456</sup> and issue directives.<sup>457</sup> It also has wide investigative powers and may request information for regulatory purposes;<sup>458</sup> conduct supervisory on-site inspections and carry out investigations if it inter alia reasonably believes that a financial sector law for which it is responsible has been, is being or will be contravened.<sup>459</sup> As set out in section 138 and 139 respectively, these investigative powers of the FSCA includes the power to enter and search premises and to apply for a search warrant. Like the PA, the FSCA can also issue guidance notices and interpretation rulings;<sup>460</sup> enter into enforceable undertakings;<sup>461</sup> make debarment orders; enter into leniency agreements;<sup>462</sup> issue standards and directives to significant owners of financial institutions<sup>463</sup> and impose administrative penalties.<sup>464</sup> Although the designation of financial conglomerates can only be done by the PA, the FSCA may also issue standards and directives to conglomerates and their holding companies.<sup>465</sup> As with the PA, it is submitted that the standards and directives that can be issued by the FSCA will be crucial to the enforcement of its mandate in general and also specifically for its mandate in assisting in maintaining financial stability hence a few remarks on these powers will be made.

The FSCA may make conduct standards in respect of financial institutions, representatives of financial institutions, key persons and contractors.<sup>466</sup> A conduct standard must be aimed at one or more of the following: ensuring the efficiency and integrity of financial markets; ensuring that financial institutions and representatives treat customers fairly; ensuring that financial education programs or other activities promoting financial literacy are appropriate; reducing the risk that financial institutions,

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<sup>456</sup> Section 106, 107 and 108.

<sup>457</sup> Section 144.

<sup>458</sup> Section 131.

<sup>459</sup> Section 134 -139.

<sup>460</sup> Section 141 and 142 respectively.

<sup>461</sup> Section 151.

<sup>462</sup> Section 156.

<sup>463</sup> Section 159.

<sup>464</sup> Section 167.

<sup>465</sup> Section 164.

<sup>466</sup> Section 106 (1). It may however not make a standard that imposes requirements on providers of payment services without the concurrence of the SARB (section 109 (1)).

representatives, key persons and contractors engage in conduct that is or contributes to financial crimes and assisting in maintaining financial stability.<sup>467</sup>

Conduct standards may accordingly be made on any of the following matters:<sup>468</sup> efficiency and integrity for financial markets; measures to combat abusive practices; requirements for the fair treatment of financial customers; including in relation to the design and suitability of financial products and services; the promotion, marketing and distribution of, and advice in relation to, those products and services; the resolution of complaints and disputes concerning those products and services and redress; and the disclosure of information to financial customers; the design, suitability, implementation, monitoring and evaluation of financial education programs or other initiatives promoting financial literacy; matters on which a regulatory instrument may be made by the FSCA in terms of a financial sector law; matters that may in terms of any other provision of the FSR Act be regulated by conduct standards; and any other matter that is appropriate and necessary for achieving any of the aims set out in section 106(2). Additional matters on which standards may be made are set out in section 108.<sup>469</sup> A conduct standard may also declare certain conduct in connection with a financial product or service to be unfair business conduct.<sup>470</sup> The FSCA may however not make a standard that imposes requirements on providers of payment services without the concurrence of the SARB neither may it make a standard aimed at assisting in maintaining financial stability without the SARB's concurrence.<sup>471</sup> As alluded to in paragraph 2.7.12 (a) the FSCA may in accordance with section 107 of the FSR Act also issue joint standards with the PA.

The FSCA may also issue written directives to a financial institution requiring it to take specified action. These directives may be issued if the financial institution is

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<sup>467</sup> Section 106 (2) (a) to (e).

<sup>468</sup> Section 106 (3) (a) to (g).

<sup>469</sup> See the discussion on prudential standards issued by the PA in paragraph 2.7.12 (a) hereof.

<sup>470</sup> Section 106(4). This may be done if the conduct is or is likely to be materially inconsistent with the fair treatment of financial customers; or is deceiving, misleading or likely to mislead financial customers; or is unfairly prejudicing or is likely to unfairly prejudice financial customers or a category of financial customers; or impedes in any other way the achievement of any of the objectives of a financial sector law.

<sup>471</sup> Section 109(1) and (2) respectively.

conducting its business in a way that poses a *material* risk to the efficiency and integrity of financial markets; or if the institution is treating financial customers in such way that the institution will not be able to comply with its obligations in relation to the fair treatment of financial customers or is providing financial education in a manner that is not in accordance with relevant conduct standards. The FSCA may also issue directives if the financial institution or a key person, representative or contractor of the financial institution has contravened or is likely to contravene a financial sector law for which the FSCA is the responsible authority; has not complied with an enforceable undertaking accepted by the FSCA; is involved or is likely to be involved in financial crime or is causing or contributing to instability in the financial system, or is likely to do so.<sup>472</sup>

The purpose of a directive by the FSCA must be aimed at achieving the objective of the FSCA. In addition, it must be to stop the institution or the directed person from contravening applicable financial sector laws or to reduce the risk of such contraventions; to ensure compliance with an enforceable undertaking that was accepted by the FSCA; to stop involvement in financial crime or reducing the risk of such involvement. It may also have as its purpose the reduction of the risk that a systemic event may occur or to remedy the effects of a contravention of a financial sector law or involvement in financial crime.<sup>473</sup>

The action that may be required in a directive by the FSCA includes requiring the financial institution to cease offering or providing a specific financial product or service; or modifying a specific financial product or service or the terms on which it is provided; or removing a person from a specified position or function.<sup>474</sup> It can also include

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<sup>472</sup> Section 144(1)(a) – (d). The FSCA may not issue a directive relating to financial stability unless directed to do so by the SARB or with concurrence of the SARB (section 144(4)).

<sup>473</sup> Section 144(3).

<sup>474</sup> Section 144(5)(a) – (c). In terms of section 145 a financial sector regulator may not issue a directive that requires the removal of a person from a specified position or function unless the person has contravened a financial sector law or has been involved in a financial crime or is responsible for, or in any way participated in, or failed to take steps open to him or her aimed at preventing a contravention of a financial sector law or involvement in financial crime or no longer complies with applicable fit and proper requirements.

requiring the financial institution not to pay a specified bonus or performance payment or to remedy the effects of a contravention of a financial sector law.<sup>475</sup>

### **2.7.13 Cooperation and Collaboration on a broader Twin Peaks level**

Appropriate and adequate prudential and market conduct regulation operate in tandem to assist with the promotion and maintenance of financial stability. Prudential regulation aims to ensure the safety and soundness of financial institutions whilst market conduct regulation aims to prevent and root out unsound market practices and to instil market discipline. As revealed by the GFC both these areas of regulation have a crucially important role in the context of financial stability and without the one or the other, a stable financial system is not possible.

Cooperation and collaboration between the SARB and the financial sector regulators is therefore crucial to the effective execution of the SARB's financial stability mandate but also, in the broader context, to the effective implementation and smooth functioning of the Twin Peaks model as supporting and enabling architecture for financial stability. Mandatory cooperation and collaboration in order to facilitate the effective implementation of the Twin Peaks model is accordingly provided for by the FSR Act on two levels. On the first level, as discussed in paragraph 2.7.10 above there is the specific and focused cooperation and collaboration between the SARB and each of the Regulators that is mandated for purposes of enabling SARB to effectively fulfil its financial stability mandate. On the second broader level there is the mandatory cooperation and collaboration that the FSR Act requires for the effective operation of the Twin Peaks model in general and without which the promotion and maintenance of financial stability will also not be realised.

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<sup>475</sup> Section 144(5)(d) to (e). The FCSA may not issue a directive in terms of section 144(5)(a) or (b) without the concurrence of the PA (section 144(6)). In addition to its power to issue regulator's directives, the FSCA may also issue a written directive to a person who is engaging or proposing to engage in conduct that contravenes a financial sector law requiring such person to cease engaging or to refrain from engaging in such conduct (section 144(8)).

The cooperation and collaboration between the SARB and the financial sector regulators, as set out in section 26 of the FSR Act, as a first line of collaboration, has been discussed in paragraph 2.7.10 above. In that discussion it was pointed out that section 26(1)(a) also requires cooperation and collaboration by the financial sector regulators with each other but that the said section does not provide specific further information in the latter regard. Such cooperation and collaboration on a broader level, is however provided for in more detail in Chapter Five of the FSR Act, as discussed below.

**(a) Cooperation and collaboration between financial sector regulators and the SARB**

Section 76 of the FSR Act deals with cooperation and collaboration generally between the financial sector regulators themselves and also between the regulators and SARB. It provides that the financial sector regulators and the SARB must cooperate and collaborate when performing their functions in terms of financial sector laws, the National Credit Act, and the Financial Intelligence Centre Act, and must for this purpose:<sup>476</sup>

- (a) generally assist and support each other in pursuing their objectives in terms of financial sector laws, the National Credit Act and the Financial Intelligence Centre Act;
- (b) inform each other about, and share information about, matters of common interest;
- (c) strive to adopt consistent regulatory strategies, including addressing regulatory and supervisory challenges;
- (d) co-ordinate, to the extent appropriate, actions in terms of financial sector laws, the National Credit Act and the Financial Intelligence Centre Act, including in relation to standards and other regulatory instruments, including similar instruments provided for in terms of the National Credit Act and the Financial Intelligence Centre Act; licensing; supervisory on-site inspections and investigations; actions to enforce financial sector laws, the National Credit Act and the Financial Intelligence Centre Act; information

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<sup>476</sup> Section 76(1)(a) – (g).

sharing; recovery and resolution; and reporting by financial institutions, including statutory reporting and data collection measures;

(e) minimise the duplication of effort and expense, including by establishing and using, where appropriate, common or shared databases and other facilities;

(f) agree on attendance at relevant international forums; and

(g) develop, to the extent that is appropriate, consistent policy positions, including for the purpose of presentation and negotiation at relevant South African and international forums.

The importance of such cooperation and collaboration is fortified by holding the financial sector regulators and the SARB accountable through obliging them, at least annually as part of their annual reports, or on request, to report to the Minister of Finance, the Cabinet member responsible for administering the National Credit Act and the National Assembly, on measures taken to cooperate and collaborate with each other.<sup>477</sup>

In order to facilitate the practical cooperation and collaboration between the various entities that are required to work together with the SARB in creating a stable financial sector in South Africa the Act requires that the financial regulators and the SARB must not later than six months after Chapters Two and Five of the Act takes effect,<sup>478</sup> enter into one or more MOUs.<sup>479</sup> These MOUs must be aimed at giving effect to their obligations as set out in section 76. In this regard it is important to note that the FSR Act is not prescriptive about the exact content of the memoranda but merely mandates the entering into these memoranda as a measure to ensure cooperation and collaboration between the various role-players. As to what the exact content of these memoranda will entail is left to the respective parties to decide and it is submitted that

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<sup>477</sup> Section 76(2).

<sup>478</sup> Chapter 2 and sections 76 to 82 that is a part of Chapter 5 took effect on 1 April 2018. Sections 83 – 86, with regards to the Financial Sector Inter-Ministerial Council, have not taken effect yet. Given the fact that the mentioned chapter 2 and part of chapter 5 took effect on 1 April 2018, it is the author's submission that these MOUs will have to be in place on or before 1 October 2018. Dr Janet Terblanche, Head of Policy Division, PA of South Africa, at the Colloquium on Twin Peaks held on 28 September 2017 in Pretoria, organised by the Faculty of Law, University of Pretoria, hereinafter Presentation Terblanche 2017, mentioned that if everything goes according to plan, these MOUs will have to be in place on or before 1 July 2018.

<sup>479</sup> Sections 27(1) and 77(1).

it should inter alia address aspects such as the regulatory remit of each regulator, and mention specific instances where deferral by one regulator to the opinion of another would be required as well as how they will deal with disputes between them. Thus it is submitted that these memoranda should be aimed at clarifying the exact scope of the jurisdiction of each regulator, areas where overlap is likely to occur and how conflict will be dealt with. It is however clear that these MOUs will be “living documents” that will be subject to annual scrutiny when the regulators report on cooperation and which, in terms of the FSRA must be reviewed and updated as appropriate, but at least once every three years.<sup>480</sup> Notably the Inter-Ministerial Council is tasked to initially and then again also every two years, commission an independent evaluation of the cooperative and collaborative mechanisms between the financial sector regulators, the SARB, the FIC, the Council for Medical Schemes and the Competition Commission.<sup>481</sup>

A delegation of a power or duty by a financial sector regulator to another financial sector regulator must also be effected by an MOU entered into in terms of this section.<sup>482</sup> It is however provided that the validity of any action taken by a financial sector regulator, the SARB or the Governor in terms of a financial sector law, the National Credit Act and the Financial Intelligence Centre Act is not affected by a failure to comply with this section or an MOU in terms of this section.<sup>483</sup> Each MOU in terms of section 76 and each amendment thereof must be published hence they will be public documents which will also serve to heighten the accountability of the regulators to cooperate effectively.<sup>484</sup>

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<sup>480</sup> Section 27(2) and section 77(4). It is further provided in section 27(3) and section 77(5) that a copy of each MOU and each amendment of such MOU must, without delay after being entered into or updated, be provided to the Minister and in terms of section 27 to the Cabinet member responsible for consumer credit matters and in terms of section 77 to the Minister and the Cabinet member responsible for administering the National Credit Act.

<sup>481</sup> Section 86(1)(a) and (b). See more on this evaluation of the Inter-Ministerial Council in paragraph 2.7.13 (d) below. Section 86(5): Any evaluation commissioned by the Inter-Ministerial Council in terms of section 86 must be tabled in Parliament immediately following the Council’s consideration of the evaluation, and must be accompanied by a report from the Council on the evaluation’s contents.

<sup>482</sup> Section 77(2).

<sup>483</sup> Section 77(3). Likewise section 27(4) also states that the validity of any action taken by a financial sector regulator in terms of a financial sector law, the National Credit Act or the Financial Intelligence Centre Act is not affected by a failure to comply with section 27 or an MOU contemplated in section 27. In the National Treasury Responses 2016 the Banking Association of South Africa recommended that this section be deleted, but it was not agreed with by the National Treasury.

<sup>484</sup> Section 77(6). Section 27 does not have the requirement that the MOU in terms of this section has to be published. This has the effect that the MOU relating to financial stability would not be in the public

**(b) Cooperation and collaboration with and by other organs of state**

Chapter Five also provides for obligations of organs of state relating to cooperation and co-ordination generally. An organ of state that has a regulatory or supervisory function in relation to financial institutions must, “to the extent practicable”, consult the financial sector regulators and the SARB in relation to the performance of that function.<sup>485</sup> A financial sector regulator or the SARB may, in writing, request an organ of state to provide information about any action that the organ of state has taken or proposes to take in relation to a financial institution specified in the request.<sup>486</sup> The organ of state is obliged to comply with such a request, but this obligation does not require or permit an organ of state to do something that contravenes a law.<sup>487</sup>

**(c) Financial System Council of Regulators**

To further enhance the framework for cooperation and collaboration between the financial sector regulators the FSR Act establishes the Financial System Council of Regulators (FSCR) as coordinating body in section 79(1). The objective of the FSCR is to facilitate cooperation and collaboration, and, where appropriate, consistency of action, between the institutions represented on this council by providing a forum for senior representatives of those institutions to discuss, and inform themselves about, matters of common interest.<sup>488</sup>

The FSCR comprises of the following members: the Director-General of the National Treasury; the Director-General of the Department of Trade and Industry; the Director-

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domain and the reason for not requiring publication can be to prevent the MOU to have an adverse effect on financial stability.

<sup>485</sup> Section 78(1).

<sup>486</sup> Section 78(2).

<sup>487</sup> Section 78(3).

<sup>488</sup> Section 79(2).

General of the Department of Health;<sup>489</sup> the Chief Executive Officer of the PA; the Commissioner of the FSCA; the Chief Executive Officer of the NCR; the Chief Executive Officer of the Council for Medical Schemes; the Director of the FIC; the Commissioner of the National Consumer Commission; the Commissioner of the Competition Commission; the Deputy Governor responsible for financial stability matters; and the head, however described, of any organ of state or other organisation that the Minister of Finance may determine.<sup>490</sup> From the aforementioned it however appears that the composition of the FSCR is broader than the mere inclusion of the regulators themselves and that it also includes the heads of the relevant state departments although not the Ministers responsible for these departments. Given that this council will serve as coordinating committee for the broader Twin Peaks model, the Minister of Finance who is responsible for the general administration of the FSR Act is empowered to indicate that the head of any other organ of state or other organisation that he deems fit, also serve on the FSCR. Meetings of the FSCR must be held at least twice a year, or more frequently as determined by the Director-General of the National Treasury,<sup>491</sup> who will also chair the meetings.<sup>492</sup>

The broader purpose of the FSCR is clear from section 81 which indicates that the FSCR's purpose is to establish working groups or subcommittees in respect of the following matters:<sup>493</sup> enforcement and financial crime; financial stability and resolution; policy and legislation; standard-setting; financial sector outcomes; financial inclusion; transformation of the financial sector; and any other matter that the Director-General of the National Treasury may determine after consulting the other members of the FSCR.

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<sup>489</sup> Since it often happens that a medical scheme is a subsidiary in a conglomerate, and in South Africa the biggest banks often have medical schemes that are part of the holding company of the bank, it is important that the Director-General of the Department of Health is a member of the FSCR, so that input regarding the medical scheme industry can be taken into account in the forum of discussion and information that the FSCR would be.

<sup>490</sup> Section 79(3)(a) – (l).

<sup>491</sup> Section 80(1).

<sup>492</sup> Section 80(2). The Director-General must convene a meeting at the request of a member of the FSCR (section 80(3)). A member of the FSCR may, with the concurrence of the Director-General of the National Treasury, nominate a senior official of the member's institution to act as an alternate for the member (section 80(4)). Meetings of the FSCR must be conducted in accordance with procedures determined by it (section 80(5)).

<sup>493</sup> Section 81(1)(a) – (h). The FSCR must determine the membership, terms of reference and procedure of a working group or subcommittee (section 81(2)).

Administrative support and other resources for the FSCR and its working groups and subcommittees has to be provided by the FSCA.<sup>494</sup> This has probably been done in order to achieve a more equal administrative workload between the FSCA and the PA, as the latter institution will be providing administrative support and resources to the FSOC and FSCF.

#### **(d) Financial Sector Inter-Ministerial Council**

In order to address all the levels at which decisions may be taken that may impact on financial stability specifically and also on the broader Twin Peaks level, it is further necessary that some form of “control” be exerted over government ministers who are responsible for the organs of state within whose jurisdiction each of the financial sector regulators is located and thus also has responsibility for the policy decisions and legislation that affects these regulators.

The FSR Act accordingly caters for this aspect by establishing the Financial Sector Inter-Ministerial Council.<sup>495</sup> The objective of the Inter-Ministerial Council is to facilitate cooperation and collaboration between Cabinet members responsible for administering legislation relevant to the regulation and supervision of the financial sector by providing a forum for discussion and consideration of matters of common interest.<sup>496</sup> The members of the Inter-Ministerial Council are the Minister of Finance, the Cabinet members responsible for consumer protection and consumer credit matters,<sup>497</sup> the Cabinet member responsible for health<sup>498</sup> and the Cabinet member responsible for economic development.<sup>499</sup> According to the Department of National

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<sup>494</sup> Section 82(1). The FSCA must ensure that minutes of each meeting of the FSCR, and of each meeting of a working group or subcommittee, are kept in a manner determined by the FSCA (section 82(2))

<sup>495</sup> Section 83(1).

<sup>496</sup> Section 83(2).

<sup>497</sup> Being the Minister of Trade and Industry.

<sup>498</sup> Being the Minister of Health.

<sup>499</sup> Being the Minister of Economic Development. Section 83(3)(a) – (d).

Treasury, the Inter-Ministerial forum has been created to embed deeper co-ordination between the various role-players.<sup>500</sup>

Meetings of the Inter-Ministerial Council take place at times and places determined by the Minister of Finance.<sup>501</sup> The Minister of Finance, or another Cabinet member nominated by the Minister, chairs the meetings of the Inter-Ministerial Council.<sup>502</sup>

## 2.8 Final remarks

To date not much exists in academic literature that ponder upon the South African Twin Peaks model. A few prominent commentators have however made observations that merit further attention.

With regard to the expanded financial stability mandate of the SARB De Jager observes that a material difficulty with the concept of financial stability is that, despite its extensive use, it has no clear definition. He observes that this uncertainty regarding the concept's exact meaning may give rise to considerable heterogeneity in how central banks perceive their financial stability objective, which may lead to a lack of clarity in the accountability and oversight of the function. In contrast to the apparent certainty in measuring price stability, he states that determining a suitable mechanism by means of which a central bank's contribution towards financial stability may be measured is likely to prove difficult.<sup>503</sup>

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<sup>500</sup> Explanatory document Dec 2014 30.

<sup>501</sup> Section 84(1).

<sup>502</sup> Section 84(2). The Minister must convene a meeting at the request of a member of the Inter-Ministerial Council (section 84(3). The Minister may invite any Cabinet member who is not a member of the Inter-Ministerial Council to attend a meeting of the Inter-Ministerial Council (section 84(5). Meetings of the Inter-Ministerial Council are conducted in accordance with procedures determined by it (section 84(6)).

<sup>503</sup> De Jager 2013 no. 2 495-496.

De Jager states that moreover, it is acknowledged that microprudential objectives of prudential regulation may conflict with the macroprudential objectives of a central bank. This may compromise the conduct of monetary policy. Such a situation may arise in particular when the banking system is under stress and the central bank as monetary authority may be hesitant to impose the appropriate degree of financial tightening through concern for the solvency of the financial institutions in the financial system it has to keep stable. In addition, if a central bank has only the short term interest rate as a tool, De Jager states that the question arises whether it makes sense to impose on a central bank what may be perceived as two potentially conflicting objectives in the form of price stability and financial stability.<sup>504</sup>

Owing to the comprehensive (and uncertain) nature of the concept of financial stability, De Jager is concerned that central banks may be called upon to become involved in the resolution of individual systemically important financial institutions (SIFIs) undergoing particular liquidity stress. He comments that if the use of taxpayers money is involved in such process it will inevitably involve the relevant government minister and in his opinion such close involvement of the government in issues pertaining to financial stability could potentially impair the independence of the central bank. He thus states that “in practice, especially during times of widespread financial turmoil, it appears evident that the same level of separation and independence from governments afforded to central banks with regard to their conduct of monetary policy cannot realistically be replicated when it comes to their pursuing their objective of financial stability. He therefore suggests that in these circumstances, instead of a central bank subservience to government, an even-handed partnership between government and the central bank should be maintained.”<sup>505</sup>

De Jager further points out that the role of the SARB in implementing monetary policy and acting both as lender of last resort and the provider of emergency liquidity assistance provides the SARB with unique insight into the workings of the entire financial sector and the macro-economy. Accordingly De Jager is of the view that the

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<sup>504</sup> De Jager 2013 no. 2 497.

<sup>505</sup> De Jager 2013 no. 2 498.

SARB is the only institution with appropriate capacity to perform the role of a macroprudential supervisor. However he cautions that the uncertain concept of financial stability casts its net widely over the financial sector and includes a vast number of players, practices, financial systems, and institutions. Owing to the wide and diverse nature of financial stability it is evident that the SARB will need to cooperate at times with other parties to fulfil its role adequately. In De Jager's opinion it thus calls for the design of coordination mechanisms to derive synergies between macroprudential, microprudential and monetary policy for the purposes of identifying and making effective use of policy tools available to all authorities vested with responsibilities for matters that may affect financial stability.<sup>506</sup>

The South African Twin Peaks model has also attracted interest from international scholars, more specifically from prominent Australian academics who are well versed with the salient aspects of Twin peaks models given that Australia pioneered the Twin Peaks model. Although they do not specifically focus on the details of the financial stability mandate of the SARB as central bank they make observations that are of importance to the broader scheme of Twin Peaks within which the SARB will be executing its mandate.

Godwin and Schmulow, in considering the South African Twin Peaks model, comment that there are many elements that underpin the effectiveness of the Twin Peaks model of financial regulation generally. These include a clear allocation of objectives and responsibilities between the regulators; effective coordination between the regulators; transparency and accountability; effective powers of supervision and enforcement as well as operational independence.<sup>507</sup> Insofar as the question whether the prudential regulator should be housed within the central bank is concerned Godwin and Schmulow observe that the weight of opinion is in favour of a standalone regulator that is independent of the central bank provided that adequate coordination is achieved between the prudential regulator and other regulators and between the prudential

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<sup>506</sup> De Jager 2013 no. 2 504-505.

<sup>507</sup> Godwin A & Schmulow A "The Financial Sector Regulation Bill in South Africa, second draft: Lessons from Australia" 2015 *South African Law Journal* 756, hereinafter Godwin & Schmulow 2015, at 758.

regulator and the central bank.<sup>508</sup> In their opinion such an arrangement would serve to avoid conflicts of interest and operational independence that may arise where the objectives of monetary policy and prudential regulation conflict such as where a decision has to be taken as to whether to allow a SIFI Bank to fail or whether to “rescue” it in the interest of consumer protection.<sup>509</sup>

They point out however, that there are also benefits to housing the prudential authority within the central bank, inter alia the ability to achieve synergies in relation to resources and expertise and to avoid difficulties relating to information-sharing that do not present where the prudential regulator and the central bank constitute one organization. Also, if the central bank has a reputation of being a strong independent bank then the housing of the prudential authority within the central bank may ensure that the prudential authority also operates more independently of government interference.<sup>510</sup>

Godwin and Schmulow however aptly remark that the regulatory design in any country has to accommodate the circumstances and needs of that country. They accordingly concede that there may be cogent reasons for housing the PA within the SARB. However they caution that it will still be necessary to ensure that the PA advances an appropriate level of operational independence in practice and that the risk of conflicts of interest and competing priorities are appropriately managed.<sup>511</sup>

Godwin and Schmulow further remark that arguably the hard law nature of regulatory coordination in South Africa which involves a statutory duty to cooperate, raises various concerns including whether it will lead to inflexibility (inability to adapt to circumstances as and when they arise) and a culture that is more concerned with

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<sup>508</sup> Godwin & Schmulow 2015 759. In this regard the authors refer to Goodhart and Schoenmaker’s opinion that conflicts of interest may arise “between the monetary authorities who wish for higher rates ... and the regulatory authorities who are frightened about the adverse effects such higher rates may have upon the bad debts, profitability, capital adequacy and solvency of banking systems.”

<sup>509</sup> Godwin & Schmulow 2015 759.

<sup>510</sup> Godwin & Schmulow 2015 760.

<sup>511</sup> Godwin & Schmulow 2015 761.

achievement of compliance than achievement of appropriate outcomes. They point out that over-prescription of aspects relating to cooperation and coordination holds the danger that it may compromise the ability of the regulators to deal with a crisis.<sup>512</sup> They also consider the role of the Council of Financial Regulators (CFR)<sup>513</sup> and whether, from the perspective of transparency and accountability, such a body should have a statutory basis like in the South African framework legislation. In this context they indicate that two questions are relevant namely first, whether the CFR has substantive powers and functions that go beyond its consultative and coordinating role and second, how accountability and transparency with regard to the CFR should be achieved? Their concern is that having an inter-agency coordinating body may have the result that it is treated as the only channel through which inter-agency coordination can be achieved and may end up “blurring the lines of responsibility”. They indicate that conferring explicit powers upon the CFR go beyond its consultative and coordinating roles and may cut across the responsibilities of other regulatory agencies. They therefore suggest that a better approach would for the CFR to be seen as the “collaborative dimension” of the regulatory agencies activities rather than a separate body with its own ability to make the regulatory agencies cooperate. They further point out that critical to regulatory coordination is, at a formal level, the regular meetings between the CFR and its working committees on an informal level, the regulatory culture between the persons involved. Godwin and Schmulow thus pertinently caution that in addition to the legislative framework a culture of coordination is necessary under which the main focus is regulatory performance rather than the regulatory structure.<sup>514</sup>

Schmulow also aptly remarks: “Ultimately, of course, the success of a Twin Peaks regime in South Africa will depend on the efficacy of enforcement - *governance* - and this in turn will depend on the goals that are set - *the principles* - and on how those

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<sup>512</sup> Godwin & Schmulow 2015 764 and 765. Their opinion is that the main value of MOUs entered into between the regulators is to signal to the public how the regulators intend to achieve coordination and how they will be reviewed.

<sup>513</sup> At the time of writing this article by Godwin & Schmulow in 2015, the proposed name for the coordinating body was referred to as the Council of Financial Regulators (CFR) in the second draft of the FSR Bill (the FSR 2014). The name of the CFR was changed to FSCR in later drafts of the FSR Bill and when the FSR Act was enacted, it was also named the FSCR.

<sup>514</sup> Godwin & Schmulow 2015 767.

goals will be pursued. That in turn will depend upon market intelligence - the risks - along with the independence and the capacity of regulators to pursue corrective action free of interference or industry capture, coordination 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.”<sup>515</sup>

## **2.9 Conclusion**

The SARB is a well-established and respected central bank with an institutional history spanning nearly a hundred years, many of them having been spent representing South Africa as G-20-member on various international bodies. Prior to the move to a Twin Peaks model of financial regulation the SARB functioned as a critical component in a sectorally regulated financial system. In this sectoral system financial regulation occurred in silos and the SARB inter alia acted as regulator and supervisor of banks. The SARB also had the responsibility for monetary policy which was its primary mandate as imposed by section 3 of the SARB Act. It further fulfilled the traditional roles that central banks generally had relating to oversight of the payments system, financial stability and lender of last resort. Like most other central banks the financial stability mandate of the SARB was an implied de facto mandate that was not captured in legislation.

At the beginning of 2007 South Africa embarked on the journey to reform its approach to financial regulation, not necessarily as a personal response to the then imminent GFC but rather as a measure to align itself with regulatory developments that were occurring on an international level. Fortunately for South Africa it was able to exit the GFC with its financial system still intact as a result of having been buffered by various features, such as inter alia the robust regulation of the banking sector by the SARB as pro-active prudential supervisor. The GFC was a global eye-opener to suffering and non-suffering jurisdictions alike, and as a G-20-member South Africa took the brave

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<sup>515</sup> Schmulow 2017 416.

step to commit itself to financial sector reform in alignment with prominent international regulatory reforms. This commitment was the drive behind the extensive financial sector review undertaken by Treasury that eventually resulted in two significant policy documents, namely the Red Book and the Roadmap, motivating the well-considered and widely-consulted selection of the Twin Peaks model as new approach for financial regulation in South Africa. The birth of Twin Peaks in South Africa was a protracted, laborious event that entailed wide consultation and saw a number of drafts of the comprehensive FSR Bill as framework legislation that was eventually in August 2017 adopted as the FSR Act 9 of 2017, containing the architecture of the unique South African Twin Peaks model.

Although named “Twin Peaks” the South African model in fact has three peaks (and some smaller hills having regard to regulators such as the NCR that have not been assimilated into the peaks). Twin Peaks South Africa comprises the SARB as apex peak, with ultimate an overall responsibility for financial stability, “grandfathering” the other peaks who has to assist in the promotion and maintenance of financial stability. The “twins” comprise of the newly established PA, with system-wide responsibility for prudential regulation of a broad range of financial institutions, and the FSCA as newly established market conduct authority. These new authorities are not merely remnants of the former BSD and FSB but each of them have a much broader macro-focused regulatory remit than the BSD and FSB previously had. Their respective mandates as set out in the FSR Act is aimed at ensuring the prudential safety and soundness of financial institutions (PA) and also the efficiency and integrity with which these institutions conduct themselves (FSCA). The ultimate objective of the Twin Peaks model as set out in the FSR Act is to create a network of institutions that will achieve better prudential and market conduct regulation in South Africa which will in turn assist the SARB as central bank to attain its broad public interest objective of promotion and maintenance of financial stability. As such the Twin Peaks model of financial regulation slots perfectly into the regulatory mind-set that emerged with more force after the GFC, hailing financial stability as core regulatory pursuit.

So how has the move towards a Twin Peaks model changed the role of the SARB as central bank? To begin with, the SARB has retained its traditional roles of being responsible for monetary policy, supervising the payments and settlement system and acting as lender of last resort and its other functions as set out in section 10 of the SARB Act (which has not been amended by the FSR Act save for the amendment to section 10(1)(v)). The responsibility for prudential supervision of banks has however been taken away from SARB (although not by amending section 10 of the SARB Act but rather by amending section 1 of the Banks Act) and given to the PA as dedicated system-wide prudential regulator. The SARB, like in the pre-Twin Peaks regime, is still responsible for financial stability with the big difference being that whereas the emphasis pre-Twin Peaks used to be on the SARB's monetary policy role (being its primary objective as per section 3 of the SARB Act) the focus in the Twin Peaks model is now on the role of the SARB in relation to the *promotion and* maintenance of financial stability. This is clear from the amendment to section 3 of the SARB Act to assign both a price stability objective and a financial stability objective to the SARB, the SARB thus having two primary objectives.

Whereas the SARB previously had some kind of a nebulous implied mandate insofar as the maintenance of financial stability was concerned, this mandate is now explicit, defined, aimed not only at maintaining financial stability but also at actively promoting it and there now exists a comprehensive legislative framework establishing an institutional and regulatory model that is geared at enabling the SARB to execute its financial stability mandate effectively. The FSR Act not only imposes the responsibility for financial stability on the SARB but it actually indicates how this mandate should be exercised by stating the SARB's objectives concerning financial stability, indicating how it must act to monitor the financial system for risk, especially systemic risk, and imposing obligations on the SARB to act swiftly in order to prevent risks from eroding financial system stability, and if systemic events do occur despite the SARB's best efforts to prevent it, then to take action to mitigate and manage the effects of those risks. Not only the obligation to conduct a financial stability review but also the aspects that should be addressed in the financial stability review is now pertinently set out in legislation mandating compliance by the SARB ensuring that the SARB will have no excuse to overlook important aspects relevant to financial stability.

The powers of the SARB in relation to its financial stability mandate are also clarified and augmented as well as the events that would trigger emergency intervention. Besides being able to issue directions to regulators to provide it with required information the SARB is given a power that it did not previously have, namely to designate SIFIs so that they can be watched closely and be subjected to heightened regulation given their ability to inflict ruin upon financial systems. In this regard it is also significant that the SARB can, via the PA, impose measures to increase the resilience of these SIFIs and so further promote financial stability.

It is also clear that the SARB will be functioning in an environment where a much higher premium is placed on cooperation and collaboration between the SARB and financial regulators than was previously the case and where this obligation is extensively entrenched in legislation. This collaboration is specifically extended to organs of state also. In fact it appears that cooperation and collaboration is the bedrock on which the effective implementation of Twin Peaks South Africa rests. Without it appropriate and adequate financial regulation will not occur and in the absence of such regulation the objectives relating to the promotion and maintenance of financial stability will also not be realised.

As such it would be fair to say that a large portion of the execution of the SARB's financial stability mandate will be enabled by its two "helpers", the PA and the FSCA. The PA's objectives are clearly stated and by keeping the broad spectrum of financial institutions safe and sound the PA will not only assist in maintaining financial stability but actually also by promoting it. The same applies to the FSCA with its stated objectives of ensuring the system-wide efficiency and integrity of financial institutions. Although not dealt with in detail for purposes of this thesis the brief overview of the regulatory tools of these two regulators leaves one with the impression that they have been provided with the necessary tools to enable the effective execution of their respective mandates.

Insofar as the various committees that are established in terms of the Act are concerned one might be forgiven for mistaking them as a potential labyrinth of duplication and overlap. However on closer inspection it becomes clear that each of these committees have a specific purpose and all these purposes in the end builds on the others. There is actually very little duplication in terms of the persons who will be sitting on these bodies and in those instances where a person sits on more than one body, the rationale for requiring such person's presence is also clear. So, it appears that the Financial Sector Council of Regulators will serve as the general coordinating body for regulators in the Twin Peaks model whereas the Financial Sector Inter-Ministerial Council will facilitate cooperation and collaboration at Ministerial level where the main policy decisions on legislation and matters affecting Twin Peaks in general and financial stability in particular will be taken. Zooming in on financial stability it is clear that a small expert committee such as the FSOC is required, comprising of all the regulatory heads and Minister of Finance (who plays a pivotal role with regard to fiscal assistance) that can convene every six months as stated in the FSR Act but that is also small enough to get together on an urgent basis if emergency decisions regarding financial stability have to be taken. It goes without saying that a body such as the FSOC will need the dedicated and focused support of a working committee such as the FSCF to inform its decision-making process.

The South African Twin Peaks model thus appears to provide an effective legislative and institutional blueprint for the execution of the SARB's explicit and expanded mandate with regard to financial stability.

## **CHAPTER 3**

### **COMPARATIVE STUDY: AUSTRALIA**

- 3.1 Historical background of financial regulation in Australia and the Reserve Bank of Australia as central bank**
  - 3.2 Rationale behind the move to a Twin Peaks system of financial regulation in Australia**
  - 3.3 Twin Peaks in Australia: The new legal framework of financial regulation**
  - 3.4 The role of the RBA in the Australian Twin Peaks system**
  - 3.5 APRA and ASIC**
  - 3.6 Cooperation and collaboration between the RBA and regulators**
  - 3.7 The Australian Twin Peaks model during the GFC**
  - 3.8 Reforms in Australia subsequent to the GFC**
  - 3.9 The Financial System Inquiry of 2014**
  - 3.10 Conclusion**
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In this chapter the Twin Peaks model of financial regulation pioneered in Australia will be discussed with specific focus on the role, functions and powers of the Reserve Bank of Australia as central bank, in the context of promotion and maintenance of financial stability before, during and after the GFC. The reason for selecting this jurisdiction is because Australia was the first country to implement a Twin Peaks model of financial regulation focusing on two broad functions: prudential regulation and market conduct regulation, which are pivotal in supporting the promotion and maintenance of financial stability. Having pioneered Twin Peaks in 1998 already, Australia has accumulated experience with this model of financial regulation for two decades and has successfully steered it through the GFC. The purpose of this chapter

is therefore to specifically consider the role of the central bank in the Australian Twin Peaks system and how this Twin Peaks model accommodates the pursuit of the promotion and maintenance of financial stability, with the focus on the role of the RBA as central bank. Such comparative study would be valuable in order to consider whether any lessons were learnt in this context and if so, whether those lessons would have any significance for South Africa.

### **3.1 Historical background of financial regulation in Australia and the Reserve Bank of Australia as central bank**

The Commonwealth Bank of Australia was established in 1911 in terms of the first Commonwealth Bank Act of 1911<sup>516</sup> and opened for business on 15 July 1912. The Bank's functions were initially that of a commercial and savings bank. It was a publicly owned commercial bank that competed with the private banks, but it was generally more stable than the commercial banks. The Commonwealth Bank soon became a significant force in the banking landscape. War financing during the First World War brought the Bank to prominence in the 1914 to 1918 conflict. The responsibility for the note issue, initially a function of the Australian Department of Treasury, was transferred to a Notes Board in 1920.<sup>517</sup> In 1924, the Commonwealth Bank Act was amended and the Commonwealth Bank was given control over the note issue. Management of the Commonwealth Bank was then vested in a board of eight directors, including the Governor and the Secretary to the Treasury.<sup>518</sup>

The Commonwealth Bank has been the source of lender of last resort support in Australia since early in the twentieth century. The resource constraints that the Bank

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<sup>516</sup> Act 18 of 1911.

<sup>517</sup> Stevens G "A brief history of the Reserve Bank of Australia" Address to the Reserve Bank of Australia's 50<sup>th</sup> Anniversary Gala Dinner in Sydney – BIS Review 27/2010 (8 February 2010) <http://www.bis.org/review/r100311b.pdf> (accessed 13 July 2017) 1, hereinafter Stevens 2010; Reserve Bank of Australia (undated) <http://www.rba.gov.au/about-rba/history/> (accessed 23 March 2017) 1, hereinafter RBA history: The Notes Board consisted of four members, appointed by the Government. The Governor of the Commonwealth Bank was ex officio a member of the Notes Board. The administration of the note issue was undertaken by the Commonwealth Bank, though the Bank and the Notes Board were formally independent of each other.

<sup>518</sup> RBA history 1.

faced at that time have determined that the last resort support provided was modest. However, some small, advances were made to private banks.<sup>519</sup>

Over many years, until 1945 (when there were major changes to the legislation), the Commonwealth Bank slowly acquired central banking functions, initially in response to the pressures of the Depression in the early 1930s and later by formal, albeit temporary, expansion of its powers under regulations during the Second World War. These included exchange control and a wide range of controls over the banking system, including authority to determine the policy on advancing money to borrowers as well as determining the policy on interest rates, and the power to require private banks to lodge funds with it in special accounts.<sup>520</sup>

The new Commonwealth Bank Act and the Banking Act, both of 1945,<sup>521</sup> formalised the Commonwealth Bank's powers in relation to the administration of monetary and banking policy, and exchange control.<sup>522</sup> The Commonwealth Bank was also given explicit macro-economic policy goals in the 1945 Commonwealth Bank Act.<sup>523</sup> Section 8 of the Act determined that the Commonwealth Bank had to pursue a monetary and banking policy to the greatest advantage of the people of Australia, exercising its powers in such a manner as to contribute to the stability of the currency, the maintenance of full employment and the economic prosperity and welfare of the people of Australia. Under the 1945 legislation, there ceased to be a board, which was replaced by an advisory council of six, comprising entirely of officials from the Bank and the Treasury. The Governor of the Bank was responsible for managing the Bank. Subsequently, legislation in 1951 established a new board (at that time of ten

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<sup>519</sup> Fitz-Gibbon B and Gyzicki M "A History of Last Resort Lending and Other Support for Troubled Financial Institutions in Australia" RBA Research discussion Paper NO 2001-07 (15 April 2008) <http://www.rba.gov.au/PublicationsAndResearch/RDP/RDP2001-07.html> (accessed 9 January 2017), hereinafter Fitz-Gibbon & Gyzicki 2008 at 2 and at 49: During the 1920s most attention of the Commonwealth Bank was devoted to the Commonwealth Bank's role as banker to the trading banks and little consideration had been given to the savings banks.

<sup>520</sup> RBA history 1.

<sup>521</sup> Commonwealth Bank Act No. 13 of 1945 and Banking Act No. 14 of 1945.

<sup>522</sup> RBA history 1.

<sup>523</sup> Stevens 2010 1.

members), including the Governor, Deputy Governor and the Secretary to the Treasury, and maintained the responsibility of the Governor for managing the Bank.<sup>524</sup>

The Liquid Assets and Government Securities (LGS) convention subsequently came into force in March 1956. Under the convention banks agreed to keep a certain proportion of their depositors' funds in liquid assets and Commonwealth Government securities. If a bank fell below the minimum it was required to borrow from the Commonwealth Bank.<sup>525</sup>

At least 30 years after discussion began about the merits of having a separate institution dedicated solely to central banking, the Reserve Bank of Australia (RBA) was established in terms of the Reserve Bank Act 1959<sup>526</sup> that took effect on 14 January 1960. The original body corporate of the Commonwealth Bank was preserved as the RBA specifically in order to manage the central bank functions in Australia. The commercial and savings bank functions were then transferred into a new institution, with the longstanding name of Commonwealth Bank of Australia.<sup>527</sup> In terms of section 26 of the Reserve Bank Act, the RBA had to carry on business as a central bank, subject to the Reserve Bank Act 1959 and the Banking Act 1959.<sup>528</sup>

Pre-Twin Peaks the specifics of the RBA's (primary) mandate rested on section 10 of the Reserve Bank Act 1959 which provided (like the 1945 Commonwealth Bank Act) that the RBA must "ensure that the monetary and banking policy of the Bank is dedicated to the greatest advantage of the people of Australia and that its powers are executed in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to (a) the stability of the currency in Australia; (b) the maintenance of full employment in Australia; and (c) the economic prosperity and welfare of the people of Australia." Given the serious damage to employment and economic prosperity that

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<sup>524</sup> RBA history 2: With minor variations in the number of members, this has been the structure of the Bank's Board since that time.

<sup>525</sup> Fitz-Gibbon & Gyzicki 2008 51.

<sup>526</sup> Act 4 of 1959.

<sup>527</sup> RBA history 2.

<sup>528</sup> Section 26 Reserve Bank Act; Banking Act 6 of 1959.

can occur in times of financial instability section 10 has long been interpreted to imply a mandate to “pursue” financial stability.<sup>529</sup>

Section 8 of the Reserve Bank Act set out general powers of the RBA and provided that it had such powers as were necessary for the purposes of the Reserve Bank Act and any other Act conferring functions on the Bank and, in particular, and in addition to any other powers conferred on it in terms of the Reserve Bank Act,<sup>530</sup> had the power:

- (a) to receive money on deposit;
- (b) to borrow money;
- (c) to lend money;
- (d) to buy, sell, discount and re-discount bills of exchange, promissory notes and treasury bills;
- (e) to buy and sell securities issued by the Commonwealth and other securities;
- (f) to buy, sell and otherwise deal in foreign currency, specie, gold and other precious metals;
- (g) to establish credits and give guarantees;
- (h) to issue bills and drafts and effect transfers of money;
- (i) to underwrite loans; and
- (j) to do anything incidental to any of its powers.

The RBA had one Board that was established in terms of section 9 of the Reserve Bank Act<sup>531</sup> and “the Board” was referred to as “the Reserve Bank Board established by this Act”.<sup>532</sup> The Reserve Bank Board consisted of the Governor, the Deputy Governors, the Secretary to the Department of the Treasury and seven other members, who were appointed by the Governor-General. Of the seven members appointed at least five had to be persons who were not officials.<sup>533</sup> A Governor of the

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<sup>529</sup> Reserve Bank of Australia and Australian Prudential Regulation Authority “Macroprudential Analysis and Policy in the Australian Financial Stability Framework” (September 2012) <http://www.rba.gov.au/fin-stability/resources/2012-09-map-aus-sf/pdf/2012-09-map-aus-fsf.pdf> (accessed 22 March 2017), hereinafter RBA & APRA Financial Stability 2012, at 2.

<sup>530</sup> In 1998 the words “and such other Acts” were added to section 8. See below in paragraph 3.4 for discussion of 1998 amendments of the Reserve Bank Act.

<sup>531</sup> The functions of the Reserve Bank Board are set out in section 10 of the Act,

<sup>532</sup> Section 5 Reserve Bank Act.

<sup>533</sup> Section 14(1) - (2).

RBA and two Deputy Governors of the Bank was appointed in terms of the Reserve Bank Act, and the Bank was managed by the Governor as chairperson subject to section 10 of the Act.<sup>534</sup> Section 13 of the Reserve Bank Act provided for the Governor of the RBA and the Secretary to the Department of the Treasury to establish a close liaison with each other and obliged them to keep each other fully informed on all matters which jointly concerned the RBA and the Department of the Treasury.

During the deficit in liquidity in 1974 banks were forced to borrow from the RBA to preserve their Liquid assets and Government Securities ratios.<sup>535</sup> Press releases on behalf of the RBA during the liquidity squeeze in 1974, stating that it would support banks that would assist troubled building societies, decreased bank runs.<sup>536</sup> So although the RBA did not make loans directly to troubled institutions, Fitz-Gibbons and Gyzicki remark that it was indeed acting as lender of last resort.<sup>537</sup>

In 1979 a major financial system inquiry (the Campbell Committee) was launched that published its report in 1981.<sup>538</sup> The Campbell Report recommended lifting much of the

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<sup>534</sup> Section 12(2).

<sup>535</sup> Fitz-Gibbon & Gyzicki 2008 51.

<sup>536</sup> Fitz-Gibbon & Gyzicki 2008 52 and 53: As Fitz-Gibbon and Gyzicki mentions, the failure of a number of property financiers precipitated runs on building societies in several states in Australia during 1974. The RBA provided some liquidity support, although it did not lend directly to non-banks. On 30 September 1974, the property financier Cambridge Credit went into liquidation. Runs then developed on building societies. Two press releases, by the Acting Federal Treasurer and by the Acting Prime Minister, were made to announce that the RBA would stand behind banks who would provide liquidity to troubled building societies that were responsibly managed and had adequate asset backing. After these press releases the bank runs decreased.

<sup>537</sup> Fitz-Gibbon & Gyzicki 2008 55; Speech by Bernie Fraser, Governor of the Reserve Bank of Australia on 10 April 1990 at Sydney "Aspects of the RBA's supervisory function" in Fitz-Gibbon & Gyzicki 2008 55: This marked the first occasion on which funds were lent under the RBA's policy confining the provision of last-resort loans to banks, while standing ready to support any bank that found its own liquidity strained as the result of providing assistance to an illiquid, but solvent, non-bank financial institution. This policy remained in place until the 1990s.

<sup>538</sup> Australian financial system *Final report of the Committee of Inquiry* – Chairman JK Campbell - Australian Government Publishing Service (September 1981) <http://fsi.gov.au/files/2014/01/Chpt1-12.pdf> and <http://fsi.gov.au/files/2014/01/Chpt13-22.pdf> and <http://fsi.gov.au/files/2014/01/Chpt23-35.pdf> and <http://fsi.gov.au/files/2014/01/Chpt36-40.pdf> and <http://fsi.gov.au/files/2014/01/Chpt40onwards.pdf> (accessed 13 February 2018) xxiii, hereinafter The Campbell Committee Report 1981: The terms of reference for the Campbell Inquiry were to report on the structure and methods of operation of the Australian financial system in view of the importance of the efficiency of the financial system for the Government's free enterprise objectives and broad goals for national economic prosperity; and to inquire into and report on the regulation and control of the financial system; and to make recommendations for the improvement of the structure and operations of the financial system as well as on the regulation and control of the financial system and on the legislation that existed relating to the

regulation imposed on the banking system. As a result, the means for conducting monetary policy moved from direct control to open market operations.<sup>539</sup> The Campbell Committee recommended that the existing provisions of the Reserve Bank Act defining the overall policy relationships between the RBA, Government and Parliament, should be retained.<sup>540</sup> It indicated that arrangements relating to the implementation of monetary and banking policy should be such as to ensure that the RBA has clear capacity to respond to market developments. It was further suggested that the RBA should be responsible for the formulation and implementation of (prudential) policy and that the principal characteristics of the policy should be publicly recorded.<sup>541</sup> The Campbell Report also set out recommendations for the conduct of the lender of last resort policy that were very much in line with Bagehot's prescriptions.<sup>542</sup>

The Campbell Committee considered that, except where there were strong reasons for believing that the overall stability of the financial system would be impaired, non-viable financial intermediaries should be allowed to fail to preserve efficiency and competition within the financial system. The Committee argued, however, that the manner in which a failure is handled is important and indicated that the exit of an insolvent institution should be managed in a way that did not cast doubt on the viability of other institutions.<sup>543</sup>

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financial system including more importantly the Reserve Bank Act, the Banking Act and Regulations and the Financial Corporations Act. At 730: The Inquiry referred to deregulation in the financial system and highlighted that it does not believe that it will be regressive, but expected that deregulating it will generally benefit the community to the extent that it makes the financial system more efficient.

<sup>539</sup> Fitz-Gibbon & Gyzicki 2008 60.

<sup>540</sup> The Campbell Committee Report 1981 758.

<sup>541</sup> The Campbell Committee Report 1981 759.

<sup>542</sup> Campbell Committee Report 1981 100. While no legislative prescription for lender of last resort policy was proposed or implemented, the Report confirmed that a central bank should ensure a sufficient availability of liquidity to preclude a financial crisis stemming from a loss of confidence in the capacity of viable financial institutions to meet their obligations. The Report argued that provision of liquidity support facilities by the central bank, unless applied with great restraint, risked creating moral hazard problems. It stated that last-resort lending should generally entail a penalty (except where the circumstances giving rise to the emergency were clearly beyond the control of an individual institution); See also Fitz-Gibbon & Gyzicki 2008 61; See also paragraph 1.2 in Chapter One on Bagehot's rule.

<sup>543</sup> Campbell Committee Report 1981 100; See also Fitz-Gibbon & Gyzicki 2008 61.

There were however no major changes in the functions of the RBA after the Campbell Report was released, until the abolition of Exchange Control following the float of the Australian dollar in 1983.<sup>544</sup> Since the early 1980s a period of financial deregulation followed in Australia in response to the perception that the existing financial system had out-dated regulatory structures.<sup>545</sup> In 1985, the LGS Convention was replaced by the Prime Asset Ratio (PAR) requirement that required banks to hold a minimum level of Commonwealth Government securities, notes and coin and balances with the RBA.<sup>546</sup> The PAR requirement was a prudential, rather than a monetary policy, requirement. This marked the end of automatic lending to the banks. Instead, any future lending to banks would be at the RBA's discretion and the Bank would aim to ensure that the banking system's need for liquidity would be met without recourse to direct lending to banks.<sup>547</sup>

According to Tyree, until 1985, the Australian payments system reflected the structure of the Australian financial industry. That structure could best be described as a closed shop. No new banking licence had been issued between 1945 and 1985 and over 80 per cent of deposits and customers were controlled by the four major banks. Current accounts paid no interest, and lending was subject to direction from the RBA.<sup>548</sup> Clearing was effected through the Australian Clearinghouse, an organization owned and strictly controlled by the participant banks. Settlement was done, by means of Exchange Settlement Accounts held by clearing institutions with the RBA.<sup>549</sup>

With the enactment of the Australian Securities Commission Act in 1989,<sup>550</sup> market integrity regulation of the whole financial sector fell under the remit of one regulator, namely the Australian Securities Commission. The obligation of consumer protection

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<sup>544</sup> RBA history 2.

<sup>545</sup> Group of 30 2008 188.

<sup>546</sup> APRA "Banks' liquidity policies and the prime assets requirement" (16 August 1999) [http://www.apra.gov.au/MediaReleases/Pages/99\\_14.aspx](http://www.apra.gov.au/MediaReleases/Pages/99_14.aspx) (accessed 2 March 2018), hereinafter APRA PAR 1999.

<sup>547</sup> Fitz-Gibbon & Gyzicki 2008 62.

<sup>548</sup> Tyree AL "The Australian Payments System" 2001 (17) *Banking and Finance Law Review* 39, hereinafter Tyree 2001, at 40.

<sup>549</sup> Tyree 2001 41.

<sup>550</sup> Act 90 of 1989.

regulation was divided between various regulators: Life and general insurance products and associated intermediaries were regulated by the Insurance and Superannuation Commission.<sup>551</sup> The Australian Securities Commission directed its attention insofar as consumer protection was concerned to shares, debentures, futures contracts and interests in collective investment schemes and associated intermediaries. General consumer protection regulation was conducted by the Australian Competition and Consumer Commission.<sup>552</sup> Prudential regulation at the time was based on an institutional approach (being a product of the broader sectoral approach) and was split between the RBA in respect of banks, the Insurance and Superannuation Commission in respect of life and general insurance companies and the Australian Financial Institutions Commission<sup>553</sup> in respect of entities like building societies and credit unions.<sup>554</sup>

Clearing arrangements also changed in 1992. The Clearinghouse was abolished and a new organization, the Australian Payment Clearing Association (“APCA”), took responsibility for payment clearing.<sup>555</sup> The Council of Financial Supervisors<sup>556</sup> was established in 1992 to facilitate coordination and communication among the major financial regulators. Its members were the RBA, the Insurance and Superannuation

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<sup>551</sup> Following the proclamation of the Insurance and Superannuation Commissioner Act 98 of 1987.

<sup>552</sup> Jensen A and Kingston M “Australian ‘twin peaks’ framework of financial system regulation: Australia and UK compared” 2010 (25) *Butterworths Journal of International Banking and Financial law* 548, hereinafter Jensen & Kingston 2010; Australian Competition and Consumer Commission (undated) <https://www.accc.gov.au/about-us/australian-competition-consumer-commission/about-the-accc> (accessed 12 October 2017): The Australian Competition and Consumer Commission was established in 1995 with the amalgamation of the Australian Trade Practices Commission and the Prices Surveillance Authority to administer the Trade Practices Act 1974, renamed the Competition and Consumer Act 2010 on 1 January 2011.

<sup>553</sup> Established in terms of the Australian Financial Institutions Commission Act 1992.

<sup>554</sup> Jensen & Kingston 2010 548.

<sup>555</sup> Tyree 2001 42. APCA website (undated) <http://www.apca.com.au/> (accessed 3 March 2018): APCA is a self-regulated body; APCA announcement (13 April 2017) [http://www.apca.com.au/docs/default-source/2017-media-releases/announcement\\_name\\_change\\_130417.pdf](http://www.apca.com.au/docs/default-source/2017-media-releases/announcement_name_change_130417.pdf) (accessed 3 March 2018) 1: APCA has changed its name to the Australian Payments Network Limited on 13 April 2017.

<sup>556</sup>Thompson G “The role of the Council of Financial Supervisors” (14 September 1995) <https://www.rba.gov.au/speeches/1995/sp-dg-150995.html> (accessed 25 April 2018): The Deputy Governor of the RBA, Graeme Thompson, mentioned in a speech in 1995 that in its report in 1991, the Martin Committee recommended that the Council of Financial Supervisors be established. The Committee’s main concern was more effective supervision of financial conglomerates, since conglomerates were at that time becoming more common in the Australian financial system and they posed particular supervisory challenges. This was the case since the various institutions forming part of a conglomerate were usually supervised by different agencies and the health of one entity could not be considered independently of the others, therefore effective communication between the agencies was important.

Commission, the Australian Securities Commission and the Australian Financial Institutions Commission.<sup>557</sup>

In the pre-Twin Peaks dispensation the RBA, as central bank operating within an institutional model of financial regulation, thus had the traditional roles that were typical of central banks, namely responsibility for monetary policy, oversight of the payments and settlement system, supervision of banks and, acting as lender of last resort in limited instances.<sup>558</sup> It was also de facto responsible for maintenance of financial stability as implied by its primary mandate set out in section 10 of the Reserve Bank Act.

### **3.2 Rationale behind the move to a Twin Peaks system of financial regulation in Australia**

In 1996 the Financial System Inquiry, chaired by Stan Wallis (the Wallis Inquiry) into the Australian financial system was announced. The Wallis Inquiry was tasked with providing a stocktake of the results arising from financial deregulation; analysing the forces driving further change to the financial landscape with particular emphasis on technological change; recommending the best overall framework for the efficient delivery of regulation; and recommending ways to improve the then current regulatory arrangements.<sup>559</sup>

Impressively the Wallis Inquiry was not prompted by any particular failure or financial crisis but came at a time of steady growth and relative calm in the Australian financial markets. Thus the Inquiry was able to consider what would be the appropriate shape

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<sup>557</sup> Council of Financial Regulators “History” (undated) <https://www.cfr.gov.au/about-cfr/history.html> (accessed 20 November 2017), hereinafter CFR History, at 1.

<sup>558</sup> See also Fitz-Gibbon & Gyzicki 1 - 2.

<sup>559</sup> Cooper J “The integration of financial regulatory authorities – the Australian experience” Australian Securities and Investments Commission (September 2006) <http://download.asic.gov.au/media/1339352/integration-financial-regulatory-authorities.pdf> (accessed 24 March 2017), hereinafter Cooper 2006, at 2.

of Australia's financial system regulation, without any pressure to repair a systemic or other regulatory or financial failure.<sup>560</sup>

The Wallis Inquiry distinguished between conduct and disclosure regulation (entailing regulation of market integrity and consumer protection) on the one hand and regulation for financial safety on the other hand.<sup>561</sup> The Inquiry thereupon considered three main regulatory possibilities for purposes of reform of the prevailing model of financial regulation in Australia,<sup>562</sup> namely that of a mega regulator, a lead regulator and a Twin Peaks regulatory model. Under the mega regulator model, a single regulator would undertake the whole spectrum of market regulation, consumer protection and prudential regulation. The main argument in favour of this model was that it would create regulatory consistency, allow more in-depth supervision of diverse financial groups and diminish the scope for 'regulatory arbitrage'.<sup>563</sup> The arguments against the mega regulator model included that adopting a 'one size fits all' approach to regulation, would give such a mega regulator too much power.<sup>564</sup>

The second model, being the lead regulator model, would entail that a single regulatory agency takes responsibility for assessing the risk profile and capital adequacy of the entire operation of a diversified group. In theory the lead regulator would gather and distribute information about the financial group from and to other regulatory agencies and coordinate the handling of difficulties in the financial group. Supporters contended that the lead regulator model would ensure a coordinated

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<sup>560</sup> Cooper 2006 2; Wallis Inquiry (March 1997) <http://fsi.treasury.gov.au/content/FinalReport.asp> (accessed 30 March 2017) hereinafter Wallis Inquiry 1997; See further Wallis Report on the Australian Financial System: Summary and Critique – Research Paper No. 16 1996-97 published by the Department of the Parliamentary Library (1997) [http://parlinfo.aph.gov.au/parlInfo/download/library/prspub/D2G30/upload\\_binary/D2G30.pdf;fileType=application/pdf#search=%221990s%201997%20publications%22](http://parlinfo.aph.gov.au/parlInfo/download/library/prspub/D2G30/upload_binary/D2G30.pdf;fileType=application/pdf#search=%221990s%201997%20publications%22) (accessed 30 December 2017).

<sup>561</sup> In its report the Inquiry first dealt with the aspect of market conduct regulation and thereafter with prudential regulation and therefore these aspects are dealt with in this paragraph in the sequence in which they were dealt with in the Wallis Report.

<sup>562</sup> Wallis Inquiry "Overview and Recommendations" (March 1997) <http://fsi.treasury.gov.au/content/downloads/FinalReport/overview.pdf> (accessed 31 January 2018 28: The framework for regulation that existed in Australia when the Wallis Inquiry was conducted, was an institutional framework.

<sup>563</sup> Cooper 2006 3: Regulatory arbitrage is where one regulator is played off against another or where gaps between regulators are exploited.

<sup>564</sup> Cooper 2006 3; Schmulow 2015 no. 1 155 points out that this approach of a mega regulator is also referred to as the integrated or unified approach and was formerly employed in the United Kingdom where various inquiries after the GFC declared that this approach failed and should be replaced.

approach to financial groups, while keeping the specialist expertise of existing regulatory agencies. The drawback of this model was however that it could lead to fragmentation of the regulatory system, as well as competition between regulators as a result of different aims and styles.<sup>565</sup>

The Wallis Inquiry opted against the mega regulator or the lead regulator models because it was of the view that the regulatory agencies that existed in Australia at that time would, with some amendment to their powers and functions, perform better taking into account their different cultures. It was also opined that the combination of the functions of existing agencies would have been premature at that stage in the history of Australia's financial regulatory arrangements; a single regulator with all of those functions might become excessively powerful; and that those functions might in any event be too wide to be combined in one agency.<sup>566</sup>

The Inquiry eventually opted for the Twin Peaks model in terms whereof two financial regulators would be established, the one responsible for prudential regulation and the other for the integrity of financial markets. The envisaged outcome of implementing this model would be that two highly specialised agencies are created with clearly defined and understandable regulatory roles that are divided along functional lines. The Wallis Inquiry thoroughly interrogated the Twin Peaks model, taking into account its disadvantages also, which it identified as the potential for regulatory overlap and duplication, conflict between different regulatory perspectives and objectives and the potential for important regulatory issues to 'fall between the cracks'.<sup>567</sup>

The features of the Twin Peaks model that made the Wallis Inquiry favour this model, were that amongst other things it addressed the problem of the many financial

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<sup>565</sup> Cooper 2006 3; Schmulow 2015 no. 1 153 indicates this approach of a lead regulator is also referred to as the "institutional", "traditional" or "silo" approach that focuses on the form of a legal entity under regulation and assigns a particular regulator accordingly.

<sup>566</sup> Cooper 2006 4 points out that Wallis took into account that in order to obtain optimal regulation of the financial system, a single regulator would have to be capable of dealing with each of four identified facets of market failure, namely market misconduct; information asymmetry; anti-competitive behaviour; and systemic instability.

<sup>567</sup> Cooper 2006 3.

products that were being developed and designed which “blurred the boundaries” between different financial instruments and institutions. This intensified competition in the financial sector was coming from sectors that were not traditionally part of the financial system and from sectors originating from other countries as well as from conglomerates that were formed. The Wallis Inquiry thus regarded the ideal regulatory scheme as that of striking a balance between the goals of preventing market failure and allowing financial markets to perform efficiently.<sup>568</sup>

Insofar as tailor-making the Twin Peaks model for Australia was concerned, the Wallis Inquiry made specific key recommendations. The Inquiry reasoned that the fragmented approach to conduct and disclosure regulation in Australia that was done by various agencies “were inconsistent with the emerging structure of markets” and “resulted in inefficiencies, inconsistencies and regulatory gaps” and that such a situation was not conducive to effective competition in financial markets.<sup>569</sup> For purposes of market integrity and consumer protection the Inquiry thus opined, and subsequently recommended, that a single market conduct regulator would be able to regulate the market conduct aspect of the whole financial sector and in the process be focused, consistent and responsive.<sup>570</sup> The Inquiry suggested that the name of the market integrity and consumer protection agency regulator should be the Corporations and Financial Services Commission (CFSC).<sup>571</sup>

The Inquiry further proposed that the prudential regulation of deposit taking institutions should be consolidated with that of insurance and superannuation<sup>572</sup> to enhance

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<sup>568</sup> Godwin et al 2016 24; Schmulow 2015 no. 3 5: The suggestion for a Twin Peaks model of financial regulation by Michael Taylor, was in reaction to the “blurring of the boundaries” phenomenon in the financial services sector in the UK.

<sup>569</sup> Wallis Inquiry 1997 17-18; See further Godwin et al 2016 23.

<sup>570</sup> Wallis Inquiry Recommendation 1; See further Jensen & Kingston 2010 548.

<sup>571</sup> See paragraph 3.3 and 3.5.2 hereof for discussion of establishment of ASIC as market conduct regulator.

<sup>572</sup> International Monetary Fund Country Report No. 12/308 *Australia: Financial System Stability Assessment* (November 2012) <https://www.imf.org/external/pubs/ft/scr/2012/cr12308.Pdf>, hereinafter IMF 12/308, at 16: Superannuation is an important part of Australia’s retirement income system that also includes a tax payer funded age pension. The superannuation system is predominantly defined contribution in nature compulsory contributions made by employers on behalf of employees as well as voluntary contributions made by employees, both supported by concessional tax arrangements. It enables people in Australia to accumulate funds to provide them with income in retirement. A “defined

competitive neutrality as well as cost effectiveness and flexibility. Thus it proposed a single prudential regulator that would take a system wide approach that would be responsive to the development of closely substitutable products across the banking and life insurance industries and would provide a sounder basis for regulating financial conglomerates; it would offer greater resource flexibility and economies of scale in regulation and it would provide flexibility to cope with industry innovation.<sup>573</sup> With regards to conglomerates, the Wallis Report mentioned that combining prudential regulation in a single regulator would better accommodate the emergence of wide ranging financial conglomerates and enable a more flexible approach over time to changes in the focus of prudential regulation. One of the outcomes sought by the Inquiry, was to provide more effective regulation for financial conglomerates which would also facilitate competition and efficiency.<sup>574</sup> The Inquiry suggested that the name of the prudential regulator should be the Australian Prudential Regulation Commission (APRC).<sup>575</sup>

The Inquiry proposed that the then-existing Council of Financial Supervisors<sup>576</sup> should be renamed to the Council of Financial Regulators (CFR) and be reconfigured with the aims of facilitating the cooperation of its three members (the RBA, APRC – being the proposed prudential regulator, and CFSC - being the proposed conduct and disclosure regulator) across the full range of regulatory functions, and the attainment of regulatory objectives with the minimum of agency and compliance costs. In addition to implementing these aims, it was proposed that the CFR should give early attention to:

- (a) considering issues of systemic stability spanning the regulator's respective jurisdictions, such as the risk characteristics of clearing and settlement arrangements, the risk control systems of futures and options exchanges and other markets, and arrangements for handling situations posing systemic problems;

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contribution pension plan" is an arrangement where members pay contributions into an individual account.

<sup>573</sup> Wallis Inquiry Recommendation 31; See further Jensen & Kingston 2010 549; Godwin et al 2016 23.

<sup>574</sup> Wallis Inquiry 1997 2.

<sup>575</sup> See paragraph 3.3 and 3.5.1 hereof for discussion of establishment of APRA as prudential regulator.

<sup>576</sup> See paragraph 3.1 above on the Council of Financial Supervisors.

- (b) monitoring the participation in Australian wholesale markets of large institutions not subject to prudential regulation domestically or overseas;
- (c) harmonising government agencies' data requirements from reporting financial entities, beginning with those of the financial regulatory agencies and Australian Bureau of Statistics;
- (d) liaising with law enforcement bodies about the implications of new financial technology or regulatory practice for enforcement of other laws; and
- (e) examining issues of competitive neutrality in financial regulation suggested from time to time by industry or advisory bodies.<sup>577</sup>

Notably, the Wallis Inquiry specifically considered whether the prudential regulator should be part of the central bank, or not.<sup>578</sup> It was considered that the operational skills and culture of the central bank were at that stage concentrated on banking, whereas the envisaged prudential regulator would be tasked with wider functions in respect of a wider variety of financial institutions and would thus have a wider regulatory remit. The Wallis Inquiry regarded the role of the central bank as that of contributing to the stability of the financial system, through securing price stability, helping to maintain sound macro-economic policies and managing the payments system and, where unavoidable, responding to systemic crises by giving liquidity support.<sup>579</sup> The Inquiry therefore opined that the central bank was best placed to ensure the stability of the financial system and to manage systemic risks. Accordingly it indicated that in the new Twin Peaks dispensation the RBA should retain overall responsibility for the stability of the financial system, in consultation (as necessary) with the Treasurer and other financial sector regulatory authorities but that prudential regulation of banks should be moved to a separate, independent prudential regulator.<sup>580</sup>

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<sup>577</sup> Wallis Inquiry Recommendation 112. According to the Wallis Inquiry, the CFR was a continuation of the Council of Financial Supervisors. The CFR had a more expanded mandate than the Council of Financial Supervisors and focused on more than conglomerates as the last mentioned did. This can be seen in what the Wallis Inquiry proposed to be the focus of the CFR in the beginning, as set out in these points (a) to (e).

<sup>578</sup> See discussion above in Chapter One paragraph 1.9.

<sup>579</sup> Jensen & Kingston 549.

<sup>580</sup> Wallis Inquiry Recommendation 56.

It was concluded that the new system-wide prudential regulator should be separate from the RBA, for the following main reasons:

- (a) It was regarded improbable that the combination of deposit taking, insurance and superannuation regulation would be carried out efficiently and flexibly by the central bank that primarily has a relationship with banks alone and whose operational skills and culture focuses on banking;
- (b) In separating these entities, it was opined that it would spell out the fact that there would be no guarantee that any financial institution would be saved from insolvency, since the prudential regulator would not have the balance sheet of a central bank, although the central bank may still provide support to maintain financial stability; and
- (c) It was opined that separation enables both the prudential regulator and the central bank to focus on their primary objectives and would diminish the risk of a potential conflict of interest if a regulated institution would need financial support. The sentiment was that a regulator that has a history of regulating an institution might assist the institution financially from failing without an objective assessment of the financial implications, therefore it might be preferable that the question of financial support should be considered by the central bank as a separate entity that would also consider possible systemic concerns.<sup>581</sup>

Although the Wallis Inquiry recommended that the prudential regulator should be separate from the RBA, it however also indicated that it was crucial that there should be close cooperation between the RBA and the prudential regulator and that strong mechanisms should be created to ensure proper coordination and cooperation between the two agencies.<sup>582</sup>

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<sup>581</sup> Cooper 2006 5; Jensen & Kingston 2010 549.

<sup>582</sup> Wallis Inquiry Recommendation 32; See further Godwin et al 2016 23 who point out that when compared with other twin peaks jurisdictions, Australia stands alone in terms of housing prudential regulation in an entity that is separate and independent of the central bank. By contrast, the UK operates a unique model where the Prudential Regulation Authority is a subsidiary of the Bank of England. In the Netherlands, Belgium and New Zealand, the prudential regulator is a part of the central bank.

The Wallis Inquiry further determined that the payments system should be regulated by the RBA under a separate Payments System Board.<sup>583</sup> The Payments System Board should have responsibility for implementing policies to improve payments system efficiency, including the adoption of the most efficient technology platforms, and enhancing the competitive framework, consistent with overall systemic stability and should also have general oversight of the clearing streams.<sup>584</sup> The Wallis Inquiry also recommended that the Payments System Board should be chaired by the Governor of the RBA and that it should include one Deputy Governor of the RBA. Other members should be appointed by the Treasurer and drawn from payments system users and industry representatives who were knowledgeable and experienced in the operations of the payments system.<sup>585</sup> It was proposed that the Payments System Board should make its decisions independently of the main RBA Board, which would concentrate on monetary policy and financial stability. In the event of a conflict between the main RBA Board and the Payments System Board, the Governor should be given statutory authority to implement the decision of the main RBA Board.<sup>586</sup>

### **3.3 Twin Peaks in Australia: The new legal framework of financial regulation**

The Twin Peaks Model of Supervision in Australia was subsequently implemented as a result of the findings of the Wallis Commission. A complete new legal framework was created that took effect from 1 July 1998. These profound amendments to the regulation of the Australian financial markets moved it from a sectoral model to a functional model of regulation by objective. The main components of the Australian Twin Peaks model consisted of thus three agencies, each with specific functional responsibilities:

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<sup>583</sup> Recommendation 64 of the Wallis Inquiry determined that the Australian Payments System Council should be disbanded, with its functions in relation to the payments system assumed by the Payments System Board

<sup>584</sup> Wallis Inquiry Recommendation 61.

<sup>585</sup> Wallis Inquiry Recommendation 62.

<sup>586</sup> Wallis Inquiry Recommendation 62

(a) The Prudential Regulator: The Australian Prudential Regulation Authority (APRA)<sup>587</sup> was established under its own legislation in 1998 by the Australian Prudential Authority Act.<sup>588</sup> APRA operates outside and independent of the central bank. It has the responsibility of prudential supervision and focuses on the safety and soundness of the entities it supervises. It has to enforce standards of prudential behaviour on all institutions that take deposits (Authorised Deposit-taking Institutions – ADIs)<sup>589</sup> and on all life insurance and general insurance companies as well as on large superannuation funds, thereby assuming the previous roles of the RBA, the Insurance and Superannuation Commission and the Australian Financial Institutions Commission relating to prudential regulation and supervision. As indicated above, the banking supervision function previously exercised by the RBA in terms of the Banking Act 1959 was transferred from the RBA to APRA.<sup>590</sup> In addition to its prudential duties APRA also has a statutory duty to “promote” financial system stability in Australia<sup>591</sup> and, in collaboration with the RBA, it is responsible for dealing with institutions that are unable to meet their obligations;<sup>592</sup>

(b) The Market Conduct Regulator: The Australian Securities and Investments Commission (ASIC),<sup>593</sup> was established when the then existing Australian Securities Commission was converted into ASIC. ASIC is governed by the Australian Securities and Investments Commission Act 2001.<sup>594</sup> ASIC has expanded responsibilities for

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<sup>587</sup> The name that the Wallis Inquiry suggested for the prudential regulator, namely the Australian Prudential Regulation Commission (APRC), as discussed in paragraph 3.2 above, was thus substituted with the name Australian Prudential Regulation Authority (APRA).

<sup>588</sup> Act 50 of 1998, hereinafter the APRA Act.

<sup>589</sup> Group 30 2008 188: Banking services in Australia are provided by Authorised Deposit-Taking Institutions (ADIs), which include banks, building societies, and credit unions. Four banks dominate the local market: the Australia and New Zealand Banking Group Limited, Commonwealth Bank of Australia, the National Australia Bank Limited, and Westpac Banking Corporation.

<sup>590</sup> Section 9(3) of the Banking Act 1959 (before it was amended in 1998) determined that the Governor-General of the RBA may grant a body corporate authority to carry on banking business in Australia. Section 9(3) of the Banking Act was amended in 1998 by the Financial Sector Reform (Amendments and Transitional Provisions) Act 1 of 1999 to read “If an application has been made, APRA may grant the body corporate an authority to carry on banking business in Australia. The authority must be in writing, and APRA must give the body corporate written notice of the granting of the authority.”

<sup>591</sup> Section 8(2) APRA Act, see discussion below in 3.5.1.

<sup>592</sup> Council of financial regulators – Annual report 2002 – Printed by Reserve Bank of Australia (2002) <http://www.rba.gov.au/publications/annual-reports/cfr/2002/cfr.html> (accessed 22 March 2017), hereinafter Council of Financial Regulators 2002, at 8; RBA history 2; Group of Thirty 2008 31 and 189; IMF 12/308 24.

<sup>593</sup> The name that the Wallis Inquiry suggested for the market integrity and consumer protection regulator, namely the Corporations and Financial Services Commission (CFSC), as discussed in paragraph 3.2 above, was thus substituted with the name Australian Securities and Investments Commission (ASIC).

<sup>594</sup> Act 51 of 2001, hereinafter the ASIC Act.

consumer protection and market integrity in areas such as superannuation and insurance across the financial system and has to maintain, facilitate and improve the performance of the financial system and the entities within that system.<sup>595</sup> As explained in more detail below, it is responsible for taking certain regulatory actions to minimise systemic risk in clearing and settlement systems, working with the RBA.<sup>596</sup> ASIC issues guidelines, including guidelines for preferred practices, regulatory guidelines, and codes of conduct. It also has a wide range of enforcement powers.<sup>597</sup>

(c) The Central Bank: The Reserve Bank of Australia (RBA) operates as central bank within the Australian Twin Peaks system and has responsibility for monetary policy, overall financial system stability, interest rates and regulation of the payments system. It is responsible for ensuring that licensed clearance and settlement facilities for securities and derivatives conduct their affairs in a manner consistent with financial stability. The RBA is also tasked to act as lender of last resort in providing liquidity support if necessary.<sup>598</sup>

Schmulow points out that the Australian model is thus in effect a three-peak model.<sup>599</sup> Each of the peaks is an independent, statutory body. Although APRA has a significant degree of statutory independence, it is accountable to the government and the Parliament and it is subject to an overriding policy determination power of the Treasurer. The three full-time Commissioners under whose direction ASIC operates, report to the Minister for Superannuation and Corporate Law and the Treasurer through their annual report and through briefings, submissions and meetings with the

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<sup>595</sup> Section 1(2)(a) ASIC Act: In performing its functions and exercising its powers, ASIC must strive to maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and promote the confident and informed participation of investors and consumers in the financial system; and administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements; and receive, process and store, efficiently and quickly, the information given to ASIC under the laws that confer functions and powers on it; and ensure that information is available as soon as practicable for access by the public; and take whatever action it can take, and is necessary, in order to enforce and give effect to the laws of the Commonwealth that confer functions and powers on it.

<sup>596</sup> See discussion below in paragraph 3.5.2.

<sup>597</sup> Godwin et al 2016 22; Council of Financial Regulators 2002 8; Group of Thirty 2008 31; RBA & APRA Financial Stability 2012 2; See discussion of this regulatory toolkit in paragraph 3.5.2 below.

<sup>598</sup> Schmulow A "Twin Peaks: an analysis of the Australian architecture" in Jung HJ (editor) 2016 *Proceedings of the 2016 Global Forum for Financial Consumers* 2016 9, hereinafter Schmulow 2016 no. 2; See also Schmulow 2015 no. 2 41; Council of Financial Regulators 2002 8; Group of Thirty 2008 31; IMF 12/308 24.

<sup>599</sup> Schmulow 2015 no. 1 169.

Treasurer or Parliamentary Secretary and both APRA and ASIC are accountable to the Federal Parliament by way of submission of Annual Reports.<sup>600</sup>

As indicated above the Wallis Inquiry recognised the need for information sharing and coordination between the key regulators and recommended that the Council of Financial Supervisors be converted to of a Council of Financial Regulators (CFR) in order to coordinate a broad range of activities to facilitate the cooperation between the RBA, APRA and ASIC.<sup>601</sup> The CFR was subsequently established in 1998 and is discussed in more detail below.<sup>602</sup>

### **3.4 The role of the RBA in the Australian Twin Peaks system**

The responsibilities that the RBA had pre-Twin Peaks in respect of monetary policy, systemic stability and lender of last resort, remained largely the same in the Twin Peaks dispensation introduced in 1998 with the exception of the prudential regulation of banks that was excised from its remit and moved over to APRA, and the addition of a separate Payments System Board constituted within the RBA to deal with payment system matters. With the commencement of the APRA Act, the Reserve Bank Act of 1959 was amended by the Financial Sector Reform (Amendments and Transitional Provisions) Act 54 of 1998<sup>603</sup> with the insertion of section 10A that established the Payments System Board.<sup>604</sup> Notably, with the enactment of the Financial Sector Reform (Consequential Amendments) Act 48 of 1998, the definition of “bank” was

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<sup>600</sup> Group of Thirty 2008 192 and 192; IMF 12/308 24 and Group 30 2008 189: The Treasury is also involved in financial regulation by providing policy advice to the government. The Minister has the legal power to give policy direction to APRA and ASIC, although this power has not been used in the case of APRA and only used once in the case of ASIC; See also Huang RH “The regulation of shadow banking in China: International and comparative perspectives” 2015 *Banking and Finance Law Review* 30 493, hereinafter Huang 2015.

<sup>601</sup> Wallis Inquiry Recommendation 112 discussed above; Godwin et al 2016 23.

<sup>602</sup> CFR History. See 3.6.1 below for more on the CFR.

<sup>603</sup> In this Act the word “Board” in the Reserve Bank Act was substituted with “Reserve Bank Board” and sections 8A, 10A, 10B and 10C as well as sections 25A to 25L were inserted in the Reserve Bank Act.

<sup>604</sup> Section 10A Reserve Bank Act. The Banking Act of 1959 was also amended by the Financial Sector Reform (Amendments and Transitional Provisions) Act to transfer prudential supervision from the RBA to APRA.

removed from the Reserve Bank Act and the definition for an ADI (authorised deposit-taking institution) was inserted to refer to a body corporate that is an ADI for the purposes of the Banking Act 1959. In three sections of the Reserve Bank Act, the word “bank” was therefore substituted with the word “ADI”, specifically with regard to membership of the Reserve Bank Board; the RBA acting as agent of an ADI and debts due to the RBA by an ADI (thus not for supervision purposes as this function had been removed from the remit of the RBA).<sup>605</sup>

As a result of the establishment of the Payments System Board in 1998,<sup>606</sup> the RBA then had two Boards with complementary responsibilities namely the Reserve Bank Board and the Payments System Board that were both accountable to the Australian Parliament.<sup>607</sup> The Reserve Bank Board was responsible for the Bank’s monetary and banking policy, and the Bank’s policy on all other matters, except for its payments system policy.<sup>608</sup> The Payments System Board was responsible for the Bank’s payments system policy.<sup>609</sup> Section 10B provided that the Payments System Board had the power to determine the RBA’s payments system policy.<sup>610</sup> It had the power to take whatever action was necessary to ensure that the RBA gave effect to the policy it determined.<sup>611</sup>

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<sup>605</sup> In section 17 of the Reserve Bank Act, it is stated that a person who is a director, officer or employee of an ADI is not capable of appointment as a member of the Reserve Bank Board; and in section 75 it is determined that the RBA may act as the agent of an ADI carrying on business within or beyond Australia; and in section 86 it is stipulated that debts due to the RBA by an ADI shall in die winding-up of such and ADI, have priority over all other debts. The Financial Sector Reform (Consequential Amendments) Act 1998 made consequential amendments related to the enactment of the Financial Sector Reform (Amendments and Transitional Provisions) Act 1998, and for other purposes.

<sup>606</sup> In 1959 the RBA had only one Board.

<sup>607</sup> Section 8A(1) Reserve Bank Act; See also Group 30 2008 191; Bird J “Regulating the regulators: Accountability of Australian Regulators” 2011 (35) *Melbourne University Law Review* 769 states that the RBA has governance arrangements that resemble those of public company boards. The Reserve Bank Board and the Payment Systems Board of the RBA have both executive and non-executive directors.

<sup>608</sup> Section 8A(2).

<sup>609</sup> Section 8A(3). Section 10C(1): Differences between the two Boards will be resolved so that if a policy determined by the Reserve Bank Board and a policy determined by the Payments System Board are inconsistent, the Reserve Bank Board’s policy prevails and the Payments System Board’s policy has effect as if it were modified to remove the inconsistency. Section 10C(2): If there is a disagreement between the Reserve Bank Board and the Payments System Board as to whether there is an inconsistency of policy between them, disagreement is to be resolved as determined by the Governor. Section 10C(3): If there is a disagreement between the Reserve Bank Board and the Payments System Board as to which of the Boards is responsible for determining the Bank’s policy on a matter, such disagreement is also to be resolved as determined by the Governor.

<sup>610</sup> Section 10B(1).

<sup>611</sup> Section 10B(2).

Section 10B(3) provided that it was the duty of the newly established Payments System Board to ensure, within the limits of its powers, that:

“(a) the RBA’s payment system policy is directed to the greatest advantage of the people of Australia; and

(b) the powers of the RBA under the Payments System (Regulation) Act 1998 and the Payment Systems and Netting Act 1998 are exercised in a way that, in the Payments System Board’s opinion, will best contribute to (i) controlling risk in the financial system; and (ii) promoting the efficiency of the payments system; and (iii) promoting competition in the market for payment services, consistent with the overall stability of the financial system; and

(c) the powers and functions of the RBA under Part 7.3 of the Corporations Act 2001<sup>612</sup> are exercised in a way that, in the Board’s opinion, will best contribute to the *overall stability* of the financial system.”<sup>613</sup>

As part of the RBA, the Payments System Board, although not the main decision maker on financial stability, thus also had to assist with financial stability by supervising the payments system, inter alia by ensuring its smooth operation, addressing risks and making sure that the functions and powers of the RBA are executed so as to contribute to financial system stability. The Reserve Bank Board had to inform the Government, from time to time, of the Bank’s monetary and banking policy and the Payments System Board had a similar duty in respect, of the Bank’s payments system policy.<sup>614</sup>

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<sup>612</sup> Act 50 of 2001. The licensing of clearing and settlement facilities is governed by Part 7.3 of the Corporations Act 2001. The powers and functions of the RBA under Part 7.3 of the Corporations Act in relation to the licensing of clearing and settlement facilities thus have to be exercised in a way that, in the Payments System Board’s opinion, will best contribute to the overall stability of the financial system.

<sup>613</sup> Author’s emphasis.

<sup>614</sup> Section 11(1)(a) and (b). Section 11(2) – (7): The Treasurer and the relevant Board are obliged to solve differences of opinion about policies to be adopted between the Board and the Government by agreement (section 11(2)). If the Treasurer and the Board are unable to reach an agreement, the Governor-General, acting with the advice of the Federal Executive Council, may determine the policy to be adopted by the RBA. The Government will then accept responsibility for the adoption of the policy by the RBA. The relevant Board must give effect to the policy. Copies of the policy as well as the statement by the Government and the statement by the relevant Board in relation to the difference of opinion have to be laid before each House of the Parliament by the Treasurer; The Treasurer and the Governor of the Reserve Bank “Statement on the Conduct of Monetary Policy” (30 September 2010) [http://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-5-3009201\\_0.html](http://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-5-3009201_0.html) (accessed 10 May 2017), hereinafter Statement Monetary Policy 2010: The procedures in section 11 of the Reserve Bank Act, in effect, allow the Government to determine policy in the event of a material difference; but

The newly established Payments System Board consisted of the Governor, one representative of the Bank, one representative of APRA and up to five other members<sup>615</sup> and was chaired by the Governor of the RBA.<sup>616</sup> The composition of the Reserve Bank Board also changed in some respects in 1998 inter alia by providing for only one Deputy Governor (and not two as was previously the case) to sit on the Board.<sup>617</sup>

The RBA's roles within the Twin Peaks model thus included the overall stability of the financial system, the safety and reliability of the payments system as well as monetary policy. The RBA further remained the sole currency-issuing authority<sup>618</sup> and banker to the federal government.<sup>619</sup> It also retained its role as lender of last resort to ADIs.<sup>620</sup>

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the procedures are politically demanding and their nature reinforces the RBAs independence in the conduct of monetary policy. According to the Monetary Policy Statement 2010 safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

<sup>615</sup> Section 25A. Section 25B(1) – (5): The member who is the representative of the Bank is to be appointed by the Governor. The person appointed must be a member of the Reserve Bank Board or a staff member of the Reserve Bank Service. The member who is the representative of APRA is to be appointed by APRA. The person so appointed must be an APRA member or an APRA staff member. Each other member is to be appointed by the Treasurer for a period specified in the instrument of appointment. The period specified must not exceed 5 years. All appointments are to be in writing and are to be on a part-time basis. The Governor is an ex officio member of the Payments System Board (and so is not separately appointed to the Board).

<sup>616</sup> Section 25C.

<sup>617</sup> Since 1998 the RBA was managed in terms of sections 10 and 10B of the Act, Section 12(3): A Deputy Governor shall perform such duties as the Governor directs and, in the event of a vacancy in the office of Governor, the Deputy Governor designated by the Treasurer shall perform the duties of the Governor and shall have and may exercise the powers and functions of the Governor. The words “designated by the Governor” again fell away in this sub-section in 1998. Section 14(1) – (2): These sections as in 1959 were amended so that the Board in 1998 had only one Deputy Governor and not two, and the “other members” changed from seven to six members and they were appointed by the Treasurer, instead of the Governor-General as in 1959. Section 14(1) - (6): An official means a staff member of the Reserve Bank Service or a person appointed or engaged under the Public Service Act 1999. A member who is an official at the time of his or her appointment holds office during the pleasure of the Treasurer. A member who is not an official is to be appointed for a period, not exceeding 5 years, specified in the instrument of appointment; and holds office subject to good behaviour. Section 20: In 1998 since there was only one Deputy Governor at that stage, the words “designated by the Governor” fell away. The Governor is the Chairperson of the Reserve Bank Board and the Deputy Governor is the Deputy Chairperson of the Reserve Bank Board.

<sup>618</sup> Section 34 of Reserve Bank Act.

<sup>619</sup> Section 27 of Reserve Bank Act.

<sup>620</sup> Group 30 2008 191.

As indicated in paragraph 3.3 above the RBA as Australian central bank had a longstanding implied financial stability mandate in the pre-Twin Peaks dispensation as inferred from a purposive interpretation of section 10 of the Reserve Bank Act and from the broader context of its roles as central bank.<sup>621</sup> Prior to the conversion to a Twin Peaks model of financial regulation the mandate of the RBA with regard to financial stability was thus not expressly and comprehensively captured in the Reserve Bank Act but was of an implicit de facto nature.

It appears that the move towards Twin Peaks did also not result in any express changes to the Reserve Bank Act at the time of the introduction of the new model in 1998 to specifically and comprehensively set out the RBA's role with regard to financial stability. This is most probably due to the fact that pre-GFC, although regulatory appreciation of the importance of financial stability was mounting, it was not general practice to capture in express terms either the central bank's financial stability mandate or its role as lender of last resort and how these roles should be executed.<sup>622</sup> The financial stability mandate of the RBA was merely confirmed in 1998 when APRA was created and the then Treasurer explicitly referred to financial stability being the regulatory focus of the RBA in the Second Reading Speech for the APRA Act.<sup>623</sup> Revised, though basically unchanged, statements were published in July 2003 and September 2006.<sup>624</sup>

## **3.5 APRA and ASIC**

### **3.5.1 APRA**

As mentioned above, the Australian Prudential Regulation Authority (APRA) was established in 1998 by the Australian Prudential Regulation Authority Act (the APRA

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<sup>621</sup> Schmulow 2017.

<sup>622</sup> See discussion above in Chapter One paragraph 1.4.2.

<sup>623</sup> Statement Monetary Policy 2010.

<sup>624</sup> RBA history 2.

Act) under the Twin Peaks model. APRA is an integrated national prudential regulator of all ADIs, friendly societies, insurance companies including life insurance and general insurance and superannuation funds.<sup>625</sup> Notable about APRA in the context of the Australian Twin Peaks model is the fact that, like the RBA, it also has a mandate with regard to financial stability<sup>626</sup> - and in particular it is important to note that this mandate has been captured in express terms in the APRA Act. Given the close interaction between the mandates of the RBA and APRA insofar as financial stability is concerned, it is thus submitted that the responsibility for financial stability in Australia can be regarded as a shared mandate between the RBA and APRA.

Although the RBA and APRA share the financial stability mandate in Australia, the RBA has the final say with regard to matters relating to financial stability. This is evident from the role that the RBA plays both in mitigating the risk of financial disturbances with potentially systemic consequences, and in responding in the event that a financial system disturbance does occur.<sup>627</sup>

The interaction between the mandates of the RBA and APRA insofar as financial stability in Australia is concerned can best be understood by having regard to the following insightful explanation by Malcolm Edey, former Assistant Governor to the RBA:<sup>628</sup> Edey remarks that “It is sometimes said in answering that question that the Bank is the macroprudential authority in Australia and APRA is the microprudential authority. The implication is that the bank looks at stability from the point of view of the system while APRA looks only at the individual institutions. I think that is at best an oversimplification and is an unhelpful way to look at the two institutional roles. It presupposes that it is possible to focus on the system as a whole without taking an

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<sup>625</sup> Council of Financial Regulators 2002 8 and at 9: APRA regulates the compliance of superannuation funds with the prudential regulation and retirement income provisions of the Superannuation Industry (Supervision) Act 1993, while ASIC has responsibility for the other provisions; See also Cooper 2006 6.

<sup>626</sup> Schmulow 2016 no. 2 10

<sup>627</sup> Reserve Bank of Australia – Financial Stability “Role of the Reserve Bank in maintaining financial stability” (undated) <https://www.rba.gov.au/fin-stability/reg-framework/role-of-the-reserve-bank-in-maintaining-financial-stability.html> (accessed 16 February 2018) 1.

<sup>628</sup> Edey M “The Financial Stability Role of Central Banks” Address delivered at the Thomson Reuters Australian Regulatory Summit Sydney (1 May 2013) <https://www.rba.gov.au/speeches/2013/sp-ag-010513.html> (accessed 25 November 2017), hereinafter Edey 2013.

interest in the individual components or, conversely, that an agency can sensibly look at parts without being interested in how they interact with the whole. The difference between the two roles, I suggest, is best understood in terms of their powers and responsibilities rather than their objectives. APRA has powers and responsibilities that relate mainly to individual institutions, but its legislative mandate includes stability of the system, and it can adjust its prudential settings to address system-wide concerns. The RBA has a broad financial stability mandate, existing in conjunction with other macro-economic objectives and attached to a very different set of powers.”

Edey thus states that in a legal sense, the RBA is authorised to provide financial services to the government and to the financial system, and has significant powers to engage in financial activities in the public interest. Those powers enable the RBA to act as lender of last resort and liquidity manager for the financial system in addition to its monetary policy role. He indicates that when Bank supervisory powers were shifted from the RBA to APRA under the 1998 Wallis Reforms, the Bank’s general mandate to use its powers to promote financial stability was reaffirmed. The Wallis Reforms and subsequent legislative changes also gave the RBA significant regulatory powers in relation to the resilience of the payments system and of financial markets infrastructure. Thus Edey concludes: “...the RBA and APRA have different powers but overlapping and complementary objectives in relation to financial stability.”<sup>629</sup>

During the research for purposes of this thesis it became evident that in the Australian Twin Peaks model APRA features very prominently probably because its financial stability mandate, although distinct, is largely on par with that of the RBA. Therefore it is apposite when considering the role of the RBA in promoting and maintaining financial stability to also consider in some detail how APRA approaches its distinct mandate to “promote” financial stability and what its powers in this regard entail given that the mandates of the RBA and APRA are complementary. The further rationale for delving deeper into APRA’s execution of its “prudential regulation cum financial stability” mandate is to get a better grasp of how prudential regulation with a dedicated

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<sup>629</sup> Edey 2013.

financial stability focus is undertaken as this may be of value to South Africa in guiding the future approach to be taken by the new South African Prudential Authority.

As provided by section 8(1) of the APRA Act, the main purposes for which APRA exists are to prudentially regulate bodies<sup>630</sup> in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation<sup>631</sup> or for retirement income standards; to administer the financial claims schemes<sup>632</sup> provided for in the Banking Act 1959 and the Insurance Act 1973; to develop the administrative practices and procedures to be applied in performing that regulatory role and administration.<sup>633</sup> In performing and exercising its functions and powers, APRA is obliged to balance the objectives of financial safety and efficiency, competition, contestability<sup>634</sup> and competitive neutrality and, in balancing these objectives, to “promote financial system stability in Australia”.<sup>635</sup> The Treasurer’s Statement of Expectations in 2007 which noted that prudential regulation seeks to reduce market failure by limiting the systemic

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<sup>630</sup> Section 3(2) of the APRA Act defines each of the following as a “body” regulated by APRA: (a) an ADI, within the meaning of the Banking Act 1959; (b) an authorised non-operating holding company (NOHC), within the meaning of the Banking Act 1959; (c) a general insurer, authorised NOHC or subsidiary of a general insurer or authorised NOHC, within the meaning of the Insurance Act 1973; (d) Lloyd’s, or a Lloyd’s underwriter, as defined in section 3 of the Insurance Act 1973; (e) a life company that is registered under section 21 of the Life Insurance Act 1995 or a registered NOHC within the meaning of that Act; (ea) a private health insurer, within the meaning of the Private Health Insurance (Prudential Supervision) Act 2015; (f) the trustee of a superannuation entity, within the meaning of the Superannuation Industry (Supervision) Act 1993; (g) a retirement savings account provider, within the meaning of the Retirement Savings Accounts Act 1997; Group 30 2008 189 and 190: The Insurance Act 1973 and the Life Insurance Act 1995 gives APRA the duty to protect insurance policyholders. The General Insurance Reform Act 2001 amended the Insurance Act 1973, and supports APRA’s prudential supervision framework for general insurance, and gives it increased flexibility for establishing and enforcing more stringent standards on capital adequacy, liability valuation, risk management, and reinsurance.

<sup>631</sup> Section 3 APRA Act: Prudential regulation or advice services means services of either or both of the following kinds: (a) services consisting of APRA performing a role in the prudential regulation or supervision of entities; (b) services consisting of APRA providing advice relating to the prudential regulation or supervision of entities.

<sup>632</sup> IMF 12/308 9: To strengthen market and consumer confidence, the government introduced the Financial Claims Scheme in October 2008 where deposits up to A\$1 million per account holder per ADI were guaranteed. A separate fee-based, unlimited, guarantee was introduced at the same time for wholesale funding instruments and large deposits above A\$1 million. These guarantee schemes reassured depositors and investors and helped keep Australian banks’ access to offshore funding open.

<sup>633</sup> Section 8(1).

<sup>634</sup> Economics online – definitions (undated) <http://www.economicsonline.co.uk/Definitions/Contestability.html> (accessed 12 January 2018): Market contestability refers to the ease with which new firms can enter and leave a market. A perfectly contestable market is one with no entry or exit costs.

<sup>635</sup> Section 8(2). See also Godwin et al 2016 25.

risks associated with breaches of financial promises, affirmed APRA's financial stability mandate.<sup>636</sup>

APRA has three main categories of powers in regulating financial institutions: authorisation or licensing powers; supervision and monitoring powers; and powers to act in circumstances of financial difficulties to protect depositors, policy holders and superannuation fund members, including powers relating to taking control of entities and/or winding up insolvent entities.<sup>637</sup> Cooper describes APRA as primarily a supervisory agency with its main aim to ensure that financial undertakings from regulated entities are met within steady, effective and competitive financial markets. APRA makes sure that the quality of a financial institution's systems for identifying, measuring and managing the various risks in its business (including, for example, adequacy of capital) are sound and act to reduce the risk of failure. When failure does occur, APRA works to maintain public confidence (and thus financial stability) in the financial system by helping the entity make an orderly exit from the market.<sup>638</sup> ADIs are regulated by APRA under a single licensing regime and are all covered by the depositor protection provisions of the Banking Act 1959 which empowers APRA to act in the interest of depositors when necessary.<sup>639</sup> It is important to note that APRA is the only agency in Australia who has the power to use the tools available for macroprudential supervision in order to change the behaviour of financial institutions.<sup>640</sup> APRA is able to respond to risks through direct intervention if necessary. For example, reflecting risks within individual institutions, APRA often imposes minimum prudential capital requirements for individual ADIs beyond the minimum requirements of the Basel framework.<sup>641</sup> APRA also has a wide range of legislated powers that enable it to take direct action if it identifies behaviour or financial

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<sup>636</sup> The Treasurer "Statement of Expectations for APRA" (20 February 2007) <http://www.apra.gov.au/AboutAPRA/Documents/Statement-of-Expectations-from-Treasurer-20-Feb-07.pdf> (accessed 1 February 2018); See also RBA & APRA Financial Stability 2012 2.

<sup>637</sup> Cooper 2006 6; See further Thompson G "APRA – its objectives and powers" (27 October 1998) [http://www.apra.gov.au/Speeches/Pages/98\\_09.aspx](http://www.apra.gov.au/Speeches/Pages/98_09.aspx) (accessed 13 January 2018).

<sup>638</sup> Cooper 2006 6.

<sup>639</sup> Section 12 Banking Act 1959; Council of Financial Regulators 2002 8.

<sup>640</sup> RBA & APRA Financial Stability 2012 14.

<sup>641</sup> Arner 2011 1599 – 1600: Basel III introduced capitalization requirements focused on common equity capital. The total minimum capital remains at 8%. However, the minimum for common equity capital is 4.5%, with Tier 1 capital at 6%, leaving Tier 2 at most 2%. In addition, there will be a 2.5% conservation buffer, made up of common equity, for a minimum capital adequacy ratio of 10.5%. Finally, there will be the possibility for an additional countercyclical buffer of 0% - 2.5% of common equity.

distress that may threaten an ADI's ability to meet its financial obligations to depositors, or otherwise threaten financial system stability. These include powers to obtain information from an ADI;<sup>642</sup> investigate an ADI;<sup>643</sup> give binding directions to an ADI (such as to recapitalise);<sup>644</sup> and, in more extreme circumstances, appoint a statutory manager to assume control of a distressed ADI<sup>645</sup> or take control of the institution itself.<sup>646</sup> If the difficulties prove unmanageable, APRA can apply to the courts to wind-up the ADI.<sup>647</sup> APRA also has the power to revoke licences,<sup>648</sup> to make prudential standards<sup>649</sup> or issue enforceable directions.<sup>650</sup>

Under APRA's directions power, in terms of the Banking and Insurance Acts, APRA possesses the broad ability to direct firms.<sup>651</sup> This power is triggered if an entity is

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<sup>642</sup> In terms of section 13(1) of the Banking Act ADI's have to supply information to APRA when required to do so; and in terms of section 13(2) an ADI has to inform APRA if the ADI is likely to become unable to meet its obligations or if it is about to suspend payment.

<sup>643</sup> Section 13(4), 13A(1) and 61 of the Banking Act: APRA may investigate the affairs of an ADI under various circumstances.

<sup>644</sup> Section 11CA of the Banking Act: APRA may give directions to ADIs and authorised NOHCs in certain circumstances.

<sup>645</sup> See Division 2 Subdivision B of the Banking Act for provisions regarding the dealing with control of an ADI's business by an ADI statutory manager, specifically section 13BA that authorises APRA to give notice that an ADI statutory manager will take control of the business of the ADI.

<sup>646</sup> Section 13A(1) and section 65 of the Banking Act. Council of Financial Regulators 2002 8: As in the case of ADIs, where the financial weakness of a life company, general insurer, friendly society or superannuation fund could have a detrimental effect on the interests of members and policyholders, APRA may intervene in the management of the troubled entity. In the case of superannuation, the Minister for Revenue and Assistant Treasurer can on public interest grounds, compensate members of a fund for losses due to fraudulent conduct or theft if the public interest requires it. The assistance can be funded either from Consolidated Revenue or by levying other funds within the industry. Again, however, members' and policyholders' entitlements are not guaranteed by either APRA or the Government.

<sup>647</sup> Section 14F of the Banking Act.

<sup>648</sup> Sections 9(4)(b), 9A and 11AB of the Banking Act.

<sup>649</sup> See section 11AF of the Banking Act with regards to prudential standards that APRA may determine for ADIs and authorised NOHCs; section 32 of the Insurance Act 1973 for prudential standards that APRA may determine for insurers; and section 230A of the Life Insurance Act 1995 for prudential standards that APRA may make for life companies.

<sup>650</sup> Division 1BA of the Banking Act with regard to APRA's power to issue directions, sections 11CA to 11CB. See further RBA & APRA Financial Stability 2012 15; Council of Financial Regulators 2002 8.

<sup>651</sup> For example in terms of Division 1BA of the Banking Act 1959, APRA has the power to issue directions to ADIs to enforce certified industry support contracts (sections 11CB and 11CC); as well as directions other than to enforce certified industry support contracts (section 11CA), for instance directions that a body corporate has to comply with the Banking Act or the Financial Sector (Collection of Data) Act 2001. In terms of Subdivision AA of the Banking Act, APRA may give recapitalisation directions to ADIs to increase its level of capital to the level specified in the direction (sections 13D to 13R). In terms of the Insurance Act 1973, APRA may give directions to a body corporate that is a general insurer or authorised NOHC that is, or is likely to become unable to meet its liabilities or has contravened or failed to comply with a provision of the Insurance Act, relating to certain assets (section 51) or to prohibit the issuing of policies or undertaking of liability under contracts of insurance (section 60).

unable to observe its regulatory requirements, or APRA considers that the entity is operating unsoundly, or in a manner that could reasonably lead to its failure. Importantly, the directions power triggers well before actual or imminent failure by a regulated firm, so when necessary APRA can issue directions timeously to avert failure.<sup>652</sup>

The APRA structure also supports an appropriate supervisory response to potential systemically important entities. The Diversified Institutions Division in APRA is a separate supervisory division for large and complex financial groups.<sup>653</sup> In this division supervisor skills and knowledge are concentrated so that prudential supervision of these financial groups is strengthened. Furthermore the size of supervision teams in APRA is adapted so that larger entities will have more dedicated supervisors and a single supervisor may look after smaller and less complex institutions. In this way APRA is able to supervise potential SIFIs in an appropriate and proportionate manner.<sup>654</sup>

As pointed out above, APRA not only supervises financial institutions on an individual micro-level but is also mandated to take a system-wide view of the financial sector.<sup>655</sup> It uses various measures to implement this systemic perspective, like its risk-based

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<sup>652</sup> RBA & APRA Financial Stability 2012 15 and 16.

<sup>653</sup> Prudential Standard APS 001 (January 2013) [http://apra.gov.au/adi/PrudentialFramework/Documents/120928-APS-001\\_FINAL.pdf](http://apra.gov.au/adi/PrudentialFramework/Documents/120928-APS-001_FINAL.pdf) (accessed 13 January 2018): APRA defined various levels of ADIs and authorised NOHCs.

<sup>654</sup> RBA & APRA Financial Stability 2012 18. APRA thus determines what level of supervision would be applied to each entity, including ADIs, general insurers and life companies, and which entities would be regarded as SIFIs and be supervised accordingly; APRA Supervision Blueprint (May 2015) <http://www.apra.gov.au/AboutAPRA/Documents/APRA-Supervision-Blueprint-FINAL.pdf> (accessed 13 January 2018) at 10: Supervisors increase the intensity of supervisory intervention in line with a regulated entity's risk profile to ensure that any issues are addressed before they pose a threat to the regulated entity or its beneficiaries; See also "Letter to industry" (August 2016) <http://www.apra.gov.au/CrossIndustry/Documents/Supervision%20of%20Conglomerate%20Groups%20-%20August%202016%20Response%20letter.pdf> (accessed 13 January 2018) for an example of letter from APRA to ADIs, general insurers and life companies regarding supervision of conglomerate groups.

<sup>655</sup> RBA & APRA Financial Stability 2012 4: Such a system-wide view involves looking both at the whole system as a single unit and at the way interactions of different parts of the system might feed back onto others. For example, decisions by lenders will affect their counterparties, and through the effect of credit supply on asset prices, will also affect others who are not their customers but own those assets. Taking a system-wide view also involves a recognition that financial instability will occur long before the median or average member of a particular sector becomes distressed: risks manifest in the most vulnerable segments. Therefore it is important to analyse both aggregated and disaggregated data.

approach with more intensive supervision and potentially higher capital towards institutions with a greater systemic risk. APRA therefore has to consider the whole financial system as well as the way that different parts of the system interplays with each other (a combination of macro- and microprudential supervision). The systems, tools and processes that APRA uses to monitor trends and potential risks in the financial industry includes its horizontal reviews and industry-wide stress tests<sup>656</sup> to identify and act on risks that might emerge throughout the financial industry. APRA's Industry Analysis team consists of a cross-divisional forum of industry groups with senior representatives coming from the supervision industry and technical services, as well as from the analysis industry including also people with policy, statistics and legal backgrounds. When such macroprudential risks have been identified, APRA develops suitable responses to mitigate those risks. It is furthermore necessary to curb behaviours that may point to vulnerabilities in future, like over-exuberance, excessive risk-taking and rent-seeking behaviour.<sup>657</sup>

In terms of section 10 of the APRA Act, APRA must advise the Minister as soon as practicable if it considers that a body regulated by it is in financial difficulty.<sup>658</sup> It *must* advise the Minister, if requested by the Minister, and *may* advise the Minister on its own initiative, regarding matters that would improve the financial safety and efficiency, competition, contestability or competitive neutrality of the sectors in which the bodies regulated by APRA operate;<sup>659</sup> or changes to, or in relation to, any prudential regulation framework law that APRA considers would overcome or assist in overcoming problems it has identified in the course of performing or exercising any of its functions and powers.<sup>660</sup> In addition, APRA *must* advise the Minister, if so requested, and *may*

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<sup>656</sup> Blaschke W, Jonets MT, Majnoni G & Peria SM "Stress testing of financial systems: An overview of Issues, Methodologies and FSAP Experiences" - IMF working paper WP/01/88 (June 2001) <https://www.imf.org/external/pubs/ft/wp/2001/wp0188.pdf> (accessed 23 March 2017) at 4: Stress testing is done by simulating vulnerabilities to major changes in the macro-economic environment and to see how these stressors affect regulated entities and/or the entire financial sector.

<sup>657</sup> RBA & APRA Financial Stability 2012 4.

<sup>658</sup> Section 10(1). Australian Prudential Authority *Annual Report 2016/2017 – Statutory Report* (2016/2017) <http://www.apra.gov.au/AboutAPRA/Publications/Pages/APRA-AR-2017-Statutory-Report.htm> (accessed 13 January 2018): The Minister who has the portfolio for APRA is the Treasurer of the Commonwealth of Australia. He is assisted in this role by the Minister for Revenue and Financial Services.

<sup>659</sup> Section 10(2)(a).

<sup>660</sup> Section 10(2)(b).

advise the Minister on its own initiative, regarding any of the Minister's functions and powers in terms of the APRA Act.<sup>661</sup>

Section 11 of the APRA Act further states that APRA has the power to do anything that is necessary or convenient to be done for or in connection with the performance of its functions. It is submitted that this is an important catch-all provision that basically extends APRA'S powers should circumstances arise that require to be addressed but for which no specific power has been allocated in the Act.

Prudential regulation by APRA in the period before the GFC was however not without challenges: In March 2001 the large Australian insurance group HIH collapsed, an event that proved to be very significant for the approach to financial regulation in Australia. As pointed out by Schmulow, at the time of the collapse of HIH, it was the second largest insurance company in Australia and this made HIH's collapse one of the biggest in the history of corporations in Australia.<sup>662</sup> A Royal Commission, headed by Justice Owen, was appointed by the Government to investigate what went wrong with the general insurer.<sup>663</sup> For purposes of strengthening prudential regulation in Australia the Commission recommended that APRA should develop a more aggressive approach to prudential regulation, for instance by introducing questioning of a more sceptical nature.<sup>664</sup> It was suggested that this more aggressive approach should also not be limited to general insurance. The Royal Commission recommended that APRA generally 'develop systems to encourage its staff and management continually to question their assumptions, views and conclusions about the financial

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<sup>661</sup> Section 10(3). See also section 12(1) of the APRA Act that determines that the Minister may give APRA a written direction about policies it should pursue, or priorities it should follow in performing or exercising any of its functions or powers.

<sup>662</sup> Schmulow 2016 no. 2 36.

<sup>663</sup> Australian Parliament *Report of the Royal Commission into HIH Insurance* (2003) <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22library%2Fprspub%2FXZ896%22> (accessed 14 October 2017).

<sup>664</sup> Recommendation 26. See also Ellis L and Littrell C "Financial stability in a low interest rate environment: an Australian case study" (2017) <http://www.rba.gov.au/publications/conf/2017/pdf/rba-conference-2017-ellis-littrell.pdf> (accessed 8 August 2017), hereinafter Ellis & Littrell 2017, at 3; See further Schmulow 2016 no. 2 37 – 39 regarding the implication of the findings of the Royal Commission's Report into HIH Insurance, that it is accepted in Australia that the Twin Peaks model will have to tolerate, from time to time, individual bank failure and whether it is realistic to assume that the financial system can tolerate the failure of a single bank; See also Cooper 2006 6; and Jensen & Kingston 2010 549.

viability of supervised entities, particularly on the receipt of new information about an entity'.<sup>665</sup> An illustration of where APRA's reforms enhanced prudential standards, occurred in 2002 when the prudential standards for the insurance industry were reformed by increasing capital requirements as well as strengthening reinsurance arrangements and promotion of appropriate risk management strategies and processes. Most general insurance companies successfully met the requirements of the new regime and were re-authorised.<sup>666</sup>

A significantly noteworthy development in its regulatory approach occurred when APRA codified its risk-based approach to financial regulation in October 2002 with the introduction of the Probability and Impact Rating System (PAIRS) and the Supervisory Oversight and Response System (SOARS).<sup>667</sup> Simply put, PAIRS is a framework that measures how risky an institution is in relation to APRA's objectives and SOARS determines how officials have to respond to that risk. More specifically, PAIRS is a consistent risk assessment tool that integrates risk of potential failure and its potential impact into a single measure of overall supervisory concern.<sup>668</sup> It separates the risk profile of regulated institutions into five categories: low, lower medium, upper medium, high and extreme. A key aspect of PAIRS is that it works on a multiplier not a linear scale. This results in a higher SOARS scale, which in turn, it is argued, compels a more aggressive supervisory response.<sup>669</sup> The type of risk that a financial institution may suffer is thus taken into account. The potential impact that a regulated entity might

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<sup>665</sup> Recommendation 28 as mentioned in Ellis & Littrell 2017 3.

<sup>666</sup> Council of Financial Regulators 2002 11. APRA's re-authorisation process involved a rigorous assessment of each general insurer's situation, business practices and plans. See Section 12 of the Insurance Act 1973 regarding obtaining authorisation from APRA to carry on insurance business in Australia.

<sup>667</sup> Council of Financial Regulators 2002 12; RBA & APRA Financial Stability 2012 17 and 18: PAIRS and SOARS are used by APRA for a measured and risk-based approach to supervision. This is done so that supervisory attention is focused on areas of an entity or industry which pose the greatest risk and to ensure that an appropriate supervisory response is taken, corresponding with the nature and degree of the risk. PAIRS assessments are undertaken by APRA to identify entities that are of potentially systemic importance by having a higher overall risk of failure and greater potential impact of failure. The SOARS framework is used to align APRA's supervisory stance with the risk facing entities. The SOARS grid is set in a way that APRA will respond earlier and more proactively towards larger institutions; See further Schmulow 2016 no. 2 9.

<sup>668</sup> Council of Financial Regulators 2002 1;. See APRA "Probability and Impact Rating System" (November 2010) [http://www.apra.gov.au/GI/Documents/PAIRS\\_112010\\_ex.pdf](http://www.apra.gov.au/GI/Documents/PAIRS_112010_ex.pdf) (accessed 13 July 2017) for an explanation of PAIRS as applied in 2010.

<sup>669</sup> Schmulow 2016 no. 2 11 points out that a similar system was used in the UK prior to the GFC and the ensuing collapse of the Royal Bank of Scotland.

have on the financial system is also divided into four categories namely low, medium, high and extreme. This rating is determined in relation to the regulated entity's total Australian resident assets, subject to a management override that can raise or lower the impact that the regulated entity might have on the financial system, depending on senior management's assessment. The size of the institution is thus furthermore taken into account.<sup>670</sup> PAIRS and SOARS are combined so that the PAIRS measure of supervisory concern is translated into a supervisory stance of one of the following: "normal", "oversight", "mandated improvement" or "restructure". Measureable assessments of probability and impact are put together in order to determine a Supervisory Attention Index while, in parallel, qualitative factors determine Supervisory Stance.<sup>671</sup> Schmulow however opines that while PAIRS examines a number of internal risk guides, an obvious omission is its failure to provide a formal assessment of industry-wide risks, which are particularly appropriate in an industry susceptible to contagion.<sup>672</sup>

The supervision of ADI conglomerates also changed in 2003 when APRA started supervising capital adequacy and large exposures and associations with related entities in a more sophisticated manner.<sup>673</sup> A further important development in the strengthening of prudential supervision of superannuation took place when the licensing and prudential requirements as well as the reporting framework for superannuation were changed in 2004.<sup>674</sup>

### **3.5.2 ASIC**

A comprehensive discussion of the role of ASIC is beyond the scope of this thesis and accordingly the discussion on ASIC hereinafter will be limited to those aspects that are

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<sup>670</sup> Schmulow 2016 no. 2 11.

<sup>671</sup> Council of Financial Regulators 2002 13.

<sup>672</sup> Schmulow 2016 no. 2 9.

<sup>673</sup> Council of Financial Regulators 2002 12 and 13.

<sup>674</sup> Council of Financial Regulators 2002 12.

relevant to its contribution in the context of financial stability within the Australian Twin Peaks model.

As mentioned above, the Australian Securities and Investments Commission (ASIC), was established on 1 July 1998 in terms of the Australian Securities and Investments Commission Act 1989 (the “old ASIC Act”)<sup>675</sup> when the Australian Securities Commission was converted into ASIC. ASIC is now governed by the Australian Securities and Investments Commission Act 2001 (ASIC Act).<sup>676</sup> It administers and enforces a range of legislative provisions relating to financial markets, financial sector intermediaries and financial products, including investments, insurance, superannuation, consumer credit and deposit-taking activities.<sup>677</sup> In terms of section 1(2) of the ASIC Act it is provided that in performing its functions and exercising its powers, ASIC must inter alia strive to

“(a) maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and  
(b) promote the confidence and informed participation of investors in the financial system;...”<sup>678</sup>

In terms of section 12A(2) ASIC has to monitor and promote market integrity and consumer protection in the Australian financial system and in terms of section 12A(6) ASIC has the power to do whatever is necessary for or in connection with, or reasonably incidental to, the performance of its functions. ASIC thus has responsibility for market integrity and consumer protection across the financial system. With this in mind, ASIC seeks to promote honesty and fairness in company affairs and securities

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<sup>675</sup> Section 254 of the ASIC Act determined that the “old ASIC Act” means the Australian Securities and Investments Commission Act 1989 as in force from time to time before the commencement of the ASIC Act. Section 261 of the ASIC Act determined that a body that was established under the old ASIC Act continues in existence as if it had been established under the ASIC Act.

<sup>676</sup> Act 51 of 2001, hereinafter the ASIC Act. See also discussion on Australia in Duggan A, Ziegel JS and Girgis J “The payment industry after the task force report: can Canada learn from the experience of others?” 2012 (53) *Canadian Business Law Journal* 180, hereinafter Duggan et al 2012, at 192.

<sup>677</sup> Council of Financial Regulators 2002 9.

<sup>678</sup> Schmulow 2016 no. 2 14: Schmulow points out that after the GFC there is little doubt that the market conduct objective of a regulator in the style of ASIC is just as important for financial system stability as a prudential regulator would be, since the GFC was the result of market misconduct as well as consumer abuse; See also Cooper 2006 7.

and futures markets through adequate and timely disclosure of market information. In addition, ASIC develops policy and guidance about the laws that it administers; licenses and monitors compliance by participants in the financial system; and provides comprehensive and accurate information on companies and corporate activity.<sup>679</sup>

As part of its consumer protection role, ASIC monitors and assesses compliance with the Code of Banking Practice, the Credit Union Code of Practice, the Building Society Code of Practice and the Electronic Funds Transfer Code of Practice and supervises a number of industry-based alternative dispute resolution schemes. ASIC also implements the provisions of the Financial Services Reform Act 2001,<sup>680</sup> which introduced a streamlined regulatory regime for market integrity and consumer protection across the financial services industry. These new arrangements came into force on 11 March 2002, with a two-year transition period. The Financial Services Reform Act provided for a harmonised licensing, disclosure and conduct framework for financial service providers, and a single statutory regime for financial product disclosure. At the same time, the framework allowed for flexible treatment of different financial products where appropriate (for instance basic deposit products are subject to less intensive regulation than more complex investment products).<sup>681</sup>

The multiple routes to licensing of securities and futures exchanges, and of clearing and settlement systems, have thus been replaced by a single licensing regime for the Australian financial market and for a clearing and settlement facility. Under the new arrangements, licensees have primary responsibility for the operation of markets and of clearing and settlement facilities; and the Minister of Finance has overall responsibility for licensing such entities. ASIC is empowered to advise the Minister on licensing matters and is also required to undertake assessments of the compliance of market and facility licensees with their legislative obligations, and to take enforcement action where necessary.<sup>682</sup> It has general powers to protect consumers against

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<sup>679</sup> Council of Financial Regulators 2002 9.

<sup>680</sup> Act No. 122 of 2001 as amended; See further Bhati S “An analysis of the Financial Services Regulations of Australia” 2008 (4) *International Review of Business Research Papers* 13.

<sup>681</sup> Council of Financial Regulators 2002 9; Duggan et al 2012 192.

<sup>682</sup> Council of Financial Regulators 2002 10.

misleading or deceptive and unconscionable conduct affecting all financial products and services, including credit and, along with other regulators, administers aspects of legislation relating to insurance, superannuation and retirement savings accounts.<sup>683</sup>

ASIC's enforcement powers include being able to investigate situations where a breach of its legislation might have occurred; prosecute in a criminal court; bring a civil action; apply for a civil penalty order; accept and enforce an undertaking to comply with the law; apply to the Takeovers Panel; and disqualify people from managing corporations or dealing in financial services.<sup>684</sup>

Godwin et al point out that ASIC does not have an express mandate to promote financial system stability such as in the case of APRA.<sup>685</sup> However, ASIC does have some responsibility in respect of financial stability, directed towards decreasing systemic risk in clearing and settlement systems.<sup>686</sup> This mandate is imposed on ASIC by the Corporations Act 2001 which includes as an objective "the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities." To support this objective, the Corporations Act sets various obligations for providers of clearing and settlement facilities.<sup>687</sup> Notably the Corporations Act gives the RBA the power under section 827D(1) to determine financial stability standards for

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<sup>683</sup> Cooper 2006 7.

<sup>684</sup> Cooper 2006 7; See ASIC Act: sections 13 – 18 (investigations); section 49 (criminal prosecution); section 50 (civil proceedings); section 12GBC (civil action for recovery of pecuniary penalties); section 93A (acceptance and enforcement of undertakings); sections 172 – 183 (takeover panel); and section 12GLD (disqualifications).

<sup>685</sup> Godwin et al 2016 26; Professor Andrew Godwin from the University of Melbourne, at the Colloquium on Twin Peaks hosted by the Faculty of Law of the University of Pretoria on 28 September 2017 in Pretoria, hereinafter Presentation Godwin 2017, confirmed that ASIC does not have an express financial stability mandate. Section 1(2) ASIC Act: In performing its functions and exercising its powers, ASIC must strive to maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and promote the confident and informed participation of investors and consumers in the financial system; and administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements; and receive, process and store, efficiently and quickly, the information given to ASIC under the laws that confer functions and powers on it; and ensure that information is available as soon as practicable for access by the public; and take whatever action it can take, and is necessary, in order to enforce and give effect to the laws of the Commonwealth that confer functions and powers on it.

<sup>686</sup> RBA & APRA Financial Stability 2012 2. See more on the cooperation between the RBA and ASIC in 3.6.3 hereof.

<sup>687</sup> RBA & APRA Financial Stability 2012 2.

the purpose of ensuring that licensed clearing and settlement facilities conduct their affairs in a way that causes or promotes overall financial stability in the Australian financial system. Such standards were issued on 30 May 2003 but revoked in 2012 and new standards came into force on 29 March 2013.<sup>688</sup>

The Corporations Act also gives both the RBA and ASIC various powers with regard to licensing and direction over such facilities. Section 823E particularly gives ASIC directions power over holders of clearing and settlement facility licences, to direct them to take actions to reduce systemic risk. Before giving, varying or revoking such a direction, ASIC must however consult the RBA, although failure to do so does not invalidate such direction or the varying or revocation thereof.<sup>689</sup> The RBA may at any time require ASIC to make a direction but interestingly enough ASIC is not required to comply with the RBA's request.<sup>690</sup> The RBA and ASIC entered into a MOU in 2002, detailing the processes and information-sharing arrangements they would follow in pursuit of these joint responsibilities.<sup>691</sup>

ASIC accordingly plays an important role in monitoring, mitigating and managing systemic risk in the Australian financial system through its Emerging Risk Committee. This Committee meets regularly and identifies and assesses emerging systemic and thematic risks and reviews the securities regulation. Important issues and concerns

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<sup>688</sup> Financial Stability Standards for Central Counterparties (CCP Standards) (December 2012) <https://www.rba.gov.au/payments-and-infrastructure/financial-market-infrastructure/clearing-and-settlement-facilities/standards/central-counterparties/2012/> (accessed 1 February 2018) and Financial Stability Standards for Securities Settlement Facilities (SSF Standards) (December 2012) <https://www.rba.gov.au/payments-and-infrastructure/financial-market-infrastructure/clearing-and-settlement-facilities/standards/securities-settlement-facilities/2012/> (accessed 1 February 2018): These two sets of standards apply to different types of licensed clearing and settlement facilities. These standards have as objective to ensure that the Australian clearing and settlement facility licensees identify and properly control risks associated with the operation of the central counterparty and the securities settlement facility and conduct their affairs in accordance with the CCP and SSF Standards in order to promote overall stability of the Australian financial system; Reserve Bank of Australia – Clearing and Settlement Facilities (undated) <https://www.rba.gov.au/payments-and-infrastructure/financial-market-infrastructure/clearing-and-settlement-facilities/standards/> (accessed 13 January 2018).

<sup>689</sup> Section 823E(7): Before giving, varying or revoking the direction, ASIC must consult the RBA. However, a failure to consult the RBA does not invalidate the direction, variation or revocation.

<sup>690</sup> Section 823E(8).

<sup>691</sup> Memorandum of Understanding between the RBA and ASIC (18 March 2002) <http://download.asic.gov.au/media/1340888/MOU-ASICandRBA.pdf> (accessed 12 September 2017), hereinafter MOU RBA & ASIC 2002; See more on this MOU in paragraph 3.6.3 below. .

arising from this process are communicated with the RBA and APRA directly or through the CFR.<sup>692</sup>

### **3.6 Cooperation and collaboration between the RBA and regulators**

Godwin et al comment on the interaction between prudential and market conduct regulation and indicate that four interrelated aspects in the policy framework that supports coordination are critical to the approach to financial regulation in Australia: (i) proactive information-sharing between the regulators; (ii) consultation and mutual assistance between the regulators; (iii) practical measures to encourage and facilitate coordination; and (iv) a coordination body.<sup>693</sup>

Firstly they indicate that proactive information-sharing entails that ASIC and APRA have to share information with each other in terms of the relevant legislation. Godwin et al point out that the objectives of the regulators in this context are different, in that APRA as prudential regulator has to control information strongly to maintain confidence in the regulated entities whereas ASIC as market regulator emphasises disclosure to customers. This can lead to tension between the regulators. Therefore, the legislation governing the regulators' various confidentiality provisions as well as provisions in the MOUs support them in the sharing of information and the performance of their functions at all levels, including in establishing policy and

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<sup>692</sup> RBA & APRA Financial Stability 2012 3; Australian Securities & Investments Commission "ASIC's internal governance" (undated) <http://asic.gov.au/about-asic/what-we-do/how-we-operate/asics-internal-governance/#risk> (accessed 18 February 2018) 1: ASIC's Risk Committees consist of the Emerging Risk Committee and the Operational Risk Committee. These Committees assist, on an ongoing basis, in the effective management of ASIC's emerging, strategic, operational and fraud risks across all areas of its business activity; ASIC Risk Committee – Purpose, Governance and Practices Summary (March 2012) <http://download.asic.gov.au/media/1346192/Risk-Committee--Purpose-governance-and-practices--March-2012.pdf> (accessed 13 January 2018): The functions and responsibilities of the ASIC Risk Committee include: The annual review of the Risk Management Framework; ensuring compliance with the Risk Management Strategy and providing a forum for the escalation of risk matters; oversight of the coordination of risk management activities, including compliance, and the review of internal policy documents; monitoring any emerging material risks, consequences, issues and incidents including key projects and reporting to the Commission key operational and strategic risks being reported and acted upon within the business; the review of compliance with the bi-annual disclosure of interest declarations by staff; oversight of the effective implementation of the Business Continuity, Pandemic and Disaster Recovery plans and planning process; and the review of reports on key operational and strategic risks prior to their submission to Commission meetings.

<sup>693</sup> Godwin et al 2016 30.

enforcing thereof. Secondly Godwin et al indicate that consultation and mutual assistance between the regulators in those areas in which action by one regulator may have an impact on the regulatory responsibilities of the other is important to support coordination between them. This is reinforced by regular meetings, consultation, proactive dialogue and liaison between APRA and ASIC. The third characteristic of the policy framework supporting coordination in Australia is practical measures at the disposal of the regulators to encourage and facilitate coordination between them. These practical measures include informal communications and secondments like engaging with the other regulator before regulatory actions are taken; notifying, discussing and jointly planning supervisory activities; discussing which regulator is the most appropriate to investigate certain matters or take particular action and if necessary, modifying original timetables to accommodate the other regulator; and coordinating day-to-day operations, especially in special circumstances. The fourth aspect to the policy framework supporting coordination in the Australian Twin Peaks model is a coordination framework. This is achieved through a coordinating body for the relevant regulatory agencies; namely, the CFR as alluded to in par 3.3 above and discussed in more detail below.<sup>694</sup>

Pertinently, the Australian legislative framework for regulatory coordination relies extensively on ‘soft law’ mechanisms in the form of bilateral memoranda of understanding and informal protocols between the RBA and APRA and ASIC. The form or content of the memoranda of understanding is not prescribed by law and the legislative framework is “more supporting than prescriptive”.<sup>695</sup> These mechanisms that exist between the regulators ensure effective coordination and cooperation between them. The purpose of these mechanisms is to provide complete exchange of information, the avoidance of duplication and a clear outline of responsibilities, in case of mainly financial disturbances. Various Memoranda of Understanding were signed between the regulators, namely between the RBA and APRA,<sup>696</sup> between the RBA

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<sup>694</sup> Godwin et al 2016 31.

<sup>695</sup> Godwin et al 2016 34.

<sup>696</sup> The RBA and APRA has signed a Memorandum of Understanding: Memorandum of Understanding between the RBA and APRA (12 October 1998) <http://www.apra.gov.au/AboutAPRA/Documents/MoU-RBA-Reserve-Bank-of-Australia.PDF> (accessed 12 September 2017) hereinafter RBA/APRA MOU 1998.

and ASIC<sup>697</sup> and between APRA and ASIC.<sup>698</sup> In these Memoranda of Understanding that are discussed in more detail below, issues such as information-sharing, speedy notification of any regulatory decisions likely to impact on the other agency's area of responsibility and consultation arrangements in the event of financial disturbances, are addressed.<sup>699</sup> These MOUs are however not legally binding.<sup>700</sup>

However the non-binding nature of these memoranda has not been an impediment to their observance due to the prevailing regulatory culture in Australia. Godwin et al, after interviews with the regulators and the Treasury, found the main reasons for the success of this soft framework of coordination, was because the process itself is regarded as crucial and not only the result thereof; the working relationships on various levels are strong<sup>701</sup> and regular meetings of the CFR adds to this; the regulators understand their complementary roles for the Twin Peaks model to be successful and the framework of coordination is flexible and not prescriptive<sup>702</sup> and adds to the "culture of coordination".<sup>703</sup> The RBA has also publicly declared that cultivating a "culture of coordination", under which the main focus is on regulatory performance, rather than regulatory structure, is crucially important.<sup>704</sup>

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<sup>697</sup> The RBA and ASIC has signed a Memorandum of Understanding: MOU RBA & ASIC 2002.

<sup>698</sup> APRA and ASIC have signed various Memoranda, namely in 1998, 2004 and 2010: Memorandum of Understanding between APRA and ASIC (12 October 1998) [http://www.apra.gov.au/MediaReleases/Pages/98\\_08.aspx](http://www.apra.gov.au/MediaReleases/Pages/98_08.aspx) (accessed 31 December 2017); Memorandum of Understanding between APRA and ASIC dated 30 June 2004; Memorandum of Understanding between APRA and ASIC (18 May 2010) <http://www.apra.gov.au/AboutAPRA/Documents/ASIC-MoU.pdf> (accessed 31 December 2017), hereinafter MOU APRA & ASIC 2010; See also Council of Financial Regulators Annual Report 2002 - Appendix B: "Memoranda of Understanding between Council Members: The Reserve Bank of Australia and the Australian Prudential Regulation Authority" for the Memoranda of Understanding between RBA and APRA dated 12 October 1998, and between APRA and ASIC dated 12 October 1998 and between ASIC and RBA dated 18 March 2002.

<sup>699</sup> Council of Financial Regulators 2002 16.

<sup>700</sup> Godwin et al 2016 30 remark that these MOUs have restricted practical effect. The regulators do not rely on the MOUs to achieve the outcomes of the regulation, but the MOUs do give an indication of how the regulators intend to achieve effective coordination.

<sup>701</sup> Godwin et al 2016 35 point out that APRA is well versed with the workings of the RBA, as the first three APRA chairs came from the RBA.

<sup>702</sup> Godwin et al 2016 35; Schmulow 2015 no. 1 171 remarks that the success accomplished in Australia during the GFC and also during the 2010 Sovereign Debt Crisis in Europe has been attributed to this flexible approach where the agencies can adjust quickly to accommodate specific needs.

<sup>703</sup> Godwin et al 2016 35.

<sup>704</sup> Schmulow 2015 no. 1 171; Edey M "Macroprudential Supervision and the Role of Central Banks" Remarks to the Regional Policy Forum on Financial Stability and Macroprudential Supervision hosted by the Financial Stability Institute and the China Banking Regulatory Commission in Beijing (28 September 2012) <https://www.rba.gov.au/speeches/2012/sp-ag-280912.html> (accessed 13 January 2018) in Schmulow 2015 no. 1 171 indicates that the Assistant Governor (Financial) of the RBA has

Schmulow further remarks that the relationship between the three peaks in Australia has historically been closely cooperative and not riven with rivalry and turf wars.<sup>705</sup> It thus appears that Australia is in the fortunate position that over the years it has built a unique regulatory culture which sustains the effective use of soft law mechanisms for cooperation and collaboration and contributes to the effective functioning of the Australian Twin Peaks model.

### 3.6.1 The Council of Financial Regulators

The Wallis Inquiry emphasized the pivotal importance of information sharing and coordination between the key regulators in the Australian financial system. It therefore recommended the establishment in 1998 of the CFR, designed as an inter-agency body to coordinate a broad range of activities in order to facilitate the cooperation and collaboration between the RBA, APRA, ASIC and the Treasury.<sup>706</sup> The composition of the CFR thus remained largely the same as that of the Council of Financial Supervisors that operated before the Twin Peaks dispensation. The latter consisted of the RBA, the Insurance and Superannuation Commission, the Australian Securities Commission and the Australian Financial Institutions Commission, thus being the RBA and the predecessors of APRA and ASIC. The Treasury though was not previously included as a body in the Council of Financial Supervisors.

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attributed the efficacy of coordination between the regulators in Australia to a culture “where we regard cooperation with the other agencies as an important part of our job, and there is a strong expectation from the public and the government that we will continue to do so... Key aspects [of coordination] include an effective flow of information across staff in the market operations and macro-economic departments of a central bank and those working in the areas of financial stability and bank supervision. Regular meetings among these groups to focus on risks and vulnerabilities and to highlight warning signs can be very valuable. A culture of coordination among these areas is very important in a crisis because, in many instances, a stress situation is first evident in liquidity strains visible to the central bank, and the first responses may be calls on central bank liquidity.”

<sup>705</sup> Schmulow AD “Doing it the Australian Way, ‘Twin Peaks’ and the Pitfalls in Between” (31 March 2016) <http://clsbluesky.law.columbia.edu/2016/03/31/doing-it-the-australian-way-twin-peaks-and-the-pitfalls-in-between-2/> (accessed 10 January 2018).

<sup>706</sup> Jensen & Kingston 2010 549; Godwin et al 2016 23; Cooper 2006 11; Godwin & Schmulow 2015 766; See also Schmulow 2015 no. 1 171.

The ultimate objectives of the CFR are to contribute to the efficiency and effectiveness of regulation and to promote the stability of the Australian financial system.<sup>707</sup> The CFR operates as an informal non-statutory body without legal personality in which members are able to share information and views, discuss regulatory reforms or issues where responsibilities overlap and, if the need arises, coordinate responses to potential threats to financial stability. The CFR has no regulatory functions separate from those of its members.<sup>708</sup>

As stated in the CFR Charter,<sup>709</sup> the CFR meetings provide a high-level forum for identifying important issues and trends in the financial system, including those that may affect overall financial stability. It is also responsible for coordination arrangements for reacting to actual or potential instances of financial instability. In instances where members' responsibilities overlap, the CFR provides a platform to ensure that these are resolved. The CFR also plays a role in advising the Government on the suitability of Australia's financial system design in light of ongoing developments.<sup>710</sup> It further discusses the development and application of various international regulatory reforms in Australia. For example, it has considered Australia's position on developments such as: strengthening the capital framework for ADIs; strengthening liquidity risk management by ADIs; the regulatory framework for financial market infrastructures; resolution frameworks and shadow banking.<sup>711</sup>

Notably, a MOU on Financial Distress Management among the CFR agencies signed in 2008, facilitates coordinated responses to stress in the financial system.<sup>712</sup> In terms

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<sup>707</sup> Council of Financial Regulators – Charter (13 January 2004) <http://www.cfr.gov.au/about-cfr/charter.html> (accessed 7 July 2017) 1, hereinafter CFR Charter 2004. See also RBA & APRA Financial Stability 2012 3.

<sup>708</sup> Cooper 2006 12.

<sup>709</sup> CFR Charter 2004 1: The CFR Charter was adapted on 13 January 2004.

<sup>710</sup> Cooper 2006 11.

<sup>711</sup> Council of Financial Regulators “About the CFR” (undated) <https://www.cfr.gov.au/about-cfr/index.html> (accessed 10 April 2017); Godwin et al 2016 33 indicate that one area in which there has been some development in Australia in relation to the CFR, is increased transparency in the form of the webpage for the CFR on the website of the Australian Commonwealth Treasury. The webpage contains information about the CFR, media releases, publications and other resources.

<sup>712</sup> Memorandum of Understanding on financial distress management between the members of the Council of Financial Regulators (18 September 2008) <http://www.apra.gov.au/AboutAPRA/Documents/MOU-CoFR-Council-of-Financial-Regulators-on-Financial-Distress-Management.pdf> (accessed 2 February 2018), hereinafter MOU CFR 2008; See also IMF 12/308 29.

of this MOU between the members of the CFR, the RBA has the primary responsibility for the maintenance of overall financial system stability, including stability of the payments system and for providing liquidity support to the financial system or to individual financial institutions where appropriate.<sup>713</sup> From this it can be derived that if the members would disagree about a financial stability issue, the RBA would have the decisive vote on it.

With regards to the detection of emerging distress in the financial system, the MOU records that the RBA has lead responsibility for monitoring financial markets, and payment and settlement systems and for advising the Treasurer or other relevant Minister on emerging distress in these markets and systems; APRA has the lead responsibility for monitoring and prudentially supervising financial institutions;<sup>714</sup> and ASIC is responsible for monitoring financial service providers and for advising on emerging vulnerabilities.<sup>715</sup> From this it can also be concluded that the RBA has comprehensive powers with regards to detection of and dealing with emerging distress.

With regards to assessment of financial stress and implementation of response options, the RBA again has the lead responsibility for assessing and advising on the nature and scale of the systemic impact of significant financial stress including implications for financial markets and the payments system. The RBA is also responsible for evaluating and implementing response options that involve liquidity support or the use of payments system powers; APRA is responsible for assessing and advising on the nature and extent of financial distress in a supervised institution, including liquidity and solvency, and for evaluating and implementing supervisory response options relating to any affected institution; and ASIC assesses and advises on the regulatory implications of the situation for financial markets and investors, the disclosure implications of any resolution option, and for liaising with market

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<sup>713</sup> MOU CFR 2008 par 2.

<sup>714</sup> MOU CFR 2008 par 5.1: APRA also has statutory responsibilities to advise the Treasurer or other relevant Ministers in the event that a supervised institution is unable, or about to become unable, to meet its financial obligations.

<sup>715</sup> MOU CFR 2008 par 5.1.

operators.<sup>716</sup> The RBA thus has the overall systemic responsibility being a wider lookout over the broader economy whilst APRA and ASIC would do detections and assessments and the RBA would then consider the holistic impact thereof on the financial system.

Many of the issues discussed by the CFR are reported on in the RBA's semi-annual Financial Stability Review, with input from the other CFR member agencies. The CFR normally meets four times per year but can meet more frequently if necessary. The CFR meetings are chaired by the Governor of the RBA with secretariat support provided by the RBA. Interagency working groups give much of the input in CFR meetings and this promotes working relationships across the various agencies at staff level.<sup>717</sup> The CFR published annual reports between 1998 and 2002. Since then, information on Council activities are found in the annual reports of Council members, as well as in Financial Stability Reviews.<sup>718</sup>

Cooperation in the CFR is largely an informal arrangement and is, as mentioned, it is governed by a series of bilateral MOUs between the agencies as discussed in more detail below.<sup>719</sup> These MOUs will be further considered in the discussion of the cooperation and collaboration between the RBA and the regulators in the following paragraphs 3.6.2, 3.6.3 and 3.6.4.

### **3.6.2 The RBA and APRA**

Given that both the RBA and APRA have responsibility for financial stability they have to coordinate effectively to ensure that information is aptly shared between them and meaningful policies are implemented. The MOU between the RBA and APRA was entered into on 12 October 1998 and deals with the following matters: responsibilities

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<sup>716</sup> MOU CFR 2008 par 5.2.

<sup>717</sup> Godwin & Schmulow 2015 766; Schmulow 2015 no. 1 171.

<sup>718</sup> Council of Financial Regulators 2002.

<sup>719</sup> IMF 12/308 29. See paragraph 3.6 above where the various MOUs that were signed between the regulators are mentioned.

(par 1-4); sharing of information (par 5-10); threats to financial system stability (par 11); RBA participation in consultations (par 12); consultation on regulatory policy changes (par 14); international representation (par 15) and coordination committee (par 16 and 17).<sup>720</sup>

The objective of the MOU is to set out a framework for cooperation between the RBA and APRA which is aimed at promoting the stability of the Australian Financial System.<sup>721</sup> Paragraph 2 indicates that the responsibilities of the RBA and APRA for financial stability are largely complementary. It points out that the RBA's role is focused on monetary policy, overall financial stability and regulation of the payments system and that it has a discretion to provide lender of last resort assistance.<sup>722</sup> APRA on the other hand is responsible for prudential supervision of banks, life and general insurance companies and superannuation funds. It has powers to act decisively in the interest of depositors or policy holders or fund members if a supervised entity is in difficulty.<sup>723</sup>

With regard to "[T]hreats to Financial System Stability" it is agreed that if either the RBA or APRA identifies a situation which is likely to threaten the stability of the financial system, it will inform the other as a matter of urgency. It is stated that responses to such disturbances will depend on the particular circumstances prevailing, but in all cases the RBA and APRA will keep each other informed of their ongoing assessment and will consult closely on proposed actions.<sup>724</sup> The MOU confirms that the RBA will be responsible for determining whether, and how, it might provide emergency liquidity support to the financial system.<sup>725</sup>

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<sup>720</sup> RBA/APRA MOU 1998; RBA & APRA Financial Stability 2012 3 and 7.

<sup>721</sup> RBA/APRA MOU 1998 par 1.

<sup>722</sup> RBA /APRA MOU 1998 par 3.

<sup>723</sup> RBA /APRA MOU 1998 par 4.

<sup>724</sup> RBA/APRA MOU 1998 par 11.

<sup>725</sup> RBA/APRA MOU 1998 par 12. It is however stated that the RBA does not see its balance sheet as available to support the solvency of an individual financial institution in difficulty.

Other aspects that are dealt with in the MOU are RBA participation with APRA in prudential consultations and on-site reviews;<sup>726</sup> consultation on regulatory policy changes;<sup>727</sup> international representation<sup>728</sup> and the Coordination Committee that facilitates close cooperation between the RBA and APRA.<sup>729</sup> According to Ellis and Littrell, even in the initial phase after separation, APRA and the RBA set up formal and informal structures to ensure effective cooperation in achieving shared goals, for example the Coordination Committee that comprised of senior staff of each agency.<sup>730</sup> The Coordination Committee is the formal structure for cooperation where attendees from the RBA and APRA meet every six weeks and as such the Coordination Committee provides a regular high-level forum to air financial stability concerns.<sup>731</sup>

Thus, if the RBA or APRA identifies a situation which is likely to threaten the stability of the financial system, each has a responsibility to inform the other as a matter of urgency. The Treasurer will also be informed.<sup>732</sup> The MOU deals extensively with information exchange and it is inter alia agreed that information available to one supervisor that is relevant to the responsibilities of the other will be shared as requested.<sup>733</sup> Both agencies track and collect data of individual financial institutions.<sup>734</sup>

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<sup>726</sup> RBA/APRA MOU 1998 par 13; See further Ellis & Littrell 2017 2 who point out that RBA have indeed accompanied APRA staff on supervisory visits.

<sup>727</sup> RBA/APRA MOU 1998 par 14.

<sup>728</sup> RBA/APRA MOU 1998 par 15.

<sup>729</sup> RBA/APRA MOU 1998 par 16 and 17.

<sup>730</sup> Ellis & Littrell 2017 2.

<sup>731</sup> International Monetary Fund Country Report No. 12/313 *Australia: Basel Core Principles for Effective Banking Supervision – Detailed Assessment of Observance* (November 2012) <https://www.imf.org/external/pubs/ft/scr/2012/cr12313.pdf>, hereinafter IMF 12/313, at 143: The RBA also provides extensive aggregate information on the banking system in its six-monthly Financial Stability Review and makes available extensive data on the banking sector on its website.

<sup>732</sup> International Monetary Fund Country Report No. 06/415 *Australia: Financial Sector Assessment Program – Detailed assessment of observance of standards and codes* (November 2006) <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Australia-Financial-Sector-Assessment-Program-Technical-Note-Investor-Protection-Disclosure-20176> (accessed 7 June 2017), hereinafter IMF 6/415, at 14.

<sup>733</sup> RBA /APRA MOU 1998 par 7.

<sup>734</sup> International Monetary Fund Country Report No. 10/343 *Australia: Report on the Observance of Standards and Codes – Data Module* (November 2010) <https://www.imf.org/external/pubs/ft/scr/2010/cr10343.pdf> (accessed 2 February 2018) at 7 and 17: The RBA disseminates monetary statistics, and although the Reserve Bank Act does not specifically include a mandate to provide for this it has performed this role for many years. Data from the banking sector is collected by APRA in terms of the APRA Act. APRA has the responsibility to collect and monitor data where necessary under The Financial Sector (Collection of Data) Act of 2001. The APRA Act provides APRA with the legal authority to provide protected data collected under the Financial Sector (Collection of Data) Act to the RBA. The MOU between the RBA and APRA sets out respective responsibilities of the two agencies and mandates the sharing of information pursuant to their objectives. In paragraph 6 it determines “APRA

When the two agencies analyse data collected, they are on the lookout for indications of vulnerability to shocks that are concentrated in a sector or group of entities.<sup>735</sup>

Ellis and Littrell further point out that the RBA also over the years engaged in its own non-supervisory liaison meetings with selected banks ahead of the drafting of each semi-annual Financial Stability Review. However the RBA refrained from setting up a rival source of supervisory intelligence and influence, and therefore avoided diminishing the authority of APRA as the actual prudential supervisor. Ellis and Littrell accordingly remark that this seems to have been helpful in building relationships and cooperation, and avoiding misunderstandings.<sup>736</sup>

APRA and the RBA also exchange information with other regulators and authorities, subject to confidentiality.<sup>737</sup> APRA has a strong framework to exchange and protect such information and has good relationships with the RBA to facilitate the exchange of information.<sup>738</sup> APRA also comments on the RBA's half-yearly Financial Stability Review.<sup>739</sup>

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gathers a wide range of prudential data on the institutions which it supervises" and in paragraph 7 "information available to one which is relevant to the responsibilities of the other will be shared as requested". Under the Reserve Bank Act and the Banking Act of 1959 data are published by the RBA only at an aggregate level.

<sup>735</sup> RBA & APRA Financial Stability 2012 9 - 10. The two agencies use various processes to conduct macro-level analysis on the financial industry and to feed those results into policymaking. Each agency conducts its own analysis and afterwards the results are shared.

<sup>736</sup> Ellis & Littrell 2017 2.

<sup>737</sup> Section 56 of the APRA Act.

<sup>738</sup> RBA & APRA Financial Stability 2012 11, 12, 14 and at 13: In the case where exchange of information will assist a financial sector supervisory agency to perform its functions or exercise its powers, such exchange does not require the existence of an agreement or understanding. This is also true where the agency is specified in regulation 5 for the purposes of section 56 of the APRA Act. The agencies specified under either section 56 or regulation 5 include the RBA, ASIC and the CFR. Similarly, the RBA has exemptions under the Reserve Bank Act to share relevant information with APRA even when that information is institution-specific information protected under section 79A of the Reserve Bank Act and therefore cannot be revealed to the public or before a court. The sharing of such protected information with APRA must be for the purposes of one or more of several laws including the Banking Act, which includes prudential matters.

<sup>739</sup> IMF 12/313 125; RBA & APRA Financial stability 2012 10: The process of drafting the Financial Stability Review begins with a meeting of the Financial Stability Department of the RBA and the Assistant Governor (Financial System) of the RBA, where the themes for the issue of the Financial Stability Review, including possible risks to the Australian financial system, are discussed. Drafts of the material proposed for inclusion are reviewed and approved by the senior management team and the Governors, and are also circulated to the other CFR agencies for comment prior to publication.

Ellis and Littrell remark that these more formal arrangements were assisted initially by existing personal relationships between RBA staff and former RBA staff at APRA. Over time these relationships could no longer be relied upon since people move on. The positive spin-off was however that an expectation of a duty to forge good working relationships had already been set up. It was also supported by specific measures, such as the inclusion of a Key Performance Indicator in the job description of the RBA's head of Financial Stability department, requiring the officeholder to build and maintain good relationships with APRA.<sup>740</sup>

### **3.6.3 The RBA and ASIC**

Although ASIC does not have the same responsibility for financial stability as the RBA and APRA, ASIC nevertheless has to take certain regulatory actions to minimise systemic risk in clearing and settlement systems, working with the RBA.<sup>741</sup>

The RBA and ASIC agreed on an MOU<sup>742</sup> in 2002, detailing the processes and information-sharing arrangements they would follow in pursuit of these joint responsibilities. This MOU sets out the respective responsibilities of ASIC and the RBA (par 3-5) and also addresses the following matters: consultation (par 6); formal requests and use of powers (par 7-10); notification and information-sharing (par 11-

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<sup>740</sup> Ellis & Littrell 2017 2; Huang 2015: 496: The RBA and APRA incorporate various tools and practices that are designed to support financial stability from a system-wide perspective. In recognition of the view that there is some degree of connection between prudential regulation and systemic stability and that the information gathered through prudential regulation is important for effective systemic regulation, the RBA has power to request APRA to collect financial sector data for it.

<sup>741</sup> RBA & APRA Financial Stability 2012 2; Speech by the Chairman of ASIC at the time, Medcraft G "Systemic risk: The role of the securities regulators" (28 June 2011) <http://download.asic.gov.au/media/1347818/Systemic-Risk--Role-of-Securities-Regulators-1.pdf> (accessed 3 February 2018) at 4 and 7: Medcraft said that ASIC is not able to eliminate systemic risks by itself, but has to work in cooperation and consultation with the RBA, APRA and the Treasury. He also said that he hopes that securities regulators like ASIC will in future, in cooperation with their partners, the central banks and the prudential regulatory authorities, be more active in identifying, monitoring, measuring, mitigating and managing systemic risks and building the resilience of the system as a whole.

<sup>742</sup> MOU RBA & ASIC 2002.

14); reporting to the Minister on annual assessment (par 15) and coordination meetings and liaison (par 16 and 17).<sup>743</sup>

The objective of the MOU between the RBA and ASIC states that it is intended to assist each agency in the performance of its regulatory responsibilities under the Corporations Act 2001 in relation to clearing and settlement facilities. The framework set out in the MOU is also intended to promote transparency, to help prevent unnecessary duplication of effort and minimise the regulatory burden on licensed facilities.<sup>744</sup>

The MOU indicates in paragraph 3 that the RBA has specific responsibilities under the Corporations Act 2001 for setting financial standards, monitoring compliance with these standards and ensuring that licensed clearing and settlement facilities do all things reasonably practicable to reduce systemic risk. Paragraph 4 points out that ASIC has responsibility under the Corporations Act 2001 for monitoring compliance with all other legislative obligations imposed on licensed clearing and settlement facilities. These include a requirement to provide financial services in a fair and effective manner, including by having arrangements in place to enforce compliance with operating rules and for resolving complaints from facility participants. Paragraph 5 determines that ASIC also has responsibility under the Corporations Act 2001 for taking action to enforce compliance with all obligations imposed upon licensed clearing and settlement facilities.<sup>745</sup>

With regard to section 823E of the Corporations Act<sup>746</sup> the MOU indicates in paragraph 8 that ASIC may give a direction to a licensed clearing and settlement facility to take specific measures to comply with a financial stability standard or to take any other action to reduce systemic risk. It may do this on its own initiative, or following a request from the RBA. The MOU further determined that ASIC anticipates that it would

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<sup>743</sup> MOU RBA & ASIC 2002; RBA & APRA Financial Stability 2012 3.

<sup>744</sup> MOU RBA & ASIC 2002 par 1 and 2.

<sup>745</sup> MOU RBA & ASIC 2002 par 3, 4 and 5.

<sup>746</sup> See paragraph 3.5.2 above wherein Section 823E of the Corporations Act was mentioned.

generally take such action at the request of the RBA, which has responsibility for assessing licensees' compliance with financial stability standards and their obligation to do all things reasonably practicable to reduce systemic risk.<sup>747</sup> It is further recorded that ASIC and the RBA would agree on detailed protocols for the handling of requests under section 823E of the Act and exchanges of information in relation to any formal exercise of power.<sup>748</sup>

A draft of the half-yearly Financial Stability Review of the RBA is distributed to ASIC (being one of the CFR agencies) for comment on it prior to publication.<sup>749</sup>

#### **3.6.4 Coordination between APRA and ASIC**

Cooperation between the RBA and each of the two lead regulators is essential in the first place for purposes of financial stability. However on a broader level cooperation between APRA and ASIC as prudential and market conduct regulator respectively is pivotal to the success of the Australian Twin Peaks model as the broader framework within which the maintenance of financial stability must be accommodated. It is crucially important that these two regulators should cooperate and that the one does not take any actions that may impede on the regulatory work done by the other and by doing so erode efforts at promoting and maintaining financial stability. Godwin et al indicate that two features stand out as being of critical importance for the optimal operation of all Twin Peaks models. The first is a clear demarcation of the responsibilities and objectives of each regulator, which requires a separation between their roles and reducing regulatory overlap. The second is an environment that encourages both regulators to cooperate and share information proactively and to work together in the execution of their supervisory and enforcement functions.<sup>750</sup>

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<sup>747</sup> MOU RBA & ASIC 2002 par 9.

<sup>748</sup> MOU RBA & ASIC 2002 par 10.

<sup>749</sup> RBA & APRA Financial stability 2012 10.

<sup>750</sup> Godwin et al 2016 24.

Under the Twin Peaks model it is critical for the effective operation of the model that the objectives and the boundaries or 'regulatory perimeters' of each regulator should be clearly defined and that there should be coordination between them.<sup>751</sup> This is because market participants are regulated by both regulators. Cooperation between APRA and ASIC is furthermore important due to the large number of financial institutions in respect of which both agencies have regulatory responsibilities. Thus, in the Australian context, coordination between APRA and ASIC is necessary to ensure that complete supervision is achieved and that issues do not fall between the cracks. Godwin et al point out that this requires consultation, information-sharing (within an appropriate confidentiality framework) and mutual cooperation in areas such as supervision and enforcement action.<sup>752</sup> Accordingly the MOUs entered into between APRA and ASIC on 12 October 1998 and 30 June 2004, as mentioned in paragraph 3.6 above, were replaced by a later MOU entered into on 18 May 2010.<sup>753</sup> The objective of this MOU between APRA and ASIC is to set out a framework for cooperation between APRA and ASIC in areas of common interest where cooperation is essential for the effective and efficient performance of their respective financial regulation functions.<sup>754</sup>

Although a comprehensive discussion of this MOU falls outside the confines of this thesis, it is pointed out for the sake of completeness that the said MOU deals with the

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<sup>751</sup> Godwin A and Ramsay I "Twin Peaks – The Legal and Regulatory Anatomy of Australia's System of Financial Regulation" CIFR Paper No. 074/2015 University of Melbourne Legal Studies Research Paper No. 725 (3 August 2015) [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2657355](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2657355) (accessed 15 July 2017), hereinafter Godwin & Ramsay 2015, at 9 remark that "A functional or objectives-based approach to regulation means that there will be dual-regulated entities; namely, entities that will be subject to the regulation and supervision of both regulators. It also means that the two regulators will need to work cooperatively to deal with regulatory overlap."

<sup>752</sup> Godwin et al 2016 24.

<sup>753</sup> MOU APRA & ASIC 2010: The MOU determined in paragraph 2.1 that APRA is responsible for the prudential supervision of banks, building societies and credit unions, life and general insurance companies, friendly societies, and superannuation funds and their trustees. APRA is also responsible for administering the Financial Claims Scheme. In performing its functions to protect the interest of depositors, policyholders and fund members, APRA is required to balance financial safety with efficiency, competitions, contestability and competitive neutrality. ASIC is responsible for monitoring, regulating and enforcing corporations' laws and financial services laws and promoting market integrity and consumer protection across the financial services and the payments system including financial markets and trustee companies. ASIC is also responsible for administering the national consumer credit legislation, including licensing and conduct obligations on credit providers and intermediaries. On ASIC's behalf, APRA is also responsible for data collection from Australian financial services licensees authorised to deal in general insurance products. The joint administration of this data collection will be set out in a Cooperative Working Agreement between the agencies.

<sup>754</sup> MOU APRA & ASIC 2010 paragraph 1.1.

following aspects: responsibilities (par 2); regulatory and policy development (par 3); mutual assistance and coordination (par 4); information sharing (par 5); unsolicited assistance (par 6); cost of provision of information (par 7) and international representation (par 8).<sup>755</sup>

Godwin et al further remark that regulatory coordination in Australia is primarily informal, long-term, frequent, voluntary and cooperative in nature.<sup>756</sup> Regular forums exist between the two agencies to ensure there is appropriate sharing of relevant information and market intelligence. These meetings focus on a range of matters including policy, operational supervision, and issues related to enforcement. The forums also discuss the practical implications for supervision arising out of changes to legislative and administrative procedures, with a view to reducing the burden of supervision on regulated institutions.<sup>757</sup>

In closing, it should be noted that the IMF conducted a Financial Sector Assessment Program of Australia in 2006.<sup>758</sup> The IMF found that Australia's approach to prudential and market conduct regulation was sound overall and that there was generally a high level of compliance with international standards and in a number of areas Australia was at the forefront of best practices. It remarked that the failure of HIH was a severe event but that it did not create a financial crisis in Australia. However the IMF did inter alia highlight the need for improved arrangements to manage the failure of financial institutions and contingency planning for crisis management.<sup>759</sup>

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<sup>755</sup> MOU APRA & ASIC 2010.

<sup>756</sup> Godwin et al 2016 29.

<sup>757</sup> Australian Prudential Authority *Annual Report 2014* <http://apra.gov.au/AboutAPRA/Publications/Documents/1410-AR-2013-Full.pdf> (accessed 10 April 2017) 63, hereinafter APRA Annual Report 2014.

<sup>758</sup> International Monetary Fund Country Report No. 06/372 *Australia: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Insurance Regulation, Securities Regulation, and Payment Systems* (October 2006) <https://www.imf.org/external/pubs/ft/scr/2006/cr06372.pdf> (accessed 19 February 2018), hereinafter IMF 6/372.

<sup>759</sup> IMF 6/372 21.

### 3.7 The Australian Twin Peaks model during the GFC

As indicated in Chapter One, the GFC severely tested systems of financial regulation in a number of countries. Australia's economy was however one of the developed economies that were the least affected by the crisis. Schmulow aptly points out that Australia fared the best among the G-20 countries during the GFC.<sup>760</sup> Various factors contributed to this such as sound government finances as well as the solid position that the broader Australian economy was in prior to the onset of the crisis. Furthermore Australia's banks were well capitalised and profitable and maintained their AA credit ratings even during the crisis.<sup>761</sup>

The resilience of Australia to the GFC was enhanced by prudent measures that were taken by the financial regulators. Prior to the GFC the Australian authorities already looked broader than merely the direct financial system for risks to financial stability and Ellis and Littrell remark that at that stage already the RBA was putting relatively more resources than some other central banks into analysing household and housing developments' implications for financial stability.<sup>762</sup> They however appear to largely attribute the resilience of the Australian financial system to measures taken by APRA, which, as alluded to in par 3.5.1 above, appears to be very prominent in the Australian Twin Peaks model. They indicate that by late 2002 APRA had largely absorbed the lessons from HIH and other failures, and fundamentally restructured its approach to supervision and regulation. It also started looking harder for signs of emerging

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<sup>760</sup> Schmulow 2016 no. 1.

<sup>761</sup> Jensen & Kingston 2010 551; IMF 12/313 8: Australia is one of the few advanced economies that avoided a recession after the GFC, in part because of strong essential characteristics that the economy had at the onset of the crisis. Growth dipped only briefly below trend during the crisis and rebounded quickly, supported by robust demand for commodities from China; Allen HJ "Financial stability regulation as indirect investor/consumer protection regulation: implications for regulatory mandates and structure" 2016 *Tulane Law Review* 90 1113, at 1124 remarks that Australia emerged relatively unscathed from the GFC. The country did not fall into recession, and its employment rate remained substantially below the Organisation for Economic Cooperation and Development average. Australian banks continued to function relatively well throughout 2008 and 2009; although they saw their profits decline somewhat over that period, no government bailouts were required. As a result, the availability of consumer financial services was not interrupted in Australia in the same way that it was in the United States and the United Kingdom. One contributing factor to the lack of systemic failure in Australia during the Financial Crisis was the requirement from APRA that banks hold higher levels of regulatory capital against nonconforming residential mortgages, ensuring that - unlike in the United States and United Kingdom - very few of such loans were made.

<sup>762</sup> Ellis & Littrell 2017 3.

systemic risks and in this regard home lending was a natural early focus.<sup>763</sup> Ellis and Littrell further point out that other than what may have been the case in other countries APRA as prudential regulator, did not take a narrow microprudential approach. They give the following examples of actions taken by APRA pre-GFC:<sup>764</sup>

(a) APRA conducted its first banking industry stress test<sup>765</sup> in 2002/2003 and this inter alia led to substantial strengthening of bank capital requirements for home loans, and to stronger capital and reinsurance arrangements for lenders and mortgage insurance companies.

(b) APRA warned off the banking industry from material participation in sub-prime lending.

(c) From 2003 APRA amended its supervisory approach to ensure that the most resources and the earliest responses to implications of weakness would be applied to the largest SIFI.

(d) APRA'S policy infrastructure, notably in adopting IFRS in 2005 and Basel II from 2005 to 2008, followed a consistently conservative line which along with other decisions have created Australian Bank capital rules that are materially super-equivalent to the international minimum standards.

The adjustments to regulatory arrangements in the wake of the failure of HIH were also crucial to the resilience of these arrangements during the GFC. Ellis and Littrell remark that the failure of HIH prompted a rethink of the importance of financial supervision generally, and the attention given to large entities in particular. Consequently a new "Australian-specific" consensus developed in favour of a strong and enquiring supervisor.<sup>766</sup> By the time the financial crisis began to hit major financial centres, Australia thus already had a reasonably well developed framework for dealing with broader risks to the economy emanating from the financial sector. It also had mature arrangements for interagency cooperation, and these deepened further in response to the crisis. Therefore, unlike the authorities in some other countries, the

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<sup>763</sup> Ellis & Littrell 2017 7.

<sup>764</sup> Ellis & Littrell 2017 2-3.

<sup>765</sup> IMF 6/372 18: Various types of stress tests can be performed by banks, for instance a macro-economic stress scenario over a three year time period; or a series of single factor stress tests on interest rates; or a mortgage portfolio stress test using data from regional banks with heavy exposure to the mortgage market.

<sup>766</sup> Ellis & Littrell 2017 2.

Australian agencies did not have to change their approach significantly in response to the experiences of the crisis.<sup>767</sup>

The FSB Country Peer Review of Australia in 2011, found that the Australian financial system indeed weathered the GFC well. The ADI sector remained profitable and no entities received any public capital support. The resilience of the system to a great extent reflected the resilience of the economy at large. Structural reforms ensured that macro-economic conditions at the time of the crisis were favourable, while a combination of automatic stabilisers and proactive policy measures buffered the domestic economy from the sharp deterioration in global economic conditions. In addition, the authorities took a number of steps to address specific financial system vulnerabilities. An important lesson from Australia's experience, according to the 2011 FSB Country Peer Review, is that strong economic fundamentals provide a crucial bulwark against the risks of a financial crisis, and that appropriate macro-economic policies matter as much for the health of the financial system as does the strength of the supervisory framework.<sup>768</sup>

The 2011 FSB Country Peer Review further pointed out that Australia is regarded as an example of a jurisdiction that takes an implicit macroprudential orientation to financial system oversight. The monitoring of risks has not required setting up a separate macroprudential regulator since both the RBA and APRA have financial stability mandates. While the institutional arrangements for macroprudential oversight in Australia are relatively informal, the FSB remarked that the CFR ensures a structured coordination process and the relevant agencies have a long history of achieving consensus on policy issues of system-wide importance - as illustrated by their actions during the crisis.<sup>769</sup>

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<sup>767</sup> Ellis & Littrell 2017 3.

<sup>768</sup> Financial Stability Board – *Peer Review of Australia* (21 September 2011) [http://www.fsb.org/wp-content/uploads/r\\_110926b.pdf](http://www.fsb.org/wp-content/uploads/r_110926b.pdf) (accessed 17 July 2017), hereinafter FSB Peer Review 2011, at 5.

<sup>769</sup> FSB Peer Review 2011 5.

It was further indicated that Australian banks performed well during the GFC and their performance has even improved since then. There was no bank failure during the crisis, although banks did experience some funding pressure and only a small increase in nonperforming loans. Notably Australian banks have actually come out of the crisis with stronger capital positions. In 2012 Australian banks were found among the most profitable in the world.<sup>770</sup>

The International Monetary Fund subsequently conducted its Country Report No. 12/308 *Australia: Financial System Stability Assessment* (November 2012) in 2012. This IMF Country Report found that the RBA, APRA and ASIC, had responded quickly to the GFC with a substantial fiscal stimulus and sizable cuts in the policy rate to support domestic demand. The authorities' wise handling of the effects from the GFC, their sensible economic management, and strong supervision of the financial sector, kept Australia on the decreasing list of AAA rated countries. Thus the IMF concluded that sound economic management, a proactive approach to supervision and a well-coordinated crisis response have helped maintain financial system soundness and stability in Australia during the GFC.<sup>771</sup>

Alex Erskine, ASIC's former chief economist commented that although no model is fool proof, economies that emerged from the GFC in better shape, including those of Australia and Canada, were those with clearly separated market conduct and prudential regulators, but which also had in place practical frameworks encouraging cooperation, coordination and information sharing between regulators, the central

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<sup>770</sup> IMF 12/308. IMF 12/313 8: This was accompanied by a rising share of Tier 1 capital in total capital and reflected both new capital raising and a shift toward lower-risk assets such as mortgages. Profitability has also improved after a drop during the crisis, with annualized after-tax return on equity rising to 15 percent in the fourth quarter of 2011 from 4.5 percent in the third quarter of 2009.

<sup>771</sup> IMF 12/308 9; Jensen & Kingston 2010 551 paint a less positive picture of Australia's performance during the GFC and remark that some large losses of investments, various listed financing and investment companies that failed and a major decline in the share market in Australia led to significant governmental and regulatory action to mitigate the effects of the GFC. Bank deposits and wholesale funding were guaranteed by the government. The RBA and the government offered liquidity support through new or more liberal security repurchases or purchase arrangements. Furthermore ASIC imposed major new restrictions on short selling of all Australian Securities Exchange traded shares between 21 September 2008 and 19 November 2008 and on financial shares until 25 May 2009.

bank and the finance ministry.<sup>772</sup> In the same vein Jensen and Kingston noted that although they cannot attribute Australia's relatively successful survival of the GFC specifically to its financial regulatory system, the view of the majority in Australia at that stage was that their financial regulatory structure does not need a major overhaul.<sup>773</sup>

Stevens however points out that although the GFC did not affect Australia as severely as some other countries, and the Australian banking system stood up fairly well during the GFC because of sound management and a healthy and strong supervisory approach, there were still lessons to be learnt and that the Australian regulators have given careful thought to them and to the associated global reforms in directing its approach to financial regulation after the Crisis.<sup>774</sup>

### **3.8 Reforms in Australia subsequent to the GFC**

Australia did not find it necessary to make any significant changes to its basic approach to financial regulation in response to the GFC. The existing Twin Peaks model was thus retained without significant modifications.

Despite not being extensively affected by the GFC in comparison to jurisdictions like the United States, Ellis and Littrell however indicate that some changes were nonetheless needed in Australia, mainly to adjust to the greater degree of post-crisis international policy activity. Both the RBA and APRA were invited to join the Basel Committee on Banking Supervision in 2009. According to Ellis and Littrell, the RBA then had to develop a deeper understanding of the prudential framework, after a decade of being little involved in formulating prudential policy. In addition, the RBA's

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<sup>772</sup> Erskine A "Rethinking securities regulation after the crisis: An economics perspective" (9 July 2010) <http://download.asic.gov.au/media/1344980/RethinkingSecuritiesRegulation-20100709.pdf> (accessed 27 April 2017) in Jensen & Kingston 2010 551.

<sup>773</sup> Jensen & Kingston 2010 551.

<sup>774</sup> Address by Glenn Stevens, former Governor of the Reserve Bank of Australia, to the Australian Securities and Investments Commission (ASIC) Annual Forum, Sydney, 26 March 2013 on "Financial regulation – Australia in the global landscape", hereinafter Stevens 2013, at 2.

participation as a member of the Financial Stability Board (FSB) became more intensive, in line with the increased activity of the FSB relative to its predecessor, the Financial Stability Forum. This also required more interagency cooperation between the RBA and APRA and the other member agencies of the CFR, namely ASIC and the Treasury, since much of the work that had to be done involved the same senior staff, and it thus reinforced the strength of the relationships needed for effective day-to-day management of domestic risks.<sup>775</sup>

From 2008 steps have been taken to strengthen the legal framework for bank resolution and crisis management in Australia which in turn contributed to financial stability. The Australian Government's Financial Claims Scheme that was established in October 2008<sup>776</sup> protects deposits in the unlikely event that a bank, building society or credit union fails; APRA was given the power to appoint a statutory manager to an ADI before the point of insolvency had been reached, and APRA's powers to facilitate the resolution of ADIs and insurers were strengthened.<sup>777</sup> The RBA and APRA have further been actively engaged in developing crisis resolution strategies and policy guidance, undertaking crisis simulation exercises in 2009 and 2011.<sup>778</sup>

In the context of recovery and resolution APRA initiated a pilot program in 2011 where the six largest ADIs were required to develop recovery plans. The aim of this program was to develop mitigating measures that could be adopted to overcome impairments to the ADIs capital and liquidity positions in a severe scenario and re-establish their financial viability without external support. Since continued efforts are necessary for recovery and resolution planning, the IMF Country Report No12/308 suggested that such requirements should be extended to all ADIs and appropriately tailored to their size. It recommended that APRA should also conduct annual checks to ensure that the recovery and contingency plans are up-to-date and adequate. In addition, it suggested that APRA should introduce resolution planning requirements for at least

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<sup>775</sup> Ellis & Littrell 2017 3.

<sup>776</sup> FSB Peer Review 2011.

<sup>777</sup> IMF 12/308 29.

<sup>778</sup> IMF 12/308 30.

the major banks, in order to increase the efficiency of the resolution process and reduce potential losses should the need arise to resolve a systemic bank.<sup>779</sup>

APRA adopted the Basel III capital standards in its prudential standards late in 2012. From 1 January 2013 Australia thus implemented the capital elements of Basel III and is considered an early adopter of the Basel III reforms. Authorised deposit-taking institutions (ADIs) had quite healthy capital positions and therefore APRA required ADIs to meet a number of the main capital measures two or three years earlier than what the more drawn-out timetable set by Basel III demanded.<sup>780</sup>

In order to help ADIs meet the liquidity coverage ratio<sup>781</sup> as proposed under Basel III, the Committed Liquidity Facility (CLF) has been established in Australia and has been approved by the Board of the RBA in November 2010.<sup>782</sup> The CLF is a facility that the RBA provides to certain ADIs that are required by APRA to maintain a liquidity coverage ratio at or above 100 percent. The liquidity coverage ratio has been developed by the RBA to promote the short-term resilience of the liquidity risk profile of banks by ensuring that they have sufficient high quality liquid assets to survive a significant stress scenario lasting 30 calendar days.<sup>783</sup> The use of the facility is at the RBA's discretion, and an ADI must have first received approval from APRA on the amount of the liquidity requirement that can be met through the CLF.<sup>784</sup>

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<sup>779</sup> IMF 12/308 31.

<sup>780</sup> Stevens 2013 2 indicate that APRA was also not using the discretion available under Basel III to provide a concessional treatment for certain items in calculating regulatory capital (for example deferred tax assets) but has moved ahead on implementing the liquidity standard together with the RBA.

<sup>781</sup> Bank for International Settlements "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools" (January 2013) <https://www.bis.org/publ/bcbs238.pdf> (accessed 4 February 2018) at 4: The high quality liquid assets should consist of cash or assets that can be converted into cash at little or no loss of value in private markets, to meet the liquidity needs of a bank. This should enable a bank to survive a significant stress scenario for 30 days by which time it is assumed that appropriate corrective actions can be taken by management and supervisors or it would give the central bank time to take appropriate measures, should they be regarded as necessary.

<sup>782</sup> Stevens 2013 2 and 3; IMF 12/308 20.

<sup>783</sup> Reserve Bank of Australia "CLF Operational Notes" (27 March 2017) <https://www.rba.gov.au/mkt-operations/resources/tech-notes/clf-operational-notes.html> (accessed 4 February 2018) at 1.

<sup>784</sup> Stevens 2013 2 and 3; IMF 12/308 20: In Australia the ADIs would be able to access a specified amount of liquidity using repurchase agreements of qualified securities outside the RBA's normal market operations. An institution qualifying for CLF-assistance will receive the money against quality collateral pledged by it and by paying a fee for it.

Although limited, Australia did suffer further events post GFC that occasioned some scrutiny of the institutional framework for financial regulation, notably the collapse of the fraudulent investment house Trio Capital in June 2009. After \$176 million were lost with the collapse of Trio Capital, the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire into the Trio Capital collapse and any other related matters on 23 June 2011.<sup>785</sup> The Committee regarded the collapse as the “largest superannuation fraud in Australian history”. A key concern expressed by the Committee related to the responsiveness of the regulators - ASIC and APRA. The Committee stated that the regulators “must take their share of the blame for the slow response to the Trio fraud”. It strongly suggested that the various agencies renew their focus on seeking to recover outstanding monies and to bring to justice all those who had been criminally involved in the scheme i.e. a call for more aggressive regulation.<sup>786</sup>

The IMF Country Report No 12/308 further highlighted the RBA’s central role in monitoring financial system soundness and warning of potential risks, through the publication of the Financial Stability Review. It indicated that since the Review assesses the health of financial institutions, corporations and households and the performance of financial markets, it serves as a useful tool of communication with financial institutions and the general public. The Review’s production requires interagency coordination, and its regular discussion at the CFR before publication keeps its members up to date on global financial market developments and their implications for domestic financial stability. Thus the IMF found the Financial Stability Review to be a well-established mechanism for systemic risk identification and monitoring. It was however suggested that the Financial Stability Review could be further improved by incorporating regular stress testing results on the financial system once the RBA had established its own stress testing framework.<sup>787</sup>

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<sup>785</sup> Parliamentary Joint Committee on Corporations and Financial Services *Inquiry into the collapse of Trio Capital* (16 May 2012) [https://www.apf.gov.au/Parliamentary\\_Business/Committees/Joint/Corporations\\_and\\_Financial\\_Services/Completed\\_inquiries/2010-13/trio/report/index](https://www.apf.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2010-13/trio/report/index) (accessed 18 July 2017), hereinafter Trio Capital Inquiry 2012.

<sup>786</sup> Trio Capital Inquiry 2012 xx and 151.

<sup>787</sup> IMF 12/308 28.

The IMF indicated that while the CFR has been effective as a coordinating body, there is scope to make its role more prominent by enhancing the transparency of its discussion process. It was suggested that a more explicit account of the CFR's discussions in the Financial Stability Review would be a step toward this goal. It was further recommended that a key priority for the CFR should be to continue enhancing preparations for possible crisis through early planning with particular attention to formulating an effective communication strategy.<sup>788</sup>

With regard to APRA, the Report indicated that the supervisory approach rooted in the PAIRS/SOARS system incorporates more intensive supervision for systemically important institutions, and is in line with international consensus that countries should implement a comprehensive framework with more intensive supervision, recovery and resolution planning and higher loss absorbency.<sup>789</sup> The Report also identified the amount of time devoted by APRA to on-site supervision of certain risk areas or entities and the extent to which supervisors perform due diligence on senior executive management, directors, controllers, or significant shareholders at the time of licensing of certain entities as areas that should receive greater prominence in the prudential and conduct supervision in Australia. It was indicated that APRA needs to increase the amount of time allocated to formal on-site reviews to be able to thoroughly check if an institution has policies, practices and the necessary governance in place to ensure effective liquidity risk management. It was also suggested that ASIC should prevent potential risks by extending risk based capital requirements, periodic capital adequacy reporting and large exposure rules to some of the Australian Financial Services Licensees not regulated by APRA.<sup>790</sup>

The IMF Country Report 12/308 further found the bank supervision approach in Australia to be principles based and outcome oriented, relying more on directors and management to interpret and apply regulatory principles than on prescriptive

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<sup>788</sup> IMF 12/308 28 and 29.

<sup>789</sup> IMF 12/308 21.

<sup>790</sup> IMF 12/308 26.

regulations.<sup>791</sup> The Report stated that APRA's notable strengths are demonstrated by its strong risk analysis embedded in the PAIRS and SOARS system, its focus on bank boards' responsibility for risk management, and its assessment of banks on a system wide basis. APRA's on- and off-site supervision was found to be well planned and executed; its credit risk management was well developed; and it was indicated that APRA's provisioning requirements typically result in higher reserves than required under IFRS (International Financing Reporting Standards).<sup>792</sup> Moreover, the IMF indicated that APRA conveys its expectations for the management of specific risks to banks through engagement with bank boards, regular contacts by supervisors and risk specialists, and letters and speeches delivered to the industry and that this approach has been broadly effective.<sup>793</sup>

The IMF Country Report 12/308 further found that APRA has made significant progress in updating the insurance regulatory regime. Its enforcement powers have been broadened, restrictions have been imposed on unauthorised foreign insurers and greater legal clarity was provided in the Treasurer's role in specific supervisory matters. The risk-based supervision framework was found to be comprehensive with established internal policies and processes to promote prompt and consistent supervisory actions. It was further found that APRA has adequate resources and technical capacity to conduct effective supervision.<sup>794</sup>

The Report however indicated that since the Minister of Finance is lawfully empowered to give policy direction to both APRA and ASIC and to decide on the change in significant ownership of an ADI, this power could reduce the capacity of APRA and

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<sup>791</sup> IMF 12/308 25: It was found that APRA does not prescribe simple regulatory limits, such as LTV ratios or debt-to-income (DTI) ratios; but preferred institutions to be internally regulated taking all loan contract terms into account.

<sup>792</sup> IFRS – webpage (undated) <http://www.ifrs.org/> (accessed 11 July 2017): The IFRS Foundation is a not-for-profit, public interest organisation established to develop a single set of high-quality, understandable, enforceable and globally accepted accounting standards – the International Financing Reporting Standards (IFRS Standards) - and to promote and facilitate adoption of the standards. Their mission is that these IFRS Standards will bring transparency, accountability and efficiency to financial markets around the world. Their work aims to serve the public interest by fostering trust, growth and long-term financial stability in the global economy.

<sup>793</sup> IMF 12/308 25.

<sup>794</sup> IMF 12/308 25.

ASIC to carry out their supervisory and regulatory functions successfully. It was pointed out that such power had nevertheless rarely been used. The Report suggested that it is thus important for APRA to be legally empowered to veto, on prudential grounds, any decision on changes in significant ownership in financial institutions.<sup>795</sup>

It was further pointed out in the IMF Report that a series of high profile and successful prosecutions, along with good shareholder protection and high accounting and auditing standards, have contributed to the standing of ASIC in the market. However it was suggested that ASIC be given more resources and flexibility over its operational budget.<sup>796</sup>

During 2012 another IMF Country Report, namely the International Monetary Fund Country Report No. 12/313 *Australia: Basel Core Principles for Effective Banking Supervision – Detailed Assessment of Observance* (November 2012) was also conducted in Australia.<sup>797</sup> This Report assessed the current state of the implementation of the Basel Core Principles in Australia as part of the Financial Sector Assessment Program (FSAP) undertaken by the International Monetary Fund (IMF) during 2012.

The IMF Country Report No. 12/313 confirmed the RBA's financial stability mandate and indicated that legal gateways exist for the RBA and APRA to share institution-level data that is needed for them to carry out their respective duties.<sup>798</sup> The Report indicated that APRA works collaboratively with the RBA and ASIC to identify trends and assess build-up of risks at both an entity level and system level. It pointed out that

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<sup>795</sup> IMF 12/308 27. The Report pointed out that the authorities did not view the Minister's power as undermining the independence of the regulatory agencies but rather as providing a mechanism for transparent interaction with the government on policy grounds, and as an important check and balance on the powers of the regulatory agencies, for holding them accountable to Parliament, and ultimately, to the people of Australia.

<sup>796</sup> IMF 12/308 25 - 26.

<sup>797</sup> International Monetary Fund Country Report No. 12/313 *Australia: Basel Core Principles for Effective Banking Supervision – Detailed Assessment of Observance* (November 2012) <https://www.imf.org/external/pubs/ft/scr/2012/cr12313.pdf>, hereinafter IMF 12/313.

<sup>798</sup> IMF 12/313 8.

the RBA in the execution of its mandate to promote financial stability, monitors the health of the financial system and provides warnings about potential risks and vulnerabilities.<sup>799</sup> Furthermore as APRA supervises both banking and insurance sectors and adopts an integrated approach to such supervision, the IMF found that there is a strong structural support for a common understanding of banking and insurance risks. It was also pointed out that the collapse of HIH in 2001 had been a positive catalyst to the RBA and APRA to become as mission focused as possible in their respective roles and this had supported cooperation between them.<sup>800</sup>

The IMF further found that the RBA plays a key role in managing and providing liquidity to the financial system: It is the ultimate provider of liquidity to the financial markets, promotes lower inflation and sustainable growth, and it also seeks to ensure that the payment system is safe and robust. It also plays a key role in developing a framework for dealing with financial institutions in distress. The IMF pointed out that the RBA chairs the CFR and the objectives of the CFR include the promotion of the stability of the Australian financial system and contribution to the efficiency and effectiveness of financial regulation.<sup>801</sup> The CFR is thus an important forum that enables the RBA to coordinate the execution of its financial stability mandate.

The Report also regarded the introduction of the Committed Liquidity Facility as of 2015 available from the RBA to enable ADIs to meet their liquidity coverage ratio requirements as an important development.<sup>802</sup> It further pointed out that APRA collaborates with the RBA in monitoring the operational incidents in Australia's high-value payments system – the RBA Information and Transfer System (RITS). Quarterly meetings are held between the RBA and APRA to discuss trends in incident data and the nature of incidents. Insights gained provide useful contextual information for

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<sup>799</sup> IMF 12/313 143.

<sup>800</sup> IMF 12/313 125.

<sup>801</sup> IMF 12/313 10.

<sup>802</sup> IMF 12/313 106 where it was indicated that APRA intends that ADIs must demonstrate that they have taken all reasonable steps towards meeting their liquidity coverage ratio requirements through their own balance sheet management, before relying on the Committed Liquidity Facility.

supervisors that may be taken into account when making assessments about individual banks or in allowing for targeted supervisory action.<sup>803</sup>

The IMF Report further noted that in cases where a bank is in serious distress, APRA would activate its internal Financial Crisis Management Plan.<sup>804</sup> The RBA plays an important role in this process, since APRA, in deciding on an appropriate course of action to resolve the situation, would consult with the CFR<sup>805</sup> (of which the RBA is a member and the Governor of the RBA the chair). Where the bank is considered to be systemically important,<sup>806</sup> the CFR would be the vehicle through which a coordinated response to the situation is prepared, with each agency performing its respective functions.<sup>807</sup>

Notably Australia does not have globally systemically important banks (G-SIBs).<sup>808</sup> APRA published an Information Paper on “Domestic systemically important banks in Australia” in December 2013.<sup>809</sup>

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<sup>803</sup> IMF 12/313 109.

<sup>804</sup> IMF 12/313 145: This would occur when there is a material or immediate threat to a bank’s capital position or solvency; or the bank’s ability to meet its obligations to depositors as and when they fall due is subject to doubt; or there is a risk of financial system instability arising from the financial condition of the bank in question. Under section 10(1) of the APRA Act, APRA is obliged to inform the Minister of Finance if it considers that a regulated body is in financial difficulty. APRA has the lead responsibility for the exercise of resolution powers under the Banking Act, including the giving of a direction to a bank, the appointment of a statutory manager (who would assume responsibility for running of the bank), the application to a Court for a winding up, and the exercise of business transfer under the Financial Sector (Business Transfer and Group Restructure) Act 1991.

<sup>805</sup> See above in 3.6.1 where the CFR was discussed.

<sup>806</sup> See also Chapter One paragraph 1.6 on systemically important financial institutions.

<sup>807</sup> IMF 12/313 145: Under section 10 of the APRA Act, APRA is obliged to inform the Minister if it considers that a regulated body is in financial difficulty. APRA, in deciding on an appropriate course of action to resolve the situation, would consult with the CFR. Where the bank is considered to be systemically important, the CFR would be the vehicle through which a coordination response to the situation is prepared, with each agency performing its respective functions. APRA has the lead responsibility for the exercise of resolution powers under the Banking Act, including the giving of a direction to a bank, the appointment of a statutory manager (who would assume responsibility for running of the bank), the application to a Court for a winding up, and the exercise of business transfer under the Financial Sector (Business Transfer and Group Restructure) Act 1991.

<sup>808</sup> See Financial Stability Board “2017 list of global systemically important banks (G-SIBs)” (21 November 2017) <http://www.fsb.org/wp-content/uploads/P211117-1.pdf> (accessed 10 May 2018).

<sup>809</sup> APRA “Information paper Domestic systemically important banks in Australia” (December 2013) <http://www.apra.gov.au/adi/Publications/Documents/Information-Paper-Domestic-systemically-important-banks-in-Australia-December-2013.pdf> (accessed 21 February 2018) at 4: No Australian bank was on the list of G-SIBs. In October 2012, the Basel Committee finalised its framework for dealing with domestic systemically important banks (D-SIBs). The D-SIB framework involved a set of principles on the assessment methodology and the higher loss absorbency requirement for banks identified as D-

The IMF Report found that Australia has a very high level of compliance with the Basel Core Principles for Effective Banking Supervision. It indicated that the Australian banking system was more protected than various other countries and weathered the GFC relatively well. This was in part due to relative focus of the system on a well performing domestic economy, but also due to a substantial contribution from a well-developed regulatory and supervisory structure. The IMF stated that prominent strengths of the Australian supervisory approach rested in its strong risk analysis. It however cautioned that the Australian banking system was still vulnerable to continuing aftershocks of the financial crisis as the way that such banks offered financing could lead to instability.<sup>810</sup>

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SIBs. In line with the G-SIB framework, the D-SIB framework came into effect from 1 January 2016, and the Basel Committee expected national authorities to introduce any D-SIB requirements into relevant regulation or prudential standards by 1 January 2014. This Information Paper outlined the approach that APRA took in implementing the D-SIB framework in Australia. Chapter 2 of the Paper set out the principles of the Basel Committee's D-SIB framework; Chapter 3 outlined APRA's framework for determining domestic systemic importance; Chapter 4 identified the banks assessed by APRA to be D-SIBs in Australia; and Chapter 5 outlined the methodologies and considerations taken into account by APRA in determining an appropriate higher loss absorbency requirement for D-SIBs; Reserve Bank of Australia "Submission to the Financial System Inquiry" (March 2014) <http://www.rba.gov.au/publications/submissions/financial-sector/financial-system-inquiry-2014-03/pdf/financial-system-inquiry-2014-03.pdf> (accessed 2 January 2018) 58, hereinafter RBA Submission FSI 2014: The Australian D-SIB framework involves an additional capital requirement to absorb losses (namely a common equity Tier 1 capital requirement equivalent to 1 per cent of their risk-weighted assets) and more intense supervision than is applied to other ADIs, a feature that is already embedded in APRA's supervisory approach. The additional capital requirement will be implemented through an extension of the capital conservation buffer of each D-SIB from 2.5 per cent to 3.5 per cent of risk-weighted assets. D-SIBs will be required to meet the capital conservation buffer, including the higher D-SIB component, by 1 January 2016; Bank for International Settlements - Basel Committee on Banking Supervision "Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement" (July 2013) <http://www.bis.org/publ/bcbs255.htm> (accessed 21 February 2018): In this Paper, APRA referred to the Basel Committee on Banking Supervision that issued its framework for dealing with global systemically important banks (G-SIBs).

<sup>810</sup> IMF 12/313 4 and 101: It is indicated that although APRA requires banks to establish policies and processes for the ongoing measurement and monitoring of its funding sources and how it may impact the bank's overall liquidity strategy, APRA does not itself set ex ante limits (for example relating to geography, product, tenor or market sector). APRA has not set limits on or targets for domestic banks in relation to the proportion of funding that is drawn from the wholesale market. APRA has required banks to prepare and submit an annual funding plan since late 2007. Supervisors assess these plans from an individual bank and industry-wide perspective. Entity-focused assessments take into account the nature and complexity of the bank's operations and place particular attention on unrealistic assumptions, over-reliance on short-term funding sources, and funding concentration risk. It is proposed that APRA's existing practice to require banks to submit annual funding plans will be formally required under a prudential standard.

### 3.9 Financial System Inquiry of 2014

Late in 2013 the Australian Government announced that the first comprehensive review of developments in the Australian financial system since the Wallis Inquiry would be undertaken to examine how the financial system could be positioned to best meet Australia's evolving needs and support its economic growth and include an international comparison.<sup>811</sup> It was stated that the 2014 Inquiry would cover the consequences of developments in the Australian financial system since 1997 and also since the GFC; the philosophy, principles and objectives supporting the development of a well-functioning financial system; issues relevant to the ways in which the Twin Peaks model operates and the emerging opportunities and challenges that would drive further change in the financial system both nationally and internationally.<sup>812</sup>

The RBA made a detailed submission to the Financial System Inquiry (FSI) in March 2014. In its submission, the RBA *inter alia* addressed the "Too-Big-to-Fail" problem of SIFIs where public authorities are assumed to be left with no option but to recapitalise SIFIs using public funds if their viability is threatened.<sup>813</sup>

Submissions for the FSI were also invited from the public and were made in two rounds: one prior to the FSI Interim Report<sup>814</sup> and the other prior to the FSI Final

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<sup>811</sup> Australian Government – The Treasury "Financial System Inquiry" (20 December 2013) <http://jbh.ministers.treasury.gov.au/media-release/037-2013/> (accessed 31 December 2017), hereinafter Aus Gov 20 Dec 2014; See also Godwin et al 2016 24.

<sup>812</sup> Aus Gov 20 Dec 2014 1; See also RBA history.

<sup>813</sup> RBA Submission FSI 2014 46. The RBA referred to the expansion of the SIFI framework to non-bank SIFIs like insurers, finance companies, securities broker-dealers and investment funds by the FSB and the standard setting bodies like the International Association of Insurance Supervisors (IAIS) and IOSCO

<sup>814</sup> Financial System Inquiry *First Round Submissions* (31 March 2014) <http://fsi.gov.au/consultation/submissions20140520/> (accessed 31 December 2017).

Report.<sup>815</sup> The FSI issued its interim report on 15 July 2014 (FSI Interim Report 2014)<sup>816</sup> and its final report on 7 December 2014 (FSI Final Report 2014).<sup>817</sup>

It is important to note that the 2014 FSI, unlike the earlier Wallis Inquiry, did not consider changes to the basic framework for financial regulation and thus had a very different focus. It indicated that Australia's financial system had performed well since the Wallis Inquiry and has many strong characteristics. Despite these strengths it however also pointed out that the system has the following weaknesses that makes it prone to calls for more regulation: taxation and regulatory settings distort the flow of funding to the real economy; it remains susceptible to financial shocks; superannuation is not delivering retirement incomes efficiently; unfair consumer outcomes remain prevalent and policy settings do not focus on the benefits of competition and innovation.<sup>818</sup>

The FSI Final Report pointed out that Australia has long adopted what could be called a macroprudential approach to supervision under the rubric of financial stability. Yet, Australia's institutional structure is relatively informal and decentralised. It was pointed out that the RBA and APRA each have responsibility for financial stability but most macroprudential tools can only be deployed by APRA thus placing a strong premium on cooperation between the two agencies.<sup>819</sup> The FSI Final Report considered whether Australia should change its institutional arrangements for making and implementing financial stability policy, but decided against it. It was found that although Australia's approach has advantages and disadvantages, alternative institutional approaches - and also the effectiveness of many macroprudential tools are yet to be tested. For this reason, the FSI recommended no fundamental change to the institutional arrangements for financial stability policy and to the prudential perimeter

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<sup>815</sup> Financial System Inquiry *Second Round Submissions* (26 August 2014) <http://fsi.gov.au/consultation/second-round-submissions/> (accessed 31 December 2017).

<sup>816</sup> Financial System Inquiry *Financial System Inquiry Interim Report* (July 2014) <http://fsi.gov.au/publications/interim-report/> (accessed 10 April 2017), hereinafter FSI Interim Report 2014.

<sup>817</sup> Financial System Inquiry *Financial System Inquiry Final Report* (November 2014) [http://fsi.gov.au/files/2014/12/FSI\\_Final\\_Report\\_Consolidated20141210.pdf](http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf) (accessed 10 April 2017), hereinafter FSI Final Report 2014.

<sup>818</sup> FSI Final Report 2014 xiii.

<sup>819</sup> FSI Final Report 2014 233.

that existed at that stage. However, it indicated that the RBA should continue to monitor risks in the non-prudentially regulated sector, and that the CFR should periodically consider whether change is required.<sup>820</sup>

Insofar as the “twin” regulators were concerned, many of the submissions made to the FSI mentioned the need to reduce regulatory overlap and inconsistency between ASIC and APRA in circumstances involving jointly supervised or dual regulated entities. This was particularly relevant with respect to superannuation funds and superannuation regulations administered by APRA and ASIC. In its FSI submission, Treasury suggested that there was a need to draw clearer distinctions between the responsibilities attributable to ASIC and APRA. Treasury submitted that it was difficult for investors, particularly retail investors, to distinguish between, on the one hand, institutions subject to prudential regulation by APRA and, on the other hand, institutions registered with ASIC and subject to the conduct and disclosure system. Treasury was thus of the opinion that the cheapest option for solving this issue, would be to improve the capacity to distinguish between entities regulated in different ways. It however also indicated that an approach of expanding the prudential perimeter to cover a larger range of businesses, could lead to regulatory arbitrage.<sup>821</sup>

During the 2014 FSI questions were also asked as to whether the CFR should have substantive powers and functions that go beyond its consultative and coordinating role and how accountability and transparency of the CFR should be ensured. The RBA submitted that the CFR had worked well since its formation and that many benefits

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<sup>820</sup> FSI Final Report 2014 234.

<sup>821</sup> Australian Government “The Department of the Treasury’s Submission to the Financial System Inquiry” (3 April 2016) <http://fsi.gov.au/files/2014/04/Treasury.pdf> (accessed 31 December 2017) at 28 – 31; See also Godwin et al 2016 28 where they indicate that one submission to the FSI noted the possibility of reducing regulatory overlap by adopting a system where an institution would have a primary regulator depending on the sector to which it belonged whilst all of the regulators would regulate in their respective areas of responsibility. However, the direct compliance and enforcement responsibilities would rest with the primary regulator. Such a model, it was suggested, would ensure a consistent and coordinated approach for regulated entities informed by a regulator who understands the business of their regulated entities and ensure that any regulation is enforced in a manner that promotes innovation, efficiency and competition in the particular sector. Although a logical solution to regulatory overlap, the ‘primary regulator’ or ‘lead supervisor’ approach has been said to ‘[create] problems in terms of coordinating supervisory action, information flows and, ultimately, crisis intervention’ and was not recommended in the FSI Final Report 2014.

were seen in practice precisely because of the non-statutory character of the CFR, especially during the GFC.<sup>822</sup> The RBA further argued that designating the CFR with explicit responsibilities and policy tools would involve moving agency powers to the CFR, with the risk of distorting lines of responsibility that have worked well in the past.<sup>823</sup> In other words, as pointed out by Godwin et al, conferring explicit powers and responsibilities on the CFR that go beyond its consultative and coordinating role might cut across the powers and responsibilities of the member agencies.<sup>824</sup> Godwin et al remark that another concern relating to a statutory-based inter-agency entity, was that it might be treated as the only channel through which inter-agency co-ordination can be achieved. Other stakeholders, like KPMG, however submitted that the role and functions of the CFR should be protected in statute so that the CFR's role, transparency and accountability would be strengthened.<sup>825</sup> The National Australia Bank also recommended that the CFR should be given a more formal structure and be tasked by the Treasurer to coordinate the implementation of regulatory change by APRA and ASIC.<sup>826</sup>

In the Interim Report of the FSI in 2014 the soft law approach to financial supervision was highlighted by drawing on the submission of the RBA and stating that '[I]egislation cannot be relied on to promote a culture of cooperation, trust and mutual support between domestic regulatory agencies. These have been highlighted as essential elements of an effective financial stability framework, especially during a crisis' and '[i]f powers were formalised in statute, this could suggest that the regulatory functions are separate from those of its members and could engender confusion as to whether

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<sup>822</sup> Reserve Bank of Australia "Submission to the Financial System Inquiry" (March 2014) [http://fsi.gov.au/files/2014/04/Reserve\\_Bank\\_of\\_Australia.pdf](http://fsi.gov.au/files/2014/04/Reserve_Bank_of_Australia.pdf) (accessed 31 December 2017), hereinafter RBA Submission FSI 2014, at 53 and 66.

<sup>823</sup> RBA Submission FSI 2014 67.

<sup>824</sup> Godwin et al 2016 32. Godwin et al 2016 33 point out that in its submission, the RBA further noted that although formal structures for co-ordination between agencies might assist to mediate resolution of differences between regulatory agencies and enforce outcomes, 'it is unclear how reassigning part of a regulatory agency's constituent powers to an overarching body will influence coordination and effectiveness of regulatory policies. Similarly, it remains to be seen if formality is the feature of institutional arrangements that ensures better outcomes.' The RBA further noted that cooperation without formal arrangements appeared to be working well in Australia.

<sup>825</sup> KPMG Submission Financial System Inquiry (31 March 2014) <http://fsi.gov.au/files/2014/04/KPMG.pdf> (accessed 31 December 2017) at 5.

<sup>826</sup> National Australia Bank "Submission to the Financial System Inquiry" (March 2014) <http://fsi.gov.au/files/2014/04/NAB.pdf> (accessed 31 December 2017) at 4; See also Godwin et al 2016 32.

the regulatory agencies' obligations to coordinate arose from their respective charters or that of the CFR".<sup>827</sup> The FSI Interim Report subsequently suggested that the CFR should preferably be seen as the united dimension of all the regulatory agencies activities, and not as a separate body with its own ability to make the regulatory agencies cooperate.<sup>828</sup> In its Final Report the Inquiry concluded that it did not support the formalization of the CFR's mandate and powers as oversight body as it "would fundamentally change the current regulatory system." It stated that if the CFR was to perform such a role it would be transformed from a mechanism to facilitate cooperation between regulators into a separate agency in its own right and that this would result in overlapping responsibilities and weakened accountability.<sup>829</sup> The Inquiry further indicated that it did not see a need to expand the permanent membership of the CFR to include the Australian Competition and Consumer Commission, the Australian Transaction Reports and Analysis Centre or the Australian Taxation Office as it indicated that these agencies could already attend meetings as necessary. However, it indicated that there would be benefit in increasing the transparency of the CFR's deliberations, including its assessment of financial stability risks and how these were being addressed.<sup>830</sup>

According to the FSI the current regulatory arrangement however lack a systematic mechanism for the Australian Government to assess the regulator's performance relative to their mandate. It was pointed out that scrutiny "tends to be episodic and focused on particular issues or decisions."<sup>831</sup> The FSI therefore further recommended that in future Australia should establish a Financial Regulator Assessment Board with the function of providing advice to the government annually on how the financial regulators have implemented their mandates, and to "provide clearer guidance to regulators in Statements of Expectations"<sup>832</sup> and increase the use of performance

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<sup>827</sup> FSI Interim Report 2014 3-119; See also Godwin et al 2016 34.

<sup>828</sup> FSI Interim Report 2014 3-119; See also Godwin et al 2016 32.

<sup>829</sup> FSI Final Report 2014 243-4.

<sup>830</sup> FS1 Final Report 2014 234.

<sup>831</sup> FSI Final Report 2014 29. Recommendation 27.

<sup>832</sup> The Treasury Australian Government "Statements of Expectations" (undated) <https://treasury.gov.au/the-department/accountability-reporting/statements-of-expectations/> (accessed 21 February 2018) at 1: The Australian Government agreed that Ministers would issue Statements of Expectations to statutory agencies. Through issuing a Statement of Expectations, Ministers are able to provide greater clarity about government policies and objectives relevant to a statutory authority, including the policies and priorities it is expected to observe in conducting its operations.

indicators for regulator performance”.<sup>833</sup> It was envisaged that under the new Regulator Performance Framework, regulators would have to undertake an annual externally-validated self-assessment of their performance and that selected regulators would also have their performance assessed externally by a review panel every three years, with the option of an annual review for major regulators.<sup>834</sup>

Notably, the Australian Government accepted all the recommendations of the 2014 FSI with the exception of the recommendation to create a Financial Regulator Assessment Board,<sup>835</sup> or as Schmulow aptly refers to it, “a regulator for the regulators”.<sup>836</sup>

Being a very pro-active jurisdiction, Australia has now embarked upon yet another financial inquiry with the establishment of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry on 14 December 2017 by the Governor-General of the Commonwealth of Australia.<sup>837</sup>

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<sup>833</sup> FSI Final Report 2014 19 and FSI Recommendation 27 239; See also Schmulow 2015 no 1 172 where he points out that this proposal has precedent in the UK, which has established a Financial Policy Committee, whose responsibility it is to identify, monitor and take action in case of a crisis looming in order to remove or reduce systemic risks. It also have to support the economic policy of the government; See also Schmulow 2016 no. 2 18.

<sup>834</sup> FSI Final Report 2014 244-245. The envisaged remit of the Assessment Board would be narrow and would specifically exclude assessments of the merits of relief for particular transactions, enforcement actions and individual complaints against the regulators and also matters of individual financial system policy regulation, such as the appropriateness of the mandates of the regulators.

<sup>835</sup> The Sydney Morning Herald “Fancy dress financial regulators ASIC and APRA must go” Schmulow A (31 May 2016) <http://www.smh.com.au/business/banking-and-finance/fancy-dress-financial-regulators-asic-and-apra-must-go-20160531-gp89dp.html> (accessed 16 August 2017) stated that this recommendation from the FSI to create a Financial Regulator Assessment Board was the only recommendation that the Abbott government rejected.

<sup>836</sup> In The Conversation “Australia’s financial regulators need policing” (8 February 2018) <http://theconversation.com/australias-financial-regulators-need-policing-91396> (accessed 22 February 2018), Schmulow, emphasized the importance thereof that APRA and ASIC should be regulated by a Financial Regulator Assessment Board as proposed by the FSI 2014. Such a regulator would “conduct ex post analyses of how regulators had discharged their mandates, evaluate their policies and the efficacy of their policy tools. According to Schmulow it “would be a sober second thought, and a crucial mechanism of double redundancy – to pick up on crucial elements that the regulator may have overlooked”.

<sup>837</sup> Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (14 December 2017) <https://financialservices.royalcommission.gov.au/Pages/default.aspx> (accessed 28 April 2018): The interim report has to be submitted no later than 30 September 2018 and the final report by 1 February 2019.

### 3.10 Conclusion

The Reserve Bank of Australia (RBA) that has its roots in the Commonwealth Bank (that was established in 1911 already) is an archetypical central bank. Pre-Twin Peaks it had the traditional functions of a central bank which included responsibility for monetary policy, oversight of the payments and settlement system, bank supervision and lender of last resort assistance. The Bank also had a mandate to promote and maintain financial stability although such mandate was not expressed in legislation but rather implied in the broader context of its role as set out in section 10 of the Banking Act 1959 which gives the RBA the mandate to ensure that the monetary and banking policy of the RBA is dedicated to the greatest advantage of the people of Australia and that its powers are executed in such a manner as to best contribute to the stability of the Australian currency, maintenance of full employment and the economic prosperity of the Australian people. Prior to Australia's adoption of a Twin Peaks model the RBA operated as central bank within a sectoral model of regulation comprising of various other financial regulators.

The Twin Peaks model of financial regulation was pioneered in Australia. The conversion to the Australian Twin Peaks model in 1998 was a deliberate calculated move that was not precipitated by any crisis. It was based on a comprehensive and purposive inquiry (Wallis) into the then existing model of financial regulation and a thorough consideration of various alternative models. The selection of the Twin Peaks model that entailed a functional split between prudential regulation and market conduct regulation located in the two new bodies with system wide regulatory mandates that were created for these purposes, APRA and ASIC, signalled a new era of financial regulation in Australia. In this new regulatory model the RBA retained its position as authority with responsibility for promotion and maintenance of financial stability although no significant amendment was effected to the Reserve Bank Act to legislatively entrench this affirmed mandate. The RBA retained its other pre-Twin Peaks roles and functions relating to monetary policy, supervision of the payments system and lender of last resort assistance but prudential regulation was removed from its regulatory and supervisory remit and moved over to the newly established

APRA. Notably the creation of APRA as prudential regulator also came with a financial stability mandate as section 8 of the APRA Act expressly provided that APRA had to promote financial stability. Thus the effect of the introduction of a Twin Peaks model insofar as financial stability was concerned was to create a shared responsibility for financial stability between the RBA and APRA. The decision to separate prudential regulation from the narrow bank supervision remit of the central bank was well motivated. The actions subsequently undertaken by APRA as prudential regulator with a dedicated macroprudential focus was clearly aimed at promoting and maintaining financial stability in Australia. One would thus be justified in concluding that this “joint venture” between the RBA and APRA laid the basis for effective promotion and maintenance of financial stability: The RBA was able to focus on monetary policy and keeping matters in check in the payments and settlement system whilst also having the stabilizing role to intervene as lender of last resort should an instance arise meriting such intervention and in the course of its interactions as central bank, concerned not only with the financial system but also the broader macro-economy, it was the guardian of financial stability in Australia. This focus of the RBA was not diluted by also requiring the Bank to regulate and supervise a whole range of financial institutions which clearly is a regulatory task of great magnitude that would on a continuous basis require a great deal of regulatory energy and effort. APRA promoted the safety and soundness of financial institutions across the financial system and thus contributed to effective prudential regulation as an important layer in the efforts directed at financial system stability.

Considering the broader architecture of the Australian Twin Peaks system it appears that this model of financial regulation also has other features that are conducive to the promotion and maintenance of financial stability. In the broader scheme of the Twin Peaks model that was introduced in Australia the RBA and APRA was further supported by ASIC as market conduct regulator which, although not the bearer of a comprehensive financial stability mandate in the likes of the RBA and APRA, nevertheless undoubtedly contributed to financial stability in Australia. This contribution by ASIC was not merely a side-effect of the fact that a combination of good market conduct discipline and good prudential discipline inarguably promotes financial stability but also because the Corporations Act 2001 specifically imposed on

ASIC the obligation to decrease systemic risk in the payments and clearing system. Another important cog in the machine of the Australian Twin Peaks model was the Treasury.

The legislative architecture of the Australian Twin Peaks model was not contained in a single legislative framework but was spread over a number of Acts, notably the Reserve Bank Act, the APRA Act and the ASIC Act. Cooperation and collaboration between the regulators were facilitated by various memoranda of understanding entered into between them and overseen by the Council of Financial Regulators (CFR) as overarching coordinating body on which they all had representation. The effective implementation of Twin Peaks in Australia as a highly developed and resilient economy hinged largely on these “soft law” MOUs that presented a flexible facilitative basis for collaboration and coordination that could be amended easily to accommodate further developments in regulatory arrangements and created a dynamic platform for the execution of the various regulatory mandates.

By the time that the GFC erupted in 2008 the Australian Twin Peaks model had been in operation for a decade already. There is no evidence that the Australian system’s stability was under any threat during the Crisis. It appears that the Australian financial system proved to be resilient inter alia as a result of robust prudential regulation by APRA. In fact the regulatory approach by all the Australian regulators intensified after the collapse of HIH in 2001 and it appears that this more aggressive regulatory approach contributed to the resilience of the Australian financial system and economy. The use of the PAIRS and SOARS risk-based approach to prudential regulation also enhanced the prudential resilience of Australian financial institutions as did the intensified supervision of financial conglomerates since 2003 and improved superannuation regulation.

ASIC as market conduct regulator has regulatory responsibilities captured in a number of Acts, with the ASIC Act as main legislative framework. Its regulatory responsibilities in terms of the Financial Services Reform Act of 2001 has strengthened its powers of

market conduct regulation. As alluded to above, ASIC's contribution to financial stability, although not expressly provided for in the ASIC Act, is fortified by section 823E of the Corporations Act 2001 that tasks ASIC with the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities. ASIC executes this mandate through its Emerging Risk Committee. In this context there is some intersection between the financial stability functions of ASIC and the RBA given that it is the RBA who is mandated to set financial stability standards. In execution of this specific financial stability mandate directions powers are bestowed on ASIC to specifically direct holders of clearing and settlement facilities to take actions to reduce systemic risk. ASIC must consult with the RBA prior to issuing a direction to a regulated institution but strangely enough it is not obliged to comply with a request by the RBA to issue a direction.

Effective coordination and cooperation between the RBA and APRA and ASIC are essential to the successful operation of the Australian Twin Peaks model specifically in the context of promotion and maintenance of financial stability. As indicated the RBA contributes to financial stability through its various roles relating to monetary policy, payment system oversight and as lender of last resort. But to ensure that financial institutions are prudentially sound the RBA has to rely on the work done by APRA who is also the only regulator empowered to use macroprudential tools. For assistance in ensuring that systemic risk emanating from the payments and clearing system is prevented from propagating into systemic events the RBA has to rely on ASIC to effectively execute the specific financial stability mandate as set out in the Corporations Act 2001. To ensure comprehensive coordination of all these actions by the various regulators with regard to financial stability the Council of Financial Regulators, chaired by the Governor of the RBA, fulfils a central role in overseeing cooperation and collaboration between the regulators. It also serves as coordinating body in the broader context of Twin Peaks that requires the regulators to work together for purposes of objectives other than financial stability also. The CFR is assisted by interagency working groups that provide the necessary input. Notably the CFR does not have a legislative underbuilt and it appears that although the lack of a legislative framework entrenching the objectives, functions and powers of the CFR has been regarded as facilitating flexibility there were nevertheless a rising sentiment (as

appeared from the 2014 FSI Interim Report) that the time has come for the CFR to be underpinned by a legislative framework. The 2014 FSI however rejected entrenching CFR's mandate and powers in legislation, indicating that it would fundamentally change the current regulatory system by resulting in regulatory overlap and weakened accountability.

The MOUs entered into between the RBA and APRA as well as the RBA and ASIC are mainly directed at cooperation and collaboration in the context of financial stability whereas the MOU between APRA and ASIC are directed more generally at issues arising from their broader mandates in the Twin Peaks system. The MOUs constitute soft law and are not legally binding thus emphasising the need for good relations between the regulators to ensure that they abide by the MOUs. As pointed out by Godwin et al such soft law cooperation and collaboration is possible because of the existing regulatory culture in Australia which inter alia embraces an outcomes –based approach to regulation.

Cooperation between the RBA and APRA for purposes of financial stability is further facilitated by the Coordination Committee that also meets regularly every six weeks. The RBA and APRA also exchange relevant information and APRA gives input in the RBA's Financial Stability Review. On occasion the RBA also accompanies APRA on supervisory visits. The Key Performance indicator in the job description of the RBA's Head of Financial Stability Department also undoubtedly has the effect that the RBA takes its obligation regarding cooperation and collaboration with APRA very seriously. The MOU between the RBA and APRA entered into in 1998 has a distinct financial stability focus that hinges on close cooperation as captured in the specific paragraph dedicated to cooperation between the RBA and APRA in the event of threats to financial stability.

Cooperation between the RBA and ASIC within the broader Twin Peaks framework and in recognition of the regulatory truth that prudential regulation supervision should be supported by good market regulation to enable the promotion and maintenance of

financial stability, is also addressed by means of a memorandum between these two lead regulators. Practical execution of these arrangements are further facilitated by regular forums where relevant matters are discussed.

The pro-active macroprudential risk-based regulatory stance by the Australian regulators in the years prior to the GFC served Australia well. APRA played a significant role in ensuring the resilience of especially the Australian banks through tools such as stress-testing and warning financial institutions against engaging in practices that eventually proved to be detrimental to financial stability in other countries, such as the high-risk subprime lending markets in the USA. Its warnings about credit build-up in households and the housing market also dampened the ability of these areas to erode financial stability in Australia. The Australian regulators also did not shun lessons from the collapse of HIH and used this opportunity to intensify their regulatory approach. By the time that the GFC hit they thus had the advantage of having a well-developed regulatory corps and a focused approach to dealing with systemic risk. Cooperation between the RBA, APRA and ASIC was also swift and effective during the years that the GFC raged elsewhere on the globe. The regulatory wisdom of sound economic management, pro-active risk-based supervision and a well-coordinated crises response thus kept the Australian financial system and broader economy stable while other financial systems and economies were collapsing under the effects of the GFC. Even in this position of strength the Australian Government and regulators were not complacent but still heeded the lessons of the crisis albeit from observing the regulatory failures in other jurisdictions.

Therefore although the GFC did not occasion wide scale regulatory reform of specifically the Twin Peaks model, Australia nevertheless made some changes in order to enhance financial regulation and general resilience of its financial system that would support financial stability in the country. Representatives from Australia joined the Basel Committee on Banking Supervision, domestic inter-agency cooperation was increased and already in 2008 Australia commenced to strengthen its resolution framework for financial institutions and has also established an explicit deposit insurance scheme in the form of the Financial Claims Scheme. It also started doing

crisis simulation exercises and established the Committed Liquidity Facility in 2010 and became an early adopter of the BASEL III reforms. The Trio Capital collapse in 2011 also served to further intensify the attempts at enforcement and redress undertaken by APRA and ASIC.

The 2012 IMF Country Report 12/308 on Financial System Stability Assessment also confirmed Australia's stable financial position referring favourably to their risk-based approach to financial regulation and supervision and the country's observance of international regulatory standards and principles. This Report acknowledged the shared responsibility for financial stability specifically between the RBA and APRA and the use of tools such as PAIRS and SOARS, stress-testing and imposing higher loss absorbency requirements on systemically important banks. The IMF further acknowledged the roles played by ASIC and the Treasury in the context of financial stability. It however also identified some risks *inter alia* relating to high household debt and higher house prices. The important role of the RBA's Financial Stability Review as a mechanism for systemic risk identification and monitoring was also highlighted by the IMF with a suggestion that the results of stress tests be incorporated into the review. Whilst the IMF regarded the CFR as an effective coordinating body it was nevertheless also recommended that it should be more transparent and should be more pro-active with regards to crisis planning, simulation and communication. It was also suggested that funding of the Financial Claims Scheme be changed to *ex ante* funding in an attempt to mitigate moral hazard and that APRA should intensify on-site supervision of regulated institutions.

In the second 2012 IMF Country Report No 12/313 on the observance by Australia of the Basel Core Principles for Effective Banking Supervision as part of the IMF FSAP on Australia, the focus fell again on the execution by the RBA and APRA of their respective financial stability mandates and how they cooperated and collaborated with each other. The RBA's key role as liquidity provider to the financial system and in dealing with financial institutions that encountered distress was *inter alia* highlighted. The envisaged introduction of the Committed Liquidity Facility by the RBA to enable ADIs to meet their liquidity coverage ratio requirements was regarded as an important

development. The cooperation by the RBA and APRA in terms of monitoring the payment system through the RBA Information and Transfer System (RITS) was also alluded to. Reference was further made to APRA'S internal Financial Crisis Management Plan where the CFR was used as platform in deciding on appropriate steps to deal with a crisis. Australia's high level of compliance with the BASEL Core Principles were also cited as reason for the resilience of the banking sector. The way in which Australian banks offered financing however raised concern with the IMF.

Another comprehensive financial system enquiry was subsequently undertaken by Australia in 2014 - again without having been precipitated by a major financial crisis. This confirms Australia's pro-active "prevention is better than cure"- approach to financial regulation that has served the country so well over the years. It is significant that a wholesale reform of the Twin Peaks approach was not on the agenda which indicates that Twin Peaks was regarded as an appropriate regulatory model even in the post GFC financial landscape which differed considerably from the financial landscape that prevailed in 1998 when the Twin Peaks model was selected by the Wallis Inquiry. No changes were made to the financial stability mandate of the RBA nor to the financial stability mandate of APRA. However it was recommended that regulatory overlap and inconsistencies between APRA and ASIC should be reduced insofar as dual regulated entities were concerned and that their supervisory responsibilities be demarcated more clearly. Apart from recommending that greater resilience be infused into the financial system through imposing higher capital requirements on ADIs the most significant other issue raised in the context of financial stability related to formalising the mandate of the CFR in legislation. This also put the spotlight on the sustainability of Australia's soft law approach to regulatory cooperation and collaboration. Notably it was recommended that a Financial Regulator Assessment Board be established in order to assess how the regulators have implemented their mandates and to provide clearer guidance to regulators in Statements of Expectation to enhance their regulatory performance.

It thus appears that Australia was a worthy and responsible pioneer of the Twin Peaks model - it remained vigilant about financial regulation despite not experiencing the full-

blown effects of the GFC - and by doing so it not only enabled the model to facilitate the promotion and maintenance of financial stability but also showcased the attractiveness of Twin Peaks as a regulatory approach that could prove beneficial to other jurisdictions.

## CHAPTER 4

### COMPARATIVE STUDY: THE NETHERLANDS

- 4.1 Historical background of financial regulation in the Netherlands and De Nederlandsche Bank as central bank
  - 4.2 Rationale behind the move to a Twin Peaks system of financial regulation in the Netherlands
  - 4.3 Twin Peaks in the Netherlands: The *Wet op het financieel toezicht* (Wft)
  - 4.4 The Dutch Twin Peaks model during the GFC
  - 4.5 Reforms in the Netherlands subsequent to the GFC
  - 4.6 Developments in Europe that significantly impacted on the Dutch Twin Peaks model and the role of DNB
  - 4.7 More recent progress made in the Netherlands with regard to financial stability
  - 4.8 Conclusion
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In this chapter the Twin Peaks model of financial regulation implemented in the Netherlands will be discussed with specific focus on the role, functions and powers of De Nederlandsche Bank (DNB), as Dutch central bank in the context of promotion and maintenance of financial stability within a Twin Peaks model during and after the Global Financial Crisis (GFC). The reason for selecting this jurisdiction is because the Twin Peaks model of financial regulation was implemented in the Netherlands shortly *before* the GFC and subsequently underwent some reform after the GFC *inter alia* with regard to the role of the central bank. It could therefore be valuable to consider what insights were gained with regard to the financial stability role of the central bank in the

Dutch Twin Peaks model and to consider the significance of those insights for South Africa.

#### 4.1 Historical background of financial regulation in the Netherlands and De Nederlandsche Bank as central bank

The supervisory framework of the financial markets in the Netherlands developed over many years from as early as the 1800s. The central bank in the Netherlands, De Nederlandsche Bank (DNB) was established on 1 April 1814 in the form of a private law legal person called *Compagnieschap onder firma* (Partnership under firm).<sup>838</sup> This first Charter of DNB made no mention of its responsibility for monetary or financial stability.<sup>839</sup> In the *Bankwet* (Banks Act) of 1863 DNB became a *Naamloze Vennootschap* (Limited Liability Company).<sup>840</sup> Later in the *Bankwet* 1903 DNB was allowed to act as bank of issue and its banknotes were given the status of legal tender. Still no mention was made in this Act of any responsibility of the bank for macro-economic stability or bank supervision. Mooij and Prast point out that although DNB was the de facto lender of last resort, this role was not explicitly laid down in the law.<sup>841</sup> In the 1918 *Bankwet* a *commissie van advies* (committee of advice) was established that had to maintain contact with the business community.<sup>842</sup> Approximately 1920 DNB also became the de facto supervisor of the Dutch banking sector.<sup>843</sup> During the Dutch

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<sup>838</sup> Everdingen, Grundmann-van de Krol, & Sachse *Aspecten van toezicht: Beschouwingen over het toezicht op de financiële sector: Preadviezen voor de Vereniging voor Effectenrecht 1999* (1999), hereinafter Everdingen et al 1999, at 13; See also Mooij J and Prast HM “A brief history of the institutional design of banking supervision in the Netherlands” Research Memorandum Wo no. 703 / Research Series Supervision No. 48 (October 2002) [https://www.dnb.nl/binaries/ot048\\_tcm46-146058.pdf](https://www.dnb.nl/binaries/ot048_tcm46-146058.pdf) (accessed 22 December 2017) hereinafter Mooij & Prast 2002; De Nederlandsche Bank “History of DNB” (undated) [https://www.dnb.nl/en/binaries/History%20DNB\\_tcm47-144511.pdf?2018021115](https://www.dnb.nl/en/binaries/History%20DNB_tcm47-144511.pdf?2018021115) (accessed 11 February 2018), hereinafter History of DNB, at 3: DNB was founded by King William I. The shares of DNB in 1814 were owned by its financiers. The duties of DNB was enshrined in a Charter which stated that DNB was the only bank in the Netherlands allowed both to issue banknotes and to extend credit.

<sup>839</sup> Mooij & Prast 2002 2.

<sup>840</sup> Everdingen et al 1999 13; History of DNB 4: In the *Bankwet* 1883 DNB was given the mandate to spread its wings from only operating in Amsterdam, to opening branches throughout the country.

<sup>841</sup> Mooij & Prast 2002 3.

<sup>842</sup> Van Zwet JR “De ontwikkeling van de Bankwet 1814-1998. Van’s Konings oudste dogter tot integrerend onderdeel van het ESCB” (March 2001) [https://www.dnb.nl/binaries/wo0649\\_tcm46-145952.pdf](https://www.dnb.nl/binaries/wo0649_tcm46-145952.pdf) (accessed 15 August 2017), hereinafter Van Zwet 2001, at 6.

<sup>843</sup> Jonker J “Between private responsibility and public duty. The origins of bank monitoring in the Netherlands, 1860-1930.” 1996 (3) *Financial History Review* 139.

Banking Crisis of 1922 to 1927 when 61 banks exited the market, 14 of them due to insolvency, DNB further developed its role as lender of last resort.<sup>844</sup> In 1923 the *Wet op het levensverzekeringsbedrijf* 1923 (Act on the Life Insurance Business) was introduced and the *Verzekeringskamer* (VK) (Insurance Chamber) was created to supervise life insurance transactions indicating the first signs that the Netherlands followed a sectoral model of financial supervision.<sup>845</sup>

Since the fall of the pound sterling in 1931, banks in the Netherlands had to report regularly to DNB.<sup>846</sup> As indicated by Mooij and Prast it was in the 1930s that the first signs of both monetary and prudential supervision at DNB appeared simultaneously.<sup>847</sup> In 1934 it was determined that the managing board of DNB would from then on consist of a president, a secretary and at least one director.<sup>848</sup> After the Second World War supervision of the credit system was introduced in the Netherlands. *De Beschikking Deblokkering* 1945 (The Unblocking Ordination) and the *Bankwet* 1948 determined that DNB would be the supervisor of the credit system and thus of banks rendering certain services as credit institutions.<sup>849</sup> In 1948 the shares of DNB were transferred to the State in terms of the *Bankwet* 1948 and DNB was thus nationalized.<sup>850</sup> The *Bankwet* of 1948 also replaced the *commissie van advies* by the *Bankraad* (Bank council) as single communicator for the different divisions in the Bank.<sup>851</sup>

In terms of section 9 of the *Bankwet* 1948 monetary supervision was entrusted to DNB, but the government could give directives to the Bank in this regard and the Bank was

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<sup>844</sup> Mooij & Prast 2002 4. They indicate that during this crisis DNB provided liquidity support to individual banks. It went even further in the case of Robaver Bank, by organizing a consortium with the aim of supporting the price of Robaver stock by acting as a buyer on the Amsterdam stock exchange.

<sup>845</sup> De Nederlandsche Bank "History of the PVK" (undated) [https://www.dnb.nl/en/binaries/History%20PVK\\_tcm47-144512.pdf](https://www.dnb.nl/en/binaries/History%20PVK_tcm47-144512.pdf) (accessed 27 January 2018), hereinafter DNB History PVK, at 2.

<sup>846</sup> Everdingen et al 1999 13.

<sup>847</sup> Mooij & Prast 2002 5.

<sup>848</sup> Van Zwet 2001 7.

<sup>849</sup> Bierman B, Silverentand L, Eerden F, Reijmer J, Sprecher J, and Wit T *Hoofdlijnen Wft*, hereinafter Bierman et al 2015, at 3.

<sup>850</sup> Everdingen et al 1999 13; See also Heertje A *De kern van de economie* (1962) 51. De Nederlandsche Bank – Governance (undated) <https://www.dnb.nl/en/about-dnb/organisation/governance/> (accessed 5 February 2018) 1: Until the present, DNB has had one single shareholder namely the Dutch State.

<sup>851</sup> Van Zwet 2001 9.

thus not independent in relation to its monetary policy mandate.<sup>852</sup> Section 9 of the *Bankwet* 1948 formulated the mandate of DNB and provided as follows: “1. It shall be the duty of the Bank to regulate the value of the Netherland’s monetary unit in such a manner as will be most conducive to the nation’s prosperity and welfare, and in so doing to keep the value as stable as possible.<sup>853</sup> 2. It shall supply bank-notes for circulation in the Netherlands, and facilitate domestic and external money transfers. 3. It shall supervise the credit system.” Mooij and Prast remark that the Banks Act 1948 gave DNB “explicit responsibilities for monetary policy and the stability of the financial system”.<sup>854</sup> However having regard to the wording of section 9 it is clear that no such express mention of a financial stability mandate is made - the reference to stability in section 9 is to the stability of the currency - and therefore it is submitted that Mooij and Prast probably inferred the financial stability mandate from the broader tenor of section 9 - and that, although not explicitly captured in legislation at that stage, the de facto position was that DNB was responsible for financial stability in the Netherlands.

From 1952 supervision of the credit system, which was the responsibility of DNB, was more comprehensively set out in the *Wet toezicht credietwezen* 1952 (Act on the Supervision of the Credit system). Section 9:3 of the *Bankwet* 1948 was amended in 1952 when the *Wet toezicht credietwezen* was enacted to provide that DNB would supervise the credit system *in pursuance of the Act on the Supervision of the Credit System*.<sup>855</sup> The *Pensioen- en spaarfondsenwet* 1952 (Pension and Savings Fund Act) was adopted and the supervision of pension and savings funds was since then exercised by the VK in addition to life insurance transactions that already formed part of its supervisory remit.<sup>856</sup> In 1956 the *Wet toezicht kredietwezen* was amended and

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<sup>852</sup> Mooij & Prast 2002.

<sup>853</sup> Or as translated in History of DNB 6: ‘... to regulate the value of the Netherlands’ currency in such a manner as will be most serviceable to the national wealth, while stabilising that value as much as possible’.

<sup>854</sup> Mooij & Prast 2002 7.

<sup>855</sup> Memorie van Toelichting - Kamerstuk 25719 nr. 3 (10 November 1997) [https://zoek.officielebekendmakingen.nl/kst-25719-3.html?zoekcriteria=%3Fzkt%3DEenvoudig%26pst%3D%26vrt%3D25719%26zkd%3DInDeGeheleText%26dpr%3DAfgelopenDag%26spd%3D20100410%26epd%3D20100411%26sdt%3DDatumBrief%26ap%3D%26pnr%3D1%26rpp%3D10%26\\_page%3D2%26sorttype%3D1%26sortorder%3D4&resultIndex=14&sorttype=1&sortorder=4](https://zoek.officielebekendmakingen.nl/kst-25719-3.html?zoekcriteria=%3Fzkt%3DEenvoudig%26pst%3D%26vrt%3D25719%26zkd%3DInDeGeheleText%26dpr%3DAfgelopenDag%26spd%3D20100410%26epd%3D20100411%26sdt%3DDatumBrief%26ap%3D%26pnr%3D1%26rpp%3D10%26_page%3D2%26sorttype%3D1%26sortorder%3D4&resultIndex=14&sorttype=1&sortorder=4) (accessed 5 February 2018) 10. Author’s emphasis.

<sup>856</sup> DNB History PVK 2 - 6. Life insurance transactions were supervised by the VK since 1923, see above.

the revised Act strengthened DNB's position as supervisor of the credit system.<sup>857</sup> The *Wet op het schadeverzekeringsbedrijf* 1961 (Act on the Non-Life Insurance Business) was later introduced which made the entire insurance and pensions sector subject to supervision by the VK.<sup>858</sup> Subsequently the *Wet toezicht kredietwezen* 1978 introduced the expression of "prudential supervision". The 1978 Act further introduced deposit insurance and emergency regulations in order to prevent bank runs.<sup>859</sup> From 1985 the *Wet Effectenhandel* (Act on securities trading) regulated securities and in 1988 the *Stichting Toezicht effectenverkeer* (STE) (Foundation for supervision of securities transactions) was introduced as securities supervisor, thus adding to the sectoral dimensions of financial regulation in the Netherlands.<sup>860</sup> In 1992 a new *Wet toezicht kredietwezen* (Act on supervision of the credit system), was introduced, which broadened the supervisory powers of DNB as prudential regulator.<sup>861</sup>

The Netherlands being a European Union (EU) Member State, the role of DNB should also be considered within the broader context of the EU financial system as its role in this context significantly influenced its role as national central bank. The establishment of the eurozone in 1999 in terms of the EU Treaty (Maastricht Treaty)<sup>862</sup> was a very

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<sup>857</sup> *Gewijzigde vaststelling van de Wet toezicht kredietwezen* (Amended adoption of the credit supervision Act): *Kamerstuk Tweede Kamer* 1955 - 1956 *kamerstuknummer* 4216 See also Mooij & Prast 2002 9. The spelling of *credietwezen* changed to *kredietwezen* in the Dutch text of the Act in 1956.

<sup>858</sup> DNB History PVK 2 - 6.

<sup>859</sup> Mooij & Prast 2002 12. Emergency regulations were designed for situations when the solvency or liquidity of a credit institution showed signs of a dangerous trend and no improvement in this trend could reasonably be expected. In those cases the Court could, at DNB's request, declare 'the credit institution to be in a position requiring special measures in the interest of all creditors' (sections 31 and 32 of the *Wet toezicht kredietwezen* 1978).

<sup>860</sup> Bierman et al 2015 3.

<sup>861</sup> Mooij & Prast 2002 17.

<sup>862</sup> Scheller HK "The European Central Bank: History, role and functions" (2004) <https://www.ecb.europa.eu/pub/pdf/other/ecbhistoryrolefunctions2004en.pdf> (accessed 18 December 2017) hereinafter Scheller 2004, at 21: The Treaty that established the European Economic Community (EEC), was signed in Rome on 25 March 1957 (therefore often referred to as the "Treaty of Rome") (officially known as the Treaty establishing the European Economic Community, hereinafter referred to as the EC Treaty) and entered into force on 1 January 1958. The EC Treaty was amended by the Treaty on European Union (hereinafter the EU Treaty, that was signed in Maastricht on 7 February 1992 and therefor commonly known as the "Maastricht Treaty") to establish the European Community from what was previously the EEC; See also Treaty on European Union – (Consolidated version 26 October 2012) [http://eurlex.europa.eu/resource.html?uri=cellar:2bf140bf-a3f8-4ab2-b506-fd71826e6da6.0023.02/DOC\\_1&format=PDF](http://eurlex.europa.eu/resource.html?uri=cellar:2bf140bf-a3f8-4ab2-b506-fd71826e6da6.0023.02/DOC_1&format=PDF) (accessed 24 January 2018); Deutsche Bundesbank Eurosystem (undated) [https://www.bundesbank.de/Redaktion/EN/Glossareintraege/T/treaty\\_on\\_the\\_functioning\\_of\\_the\\_european\\_union.html](https://www.bundesbank.de/Redaktion/EN/Glossareintraege/T/treaty_on_the_functioning_of_the_european_union.html) (accessed 24 February 2018) 1: The Treaty on the Functioning of the European Union (hereinafter the TFEU) was signed at Lisbon on 13 December 2007, and therefor also referred to as the Lisbon Treaty. It came into force on 1 December 2009. The TFEU amended both the EC

significant development in the broader EU context that significantly impacted on the role of national central banks in EU Member States insofar as monetary policy is concerned and it consequently also had significance for the role of European central banks, located in the various Member States, with regard to maintenance of financial stability.<sup>863</sup> The decision on EU-level to use the euro as single monetary currency prompted the establishment on 1 June 1998 of the European Central Bank (ECB) and the European System of Central Banks (ESCB) by means of the *Statute of the European System of Central Banks and of the European Central Bank* in preparation for the move to a eurozone.<sup>864</sup> The ECB became responsible for monetary policy in the EU on supranational level, on 1 January 1999, pursuing a price stability objective.<sup>865</sup> The responsibility for monetary policy decision making was thus transferred from several central banks, including DNB, to the new supranational institution.<sup>866</sup> The ECB is directly accountable to the European Parliament and Council for carrying out its supervisory role and has to present an annual report in public to the European Parliament.<sup>867</sup> Alexander further points out that the EU Treaty established a strong form of (instrument) independence for the ECB in deciding what measures it

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Treaty and the EU Treaty. The EU Treaty contains, amongst other things, provisions on the bodies of the EU, such as the European Parliament, the European Council and the EU Council. The TFEU contains, amongst other things the framework for economic and monetary policy; See also Treaty on the Functioning of the European Union (TFEU) (Consolidated version 2016) <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:C:2016:203:TOC> (accessed 22 January 2018).

<sup>863</sup> The developments in the EU relating to financial stability are discussed in par 4.6 below.

<sup>864</sup> Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank (26 October 2012) [http://www.ecb.europa.eu/ecb/legal/pdf/c\\_32620121026en\\_protocol\\_4.pdf](http://www.ecb.europa.eu/ecb/legal/pdf/c_32620121026en_protocol_4.pdf) (accessed 22 December 2017); EU Treaty Article 282(1) provides that the “ECB, together with the national central banks, shall constitute the ESCB. The ECB, together with the national central banks of the Member States whose currency is the euro, which constitute the Eurosystem, shall conduct the monetary policy of the Union. (2) The ESCB shall be governed by the decision-making bodies of the ECB. The primary objective of the ESCB shall be to maintain price stability. Without prejudice to that objective, it shall support the general economic policies in the Union in order to contribute to the achievement of the latter’s objectives. (3) The ECB shall have legal personality. It alone may authorise the issue of the euro. It shall be independent in the exercise of its powers and in the management of its finances. Union institutions, bodies, offices and agencies and the governments of the Member States shall respect that independence”; See also Scheller 2004 21 who further points out that the legal basis for the ECB is the EU Treaty.

<sup>865</sup> K Alexander “Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism” 2015 *European Law Review* 154, hereinafter Alexander 2015.

<sup>866</sup> European Central Bank Eurosystem “The monetary policy of the ECB” (2011) <http://www.ecb.europa.eu/pub/pdf/other/monetarypolicy2011en.pdf?4004e7099b3dcdbf58d0874f6eab650e> (accessed 5 February 2018) 14, hereinafter ECB monetary policy 2011, at 14.

<sup>867</sup> SSM Regulation article 20; See also Alexander 2015 166 -170.

should use to conduct monetary policy and to achieve its primary objective of price stability in the eurozone.<sup>868</sup>

The creation of the single monetary area (eurozone) had the effect that although numerous central banks in the euro area were responsible for domestic financial supervision of banks, a “double separation” was created (geographical and functional) between the tasks of financial supervision and monetary policy-making.<sup>869</sup> Scheller thus remarks that the transfer of monetary policy to the Community level has required substantial changes to the European central banking framework.<sup>870</sup> The establishment of the ECB *inter alia* implied that emergency liquidity support by DNB should not interfere with monetary policy by the ECB. To the extent that this support would have an overall effect that would be relevant for monetary policy or have a financial stability implication for the euro area, the Eurosystem<sup>871</sup> would be actively involved.<sup>872</sup> The Eurosystem uses three monetary policy instruments to influence the liquidity position of the banking sector, namely minimum reserve requirements, open-market operations<sup>873</sup> and standing facilities.<sup>874</sup>

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<sup>868</sup> Alexander 2015 170; See article 130 and 282(3) of the TFEU and article 7 of the Statute of the European System of Central Banks and of the European Central Bank regarding the independence of the ECB.

<sup>869</sup> Padoa-Schioppa T “EMU and Banking Supervision” Lecture at the London School of Economics to the Financial Markets Group (24 February 1999) <https://www.ecb.europa.eu/press/key/date/1999/html/sp990224.en.html> (accessed 18 December 2017). See also M Chang “The rising power of the ECB: The case of the Single Supervisory Mechanism” Paper presented for the Biennial Conference of the European Union Studies Association Boston (5-7 March 2017) <https://eustudies.org/conference/papers/download/24> (accessed 19 December 2017).

<sup>870</sup> Scheller 2004 21.

<sup>871</sup> European Central Bank – Eurosystem “ECB, ESCB and the Eurosystem” (undated) <https://www.ecb.europa.eu/ecb/orga/escb/html/index.en.html> (accessed 10 February 2018) 1: The Eurosystem comprises the ECB and the national central banks of all EU Member States, whether they have adopted the euro as monetary unit or not.

<sup>872</sup> Mooij & Prast 2002.

<sup>873</sup> De Nederlandsche Bank Eurostysteem “Monetary policy instruments” (undated) <https://www.dnb.nl/en/interest-rates-and-inflation/monetary-policy/monetary-policy-instruments/> (accessed 5 February 2018) 1, hereinafter DNB Eurostysteem Monetary Policy: Open-market operations are operations through which the ECB provides refinancing to help banks meet their liquidity needs or to withdraw liquidity from the system.

<sup>874</sup> DNB Eurostysteem Monetary Policy 1: Standing facilities allow credit institutions to either borrow liquidities (until the next morning) from their national central banks using the marginal lending facility, or to deposit excess liquidities with their national central banks using the deposit facility. ECB monetary policy 2011 93: In the Eurosystem’s minimum reserve system, institutions that are subject to minimum reserve requirements according to the Statute of the European System of Central Banks are obliged to hold reserves with the national central banks, and thus DNB in the Netherlands.

In view of the intended establishment of the Economic and Monetary Union and the use of the euro as single currency for the euro area (eurozone) on 1 January 1999, as discussed in more detail in paragraph 4.6, a new *Bankwet* was adopted in the Netherlands in 1998. With this Act the right of the government to give directives regarding monetary policy to DNB as previously introduced by the *Bankwet* of 1948 was abolished, making the Bank independent with regard to monetary policy.<sup>875</sup> Like its predecessors the 1998 Act did not explicitly capture the role of DNB as lender of last resort.<sup>876</sup> The legal basis for the supervisory powers and functions of DNB pre-Twin Peaks was set out in the *Bankwet* of 1998,<sup>877</sup> which confirmed its role as central bank and in the *Wet toezicht kredietwezen* 1992 (Wtk 1992), the *Wet toezicht beleggingsinstellingen* 1990 (Wtb) (Act on the supervision of investment institutions) and in the *Wet inzake de wisselkantoren* 1994 (Wwk) (Act on exchange offices) which captured its role as prudential regulator. DNB obtained its position as supervisor of credit institutions (thus banks and the banking sector)<sup>878</sup> not through delegation by the Minister of Finance, as in the case of the STE and the VK but directly from the *Bankwet* of 1998. In terms of the *Bankwet* the *overheidscommissaris* (a state representative)<sup>879</sup> informed the Minister of Finance whether DNB accomplished its objectives and thus ensured the accountability of DNB for the execution of its mandate.<sup>880</sup>

The objective and tasks of DNB were set out in sections 2, 3 and 4 of the *Bankwet* 1998. The 1998 amendments to the *Bankwet* were effected specifically to address the “expanded” role of DNB as part of the European System of Central banks in accordance with the Treaty on the Functioning of Europe (TFEU). In terms of section 2 of the *Bankwet* 1998, the primary objective of DNB, in implementation of the Treaty,

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<sup>875</sup> Mooij & Prast 2002 19.

<sup>876</sup> Mooij & Prast 2002 19 remark that the reason for not “defining” the lender of last resort function of DNB was due to the view that maintaining “constructive ambiguity” may help to reduce the moral hazard associated with a safety net.

<sup>877</sup> *Wet van 26 Maart* 1998 (Act of 26 March 1998).

<sup>878</sup> At that stage in the Netherlands, credit institutions were seen as mentioned in Everdingen et al 1999 on 14 as a “*bedrijf van het aantrekken van opvorderbare gelden en voor eigen rekening verrichten van kredietuitzettingen of beleggingen*”, thus actually banks and the banking sector, as opposed to the two other main sectors in the financial market, namely insurance and securities.

<sup>879</sup> Sections 13 and 14 *Bankwet* 1998.

<sup>880</sup> Everdingen et al 1999 13; See also Van Zwet 2001 1 – 11 for the development of the *Bankwet* until 1998.

was to maintain price stability (in execution of its monetary policy objective).<sup>881</sup> In terms of section 3(1), it was stated that, in implementation of the Treaty, within the framework of the European System of Central Banks, DNB “contributes” to the following tasks:

- a. to co-determine and implement monetary policy;
- b. to conduct foreign exchange operations consistent with the provisions of Article 219 of the Treaty;
- c. to hold and manage the official foreign reserves;
- d. to provide for the circulation of money as far as it consists of banknotes;
- e. to promote the smooth operation of payment systems.

Section 3(2) further provided that, in implementation of the Treaty, within the framework of the European System of Central Banks, DNB “contributes” to the pursuit of sound policies by the competent authorities relating to the prudential supervision of banks and the stability of the (eurozone) financial system.<sup>882</sup>

Section 4 of the *Bankwet* 1998, provided specifically that DNB had the following (domestic) functions:

“(a) the Bank has the task of supervising financial institutions<sup>883</sup> on the basis of dedicated legislation;

(b) it has the task to promote the efficient working of the payment system;<sup>884</sup>

(c) it must gather statistical data and compile statistics in accordance with dedicated legislation;

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<sup>881</sup> Section 2 of the *Bankwet* further provides: 2(2). In implementation of the Treaty, without prejudice to the objective of price stability, the Bank supports the general economic policies in the European Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. 2(3). The Bank acts in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119 of the Treaty. 2(4). It is also the Bank's objective to perform tasks other than those referred to in Section 3, insofar as these are conferred upon it by or pursuant to the law; See also Van Zwet 2001 11.

<sup>882</sup> It was provided by section 3(3) that DNB may, in implementation of the Treaty and in carrying out its tasks and duties under section 3(1) and (2), seek and take instructions exclusively from the European Central Bank

<sup>883</sup> The financial institutions include banks and the banking industry, as well as the investment industry in terms of the legislation mentioned in previous paragraph, namely the *Wtk* 1992, *Wtb* and the *Wwk*. See more on supervision of investment industry in a paragraph below.

<sup>884</sup> Mooij & Prast 2002 21: This section 4(b) gave DNB for the first time the explicit task of promoting the smooth operation of the payment system.

(d) it can after approval by virtue of a royal decision, in the general (public) interest, conduct other tasks than those mentioned in the *Bankwet*. “

The *Bankwet* 1998 thus made provision for DNB's functions as part of the European System of Central Banks (section 2 and 3) and also for its functions as domestic central bank of the Netherlands (section 4). Although some reference was made in section 3(2) to the stability of the financial system (apparently on EU-level) notably no such mention was made of financial stability in section 4 that set out DNB's domestic mandate.

The day-to-day management of DNB pre-Twin Peaks was conducted by the Governing Board, consisting of a President and a maximum of five Executive Directors. Governing Board members are appointed by the Crown, for seven-year tenures.<sup>885</sup> As a *Naamloze vennootschap*, (NV, a Limited Liability company), DNB also had a *Raad van Commissarissen* (Supervisory Board)<sup>886</sup> and as well a *Bankraad* (Bank council) that functioned as an advisory body.<sup>887</sup> The Supervisory Board had a number of important powers, such as compilation of the annual report, adoption of the annual accounts and overseeing the general course of business in DNB and the policy pursued by the Governing Board in implementation of section 4.<sup>888</sup> One member of the Supervisory Board was appointed by the government. The Supervisory Board exercised oversight in respect of the general operations of DNB whilst the Bank Council acted as the Governing Board's sounding board. The President of DNB reported to the Bank Council on the general economic and financial developments and on the policy pursued by DNB.<sup>889</sup> The Bank Council could advise the Governing Board but did not concern itself with supervisory matters.<sup>890</sup> Two members of the Supervisory

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<sup>885</sup> Section 12 of the *Bankwet* 1998.

<sup>886</sup> In the Dutch two-tier management model, companies have a management board that performs the executive function, and a non-executive supervisory board that advises and supervises the management board.

<sup>887</sup> Section 15 of the *Bankwet* 1998.

<sup>888</sup> Section 13 of the *Bankwet* 1998. Section 13:6 determines that with due observance of the provisions of the Treaty and the Statute of the European System of Central Banks, the Supervisory Board oversees the general course of business within DNB and the policy pursued by the Governing Board in implementation of Section 4. The Supervisory Board advises the Governing Board and adopts the annual accounts.

<sup>889</sup> Section 15 of the *Bankwet* 1998.

<sup>890</sup> Banking supervision in the Netherlands (2017) [https://english.rekenkamer.nl/Banking+supervision+in+the+Netherlands+WR%20\(3\).pdf](https://english.rekenkamer.nl/Banking+supervision+in+the+Netherlands+WR%20(3).pdf) (accessed 24 February 2018) 25.

Board serve on the Bank Council, including the member appointed by the government. The Bank Council was furthermore composed of representatives of the social partners and the financial sector as well as independent experts.<sup>891</sup>

Pre-Twin Peaks there were thus many different pieces of legislation constituting the regulatory framework for financial markets in the Netherlands and each one covered a different sector of the financial markets. DNB, as central bank, was the supervisor for banks, the STE<sup>892</sup> was the securities supervisor and the *Stichting Pensioen- en Verzekeringskamer* (PVK) (Pension and Insurance Chamber - that changed from VK to PVK in 2001), supervised insurance and pension funds.<sup>893</sup> Supervision of financial institutions and markets in the Netherlands, like in most other European countries at the time, thus developed along sectoral lines.<sup>894</sup>

Everdingen states that the formal purpose of the three financial supervisors, DNB, STE and PVK, in terms of the financial supervision acts were the same, namely the protection of the customers of financial institutions and the promotion of the proper functioning of the financial markets as well as maintaining confidence in the financial sector (i.e. its implied mandate of maintaining financial stability). In practice there were however two different goals, as the supervision by DNB and PVK were primarily focused on the safety and soundness of individual financial institutions (thus prudential supervision) whilst the supervision by STE focused on the protection of customers

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<sup>891</sup> Section 15 of the *Bankwet* 1998; See also De Nederlandsche Bank – about DNB – Organisation-Governing board and Supervisory Board and Bank Council (undated) <https://www.dnb.nl/en/about-dnb/organisation/directie/> (accessed 12 February 2018).

<sup>892</sup> Everdingen et al 1999 15: The Minister of Finance delegated its powers of regulation of securities transactions to STE. The state chose in this way that supervision was done at a distance.

<sup>893</sup> Bierman et al 2015 3; Everdingen et al 1999 13 indicates that the legal basis for further supervision tasks of the PVK with regards to mainly the insurance companies, was set out in the *Wet toezicht verzekeringsbedrijf* 1993 (Wtv 1993) (Act on supervision of insurance business) and the *Wet toezicht natura-uitvaartverzekeringsbedrijf* 1995 (Wtn) (Act on supervision of funeral expenses and insurance of benefits in kind).

<sup>894</sup> Busch D, Doorenbos DR, Grundmann-van de Krol CM, Maatman RH, Nieuwe Weme MP and Rank WAK *Onderneming en Financieel Toezicht* (2010), hereinafter Busch et al 2010, at 23; See also Kremers J and Schoenmaker D “Twin Peaks: Experiences in the Netherlands” December 2010 *LSE Financial Markets Group Paper Series – Special Paper number 196* 1, hereinafter Kremers & Schoenmaker 2010.

(thus market conduct supervision).<sup>895</sup> The methods that the three financial supervisors used, were largely similar, in the sense that the essential part of the supervision was based on a licensing system. After granting of a license, the financial institution would then continuously be subjected to supervision conditions that had to be met.<sup>896</sup> DNB was thus part of a silo sectoral system of financial regulation that occurred on microprudential level and focused on individual institutions.

In the sectoral model that prevailed pre-Twin Peaks DNB had a traditional central bank role comprising of responsibility for monetary policy (shared with the ECB), bank supervision,<sup>897</sup> supervision of the payments and settlement system and acting as lender of last resort. It is to be noted though that the *Bankwet* 1998 did not expressly confer a domestic financial stability mandate on DNB as is clear from section 4 thereof. However taking into consideration all the other traditional roles of DNB and the fact that it was de facto responsible for financial stability in the Netherlands, it can be concluded that DNB had an “implied” de facto financial stability mandate prior to the move by the Netherlands to a Twin Peaks model of financial regulation. In this regard the following statement by Mooij and Prast in respect of the role of DNB during this epoch is instructive: “The choice in the Netherlands to maintain a structure in which the central bank is responsible for the prudential supervision of banks has to do with *stability considerations*. In view of the high degree of concentration in the banking sector *systemic* and prudential supervision are appropriately placed close at the hand of the central bank.”<sup>898</sup>

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<sup>895</sup> Everdingen et al 1999 14: The primary question here was whether services, products and advertisements were fair in order to take care of an honest trade of shares, where everyone has the same opportunity.

<sup>896</sup> Everdingen et al 1999 14.

<sup>897</sup> Everdingen et al 1999 14: Section 85a was added to the Wtk 1992 on 3 April 1999 and it determined that DNB could make rules with regards to the provision of information by credit institutions and financial institutions to the public. With the enactment of this section the supervision of DNB was thus expanded to conduct of financial institutions.

<sup>898</sup> Mooij & Prast 2002 20.

## 4.2 Rationale behind the move to a Twin Peaks system of financial regulation in the Netherlands

As pointed out by Bierman the trend towards the end of the 20<sup>th</sup> century was that financial markets globally diversified and internationalised and started to develop more and more cross-sectorally.<sup>899</sup> Mooij and Prast remark that the final decades of the twentieth century saw a distinct change in the financial landscape in the Netherlands. Globalisation, conglomeration, the blurring of distinctions between banking, insurance and securities activities, the single market for financial services in the European Union, the birth of the euro and a growing awareness of the importance of financial integrity and consumer protection were challenging regulatory and supervisory policy and affected the institutional structure of financial supervision in the Netherlands in various ways. The lifting in 1990 of the prohibition on combining banking and insurance activities in one financial institution, paved the way for mergers between banks and insurance companies resulting in large financial conglomerates.<sup>900</sup> The emergence of these large, complex conglomerates and increasingly complex financial products resulted in a greater emphasis being placed on efficient and comprehensive supervision of the financial sector in the Netherlands.<sup>901</sup> The sectoral approach to financial regulation consequently came under scrutiny and various problematic aspects inherent in this approach to financial regulation were revealed.

One such problem was different regulatory approaches and cultures within the prevailing Dutch sectoral model. Whilst there were three financial supervisors in the Netherlands, the risk pertaining to the various parts of the financial sector differed because the financial institutions concerned had very different ways of operating. This in turn led to big differences in the approach to supervision of the various financial

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<sup>899</sup> Bierman et al 2015 4; See also paragraph 1.8 above with regard to the functional approach where supervision is done across functional lines, as opposed to supervising according to the legal entity involved.

<sup>900</sup> Mooij & Prast 2002 17. They point out that in fact, the Netherlands were pioneers in the area of “bancassurance”.

<sup>901</sup> Everdingen et al 1999 19.

institutions concerned and accordingly regulatory arbitrage became a significant challenge.<sup>902</sup>

Another concerning aspect was that the efficiency of the three financial sector supervisors in the Netherlands had deteriorated because they all had unclear objectives and thus misunderstandings abounded between them, leading to various “turf wars”. This problem was exacerbated by the vague boundaries that also existed between financial institutions, markets and products in the financial sector. As pointed out by Kremers and Schoenmaker, the efficiency of the traditional design of financial regulation in the Netherlands had thus come under pressure and “had begun to lose energy”.<sup>903</sup>

A major driver behind the move in the Netherlands to Twin Peaks was the development of financial conglomerates as alluded to above, on national and international scale, and the increasing risk that their size and activities posed to a country’s economy and specifically to the maintenance of financial stability.<sup>904</sup> It became increasingly difficult to appropriately supervise these large and complex entities in order to prevent them from posing significant risk to systemic stability. On 12 May 1998 the Minister of Finance wrote a letter to the *Tweede kamer* of the Dutch Parliament in which he mentioned the biggest problems regarding these financial conglomerates as being that the conglomerates were not transparent, and accordingly that it was difficult for financial supervisors to determine where in a conglomerate the responsibility for decision making lay and who should be made personally responsible by the financial supervisor.<sup>905</sup>

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<sup>902</sup> Everdingen et al 1999 14.

<sup>903</sup> Kremers & Schoenmaker 2010 1.

<sup>904</sup> International Monetary Fund Country Report 11/208 *Kingdom of the Netherlands - Netherlands: Financial Sector Assessment Program Documentation – Technical Note on Financial Sector Supervision: The Twin Peaks Model* (July 2011) <https://www.imf.org/external/country/NLD/index.htm?pn=3> (accessed 12 October 2015), hereinafter IMF 11/208, at 5: Globally the tendency was such that financial systems were overshadowed by a small number of very large financial conglomerates operating in the field of banks, insurance companies and pension funds. As these conglomerates offered increasingly complex financial products that blurred the lines between traditional credit and insurance and securities companies these conglomerates posed serious challenges to the regulation of financial institutions.

<sup>905</sup> Everdingen et al 1999 20.

The Netherlands was thus at a crossroads where it had to reconsider its approach to financial sector regulation. In 1999 the Ministry of Finance in the Netherlands informed Parliament that the main reason for reconsidering the prevailing sectoral model of supervision was because the various parts of the financial sector were “intertwined with each other” which posed a significant challenge to pure sectoral supervision. The existence of many financial conglomerates were specifically cited as complicating financial supervision. The position at that time was that financial conglomerates had a market share of 90% of the banking sector, 80% of the stock exchange and 70% of the insurance market, thus exacerbating the regulatory challenge. The Ministry of Finance indicated that because of the synergy found in centralisation of management functions and the development of an integrated product and market approach, the operational structure of financial conglomerates differed significantly from the legal structures of the past. It was clear that a solution to provide for proper and comprehensive regulation of these financial giants had to be found. Another issue that was raised was that the sectoral friction that existed in the regulation of financial markets further compromised effective supervision.<sup>906</sup> All these changes and challenges in the financial sector thus raised serious questions about the appropriateness of the then prevailing sectoral model of regulation and supervision.<sup>907</sup>

The Ministry of Finance considered three possible models in the quest to find a more suitable model of regulating and supervising the Dutch financial sector:

- (a) The Australian variant of the Twin Peaks model - on the basis of supervision goals;<sup>908</sup>
- (b) The then English model (Single regulator model) - which entailed the detaching of supervision of banks from the central bank and the integration of supervisors of different sectors within one supervisor;<sup>909</sup>

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<sup>906</sup> Everdingen et al 1999 29.

<sup>907</sup> Busch et al 2010 30.

<sup>908</sup> For a detailed discussion of the Australian Twin Peaks model see Chapter Three.

<sup>909</sup> A detailed discussion of this model is beyond the scope of this thesis. LJ Silverentand Chapter 2 “Types of securities and the statutory framework applicable to securities” in Van den Niewenhuijzen. *Financial Law in the Netherlands* (2010) 1, hereinafter Van Den Niewenhuijzen 2010, points out that the formation of a single regulator, such as was applicable in the UK at the time, which could handle prudential supervision as well as conduct-of-business supervision, was considered in the Netherlands

(c) A strengthening of the sectoral model prevailing in the Netherlands by the introduction of a sector-transcending supervision dimension.<sup>910</sup>

The Minister of Finance eventually selected the third option, namely “amplified sectoral supervision”, as the appropriate regulatory approach for the Netherlands.<sup>911</sup>

The *Raad van Financiële Toezichthouders* (RFT), a council of financial regulators, was subsequently created in 1999 as a collaborative alliance between DNB, the PVK and the STE. A memorandum to the *Tweede Kamer* was delivered by the Minister on 2 April 1999 advising that the RFT would be implemented on 1 July 1999. It was indicated that the RFT would not be a fourth supervisor, but that it would be a consultative body comprised of representatives of DNB, PVK and STE.<sup>912</sup> The RFT was established specifically to coordinate microprudential and conduct of business supervision between the sectorally-based supervisory agencies.<sup>913</sup> It was envisaged that the RFT would serve as coordinating body in order to coordinate the regulation and supervision of conglomerates, as well as regulation and supervision of the integrity of the financial sector and for provision of information to consumers.<sup>914</sup> The legislation establishing the RFT<sup>915</sup> was subsequently adopted on 13 September 2001 by the

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as a possible approach to regulate financial conglomerates. The belief was that the single regulator would be strengthened by the synergy between the prudential supervision and the conduct-of-business supervision. This approach however did not eventually find favour in the Netherlands reforms as it was considered that such supervision had to be very objective and therefore it was preferred that prudential and conduct-of-business supervision should be separated between two bodies in accordance with the Twin Peaks model.

<sup>910</sup> Busch et al 2010 31-32 indicate that an important similarity between the Australian and English model is that supervision of individual financial institutions is completely disconnected from the central bank.

<sup>911</sup> Busch et al 2010 35.

<sup>912</sup> Kamerstuk Tweede Kamer der Staten-Generaal (9 April 1999) Kamerstuk 26466 nr. 1: “Nota: Institutionele vormgeving van het toezicht op de financiële marktsector”

<sup>913</sup> IMF 4/311 5.

<sup>914</sup> Vennootschap & Onderneming “Veranderend toezicht; de stand van zaken” (February 2002) 27 [http://www.openaccessadvocate.nl/tijdschrift/vennootschapenonderneming/2002/2/VenO\\_2002\\_013\\_002\\_003.pdf](http://www.openaccessadvocate.nl/tijdschrift/vennootschapenonderneming/2002/2/VenO_2002_013_002_003.pdf) (accessed 18 December 2017).

<sup>915</sup> *Wet van 22 November 2001 tot het voorzien in bepalingen ter introductie van een niet-sectorenspecifieke toezichtsdimensie in de Wet toezicht beleggingsinstellingen, de Wet toezicht effectenverkeer 1995, de Wet toezicht kredietwezen 1992, de Wet toezicht natuura-uitvaartverzekeringsbedrijf en de Wet toezicht verzekeringsbedrijf 1993* (Act of 22 November 2001 to provide for the introduction of a non-sector specific oversight dimension in the Act on the supervision of investment institutions 1995, the Act on supervision of securities transactions 1995, the Credit supervision act 1992, the Act on supervision of funeral expenses and insurance of benefits in kind and the Act on supervision of insurance business 1993).

*Tweede Kamer*.<sup>916</sup> This legislation however only came into force on 1 December 2003.<sup>917</sup> Mooij and Prast state that the aim of the RFT was to give “an additional impulse” to cross-sector cooperation between the financial supervisors. They further point out that the RFT was not a decision-making body on regulatory and supervisory issues but merely a forum for discussion and further cooperation on cross-sector regulatory and supervisory issues.<sup>918</sup>

Interestingly, less than two years after the decision to move to an amplified sectoral model of financial regulation and supervision, plans for the adoption of a cross-sectoral supervisory framework were submitted to Parliament by the Finance Minister. The plan envisaged the consolidation of macro- and microprudential supervision into a single entity, and the establishment of a separate entity for conduct of business supervision.<sup>919</sup> Late in 2001, the Minister of Finance announced that the Netherlands would switch from the prevailing model of amplified sectoral supervision to a functional Twin Peaks model.<sup>920</sup> This sudden change in regulatory direction occurred pursuant to a letter on 12 October 2001 by the three financial supervisors to the Minister of Finance wherein they discussed some important developments in the financial system as well as their joint proposal for future financial supervision. The developments that they listed were the following: The bank creditor respectively insurance policy holder, had developed into an articulate client; consumers were buying complex financials products, with more risk involved, and they needed to be informed about that risk; bundling and concentration of diverse activities in financial conglomerates were increasing; there was an increase in complex and advanced techniques and risk oriented management; as well as a growing demand for integrity of role players in the financial markets.<sup>921</sup>

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<sup>916</sup> Eerste Kamer der Staten-Generaal (undated) [https://www.eerstekamer.nl/wetsvoorstel/27290\\_introductie\\_niet](https://www.eerstekamer.nl/wetsvoorstel/27290_introductie_niet) (accessed 18 December 2017). The Act was published in the *Staatsblad* 596 on 13 December 2001.

<sup>917</sup> Busch et al 2010 38.

<sup>918</sup> Mooij & Prast 2002 20.

<sup>919</sup> IMF 4/311 6.

<sup>920</sup> Busch et al 2010 35. Oppelaar in Busch et al 2010 remarks that one of the reasons for this change was probably the conclusion that one separately situated prudential supervisor would be vulnerable. A reason for this may be the fact that DNB was already conducting supervision for many years and taking supervision away from DNB would expose such a separate supervisor too much and could leave it open for criticism. Supervision by DNB would thus be less exposed and therefore more acceptable.

<sup>921</sup> Busch et al 2010 36.

In the aforementioned letter the supervisors also highlighted certain problems with the then prevailing “amplified” sectoral model of financial regulation which indicated that a new and different approach to financial regulation was required. They pointed out that the sectoral supervision model was primarily linked to the nature of the institution that was being supervised. Such an approach was acceptable as long as the various financial institutions in the financial system did not look alike and had little to do with each other - however that was not the case in the Netherlands anymore where financial institutions had become increasingly complex, integrated and interconnected and boundaries were “blurred”. They also highlighted the tension between the interests of safety and soundness of financial institutions and the interests of consumer protection - indicating that each of these areas of regulation required a dedicated regulator. The joint proposal of the supervisors was accordingly that the prevailing model of amplified sectoral supervision should be substituted with a functional Twin Peaks model of regulation by objective in terms whereof DNB and PVK would become the (combined) prudential supervisor for the entire financial system, and the STE would become the single system-wide conduct supervisor for the entire financial system. Under this Dutch Twin Peaks model they had in mind, DNB’s prudential mandate would thus be expanded to include supervision of other financial institutions and not merely banks, as was the case in the pre-Twin Peaks dispensation.<sup>922</sup>

In their letter the supervisors indicated that the supervision of banks and insurance companies would primarily be prudential in nature and the supervision of investment- and security institutions would primarily entail market conduct supervision. Accordingly banks and insurance companies would obtain their consents for licences from DNB/PVK<sup>923</sup> and investment- and security institutions would obtain their licensing consents from the STE.<sup>924</sup> With regard to cooperation and collaboration between the supervisors it was submitted that when radical supervision decisions would have to be

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<sup>922</sup> Busch et al 2010 38.

<sup>923</sup> See discussion of *Fusiewet De Nederlandsche Bank N.V. en de Stichting Pensioen- & Verzekeringkamer* below.

<sup>924</sup> Busch et al 2010 38 indicates that the supervisor that is not the licensing supervisor, may supervise the institutions that did not obtain their licence from it; and the review of managers of institutions will be done by the supervisor that gave the consent to the licensing of the institution.

taken, the supervisors would discuss it with each other beforehand; and that they would make concrete arrangements (via memoranda of understanding) regarding the demarcation of each other's area of operation.<sup>925</sup>

In the above-mentioned letter from the supervisors, they also referred to cases where prudential supervision and conduct supervision entered “*een spanningsveld*”, or an “area of tension” between them. It could for instance happen, they suggested, that a conduct supervisor would be of the opinion that a certain activity should be terminated if it holds too many risks for a consumer and at the same time a prudential supervisor, who focuses on the soundness of an institution, would have the priority of the profit of the institution at heart and would not want to end the activity. This area of tension would thus have to be managed appropriately within the envisaged Dutch Twin Peaks model.<sup>926</sup>

It appears as if, at this stage, the regulatory attention was mainly focussed on the relationship between prudential supervision and conduct supervision, because in the document from the *Tweede Kamer “Hervorming van het toezicht op de financiële marktsector”* (Reform of supervision of the financial market sector) mention is made of systemic supervision that DNB would attend to, but very little is written about it and all the organisations who commented on the document focused on the cohesion between the prudential and conduct supervisors. They did not have any comments on the cohesion between systemic supervision and prudential supervision or specifically on the role of DNB with regard to financial stability within the proposed Twin Peaks model - thus there was no specific indication that DNB's financial stability mandate should be captured expressly in legislation and how this mandate would be expanded.<sup>927</sup>

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<sup>925</sup> Busch et al 2010 38.

<sup>926</sup> Busch et al 2010 36 and 37.

<sup>927</sup> Kamerstukken II, 28 122, 2001/02, nr. 2 Tweede Kamer der Staten-Generaal “Hervorming van het toezicht op de financiële marktsector” (2001) <https://zoek.officiëlebekendmakingen.nl/kst-28122-2.html> (accessed 24 April 2017).

Mooij and Prast point out that in 2001, in anticipation of the move to Twin Peaks, DNB and PVK established closed links between their boards of directors, with cross-board appointments at executive and non-executive levels. They remark further that “[I]n the new model, financial supervision is organised not by industry, with each sector having its own supervisor, but on a cross-sector basis in line with its main objectives: systemic stability, prudential supervision and conduct-of-business supervision. In the new set up *the Bank remains responsible for systemic stability*.<sup>928</sup> The DNB would thus have the financial stability mandate whilst responsibility for prudential supervision would be taken care of by both DNB and the PVK. In March 2002 the STE was converted into the *Autoriteit Financiële Markten* (AFM) (Netherlands Authority for Financial Markets), taking on responsibility for conduct of business supervision on a cross-sectoral basis, while its previous microprudential supervisory responsibilities for securities market activities were taken over by DNB. At the same time DNB and PVK agreed to intensify cooperation and integration of management and activities in many microprudential areas, while transferring responsibility for conduct of business supervision to the AFM.<sup>929</sup>

A crucial element in facilitating the shift toward system-wide supervision in the Netherlands was the establishment of a Covenant between DNB, PVK and the AFM in September 2002 to provide for close cooperation between them. It was recognized that the cross-sectoral approach would result in most financial firms being supervised by both prudential and conduct of business supervisors, with inherent dangers of overlapping and excessive regulatory burdens. The Covenant thus set out a basic framework for cooperation among the supervisors including:

(a) Designation of a lead (“authorizing”) agency with overall responsibility for supervision (including licensing) of each financial institution and coordination of

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<sup>928</sup> Author’s emphasis.

<sup>929</sup> IMF 4/311 6; Mooij and Prast 2002 20-21 indicate that the reorganisation of the Dutch model of financial regulation was based on the philosophy that financial supervision should meet three criteria: “It should be effective, market-oriented and efficient. Effectiveness implies that supervision should meet the objectives of systemic supervision, soundness of financial institutions and proper conduct of business, including market transparency. Market-oriented implies that markets should be as undistorted as possible, and that institutions can compete in a level playing field. Efficiency requires that the overlap between the tasks of the different supervisors should be kept to a minimum and that the administrative burden of the supervised institutions should be restricted.”

supervisory activities. DNB/PVK is the lead agency for institutions mainly in the banking, insurance and pensions sectors, while AFM leads for securities firms;

(b) Agreement that the lead supervisor would defer to the judgement of the other supervisors in their areas of responsibility;

(c) Agreement on which aspects of a firm's management resort under prudential supervision, and which resort under conduct of business supervision;

(d) Rules for consultation and sharing of information between the supervisors; and

(e) Provision for annual review of the Covenant and adjustments as needed.<sup>930</sup>

On 30 October 2004 DNB and PVK were merged in terms of the *Fusiewet De Nederlandsche Bank N.V. en de Stichting Pensioen- & Verzekeringskamer* (Merging of the Netherlands Bank N.V. and the Pension and Insurance Chamber Act). DNB took over all the functions of PVK and the latter ceased to exist.<sup>931</sup>

A notable feature of the role of DNB in the Dutch Twin Peaks model is that prudential supervision remained part of the remit of the central bank and that its role as prudential supervisor was actually expanded to cover supervision of a wider array of financial institutions. According to the IMF report 11/208, as discussed in more detail below, the reason for positioning system wide prudential supervision of financial institutions (and not merely banks) within DNB in this new Twin Peaks model was based on several factors, inter alia the synergy between prudential and monetary policy, and the close link between macro-economic stability and financial stability. It was expected that prudential supervision could benefit from the central bank's macro-economic analysis, as well as from the central bank's long standing credibility. It was further argued that the long standing independence of the central bank could also be an asset during times when difficult decisions would have to be made.<sup>932</sup>

Interestingly, the RFT was however subsequently dissolved in terms of a resolution signed on 15 November 2004. The coordination between the financial supervisors that

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<sup>930</sup> IMF 4/311 6.

<sup>931</sup> In terms of section 2 of *Fusiewet De Nederlandsche Bank N.V. en de Stichting Pensioen- & Verzekeringskamer* act of 13 October 2004, DNB would perform all the tasks of PVK.

<sup>932</sup> IMF 11/208 7.

took place in the RFT, was continued further in a subsequent *Convenant* (Covenant) concluded between the AFM and DNB – also on 15 November 2004,<sup>933</sup> which *Convenant* replaced the previous *Convenant* between DNB, PVK and the AFM.<sup>934</sup>

Notably Mooij and Prast point out that “[T]he changes in financial supervision in the Netherlands have been inspired not by major banking crises, but by the evolving role of banks and by changes in the structure of the financial sector”<sup>935</sup> Similar remarks are made by Kremers and Schoenmaker on the move in the Netherlands towards a Twin Peaks model of functional financial supervision. They indicate that it was driven by two main considerations. The first was the conviction that prudential and conduct of business supervision were really two different objectives, each requiring a different skill set, a different external profile and distinct decision making powers and responsibilities to do justice to both these objectives. The second was the conviction that financial system stability must be closely linked with microprudential stability of individual firms, especially in a concentrated financial market with systemically important financial institutions, as was the case in the Netherlands - and also with monetary policy with its decisive influence on financial market conditions. They remark that “DNB was made responsible for system stability and micro-prudential (supervision), thereby also offering some link with monetary policy through its role in the ESCB/ECB.”<sup>936</sup>

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<sup>933</sup> Jaarverslag 2003/2004 Raad van Financiële Toezichthouders [https://www.dnb.nl/binaries/RFT%20Jaarverslag%202003-2004\\_tcm46-146964.pdf](https://www.dnb.nl/binaries/RFT%20Jaarverslag%202003-2004_tcm46-146964.pdf) (accessed 18 November 2017) 5: In the final annual report of the RFT for 2003/2004 it was stated that in consultation with the Minister of Finance it was decided that the RFT would be dissolved; *Staatscourant Nr. 224 Jaargang 2004 Gepubliceerd op 19 November 2004* <https://zoek.officielebekendmakingen.nl/stcrt-2004-224-p31-SC67521.html?zoekcriteria=%3Fzkt%3DEenvoudig%26vt%3Dstcrt%2B2004%2B224&resultIndex=1&sorttype=1&sortorder=4> (Government Gazette No. 224 Year 2004 Published on 19 November 2004): Covenant between the *Stichting Autoriteit Financiële Markten* and *De Nederlandsche Bank N.V.* with regards to cooperation and coordination in the area of supervision, regulation, policy, (inter)national consultation and other tasks with a common interest. The Covenant was signed having regard to the *Wet toezicht effectenverkeer* 1995, the *Wet toezicht kredietwezen* 1992, the *Wet toezicht verzekeringsbedrijf* 1993, the *Wet toezicht natura-uitvaartverzekeringsbedrijf* en and the *Wet toezicht beleggingsinstellingen*.

<sup>934</sup> Section 16 of the new *Covenant* determined that all previous *Covenants* between regulators would be replaced by the new *Covenant*,

<sup>935</sup> Mooij & Prast 2002 22.

<sup>936</sup> Kremers & Schoenmaker 2010 2.

Though the Dutch writers refer to financial system stability, the practical situation was however that, as indicated above, the emphasis in this phase appears to have been not on the development and construction of an amplified macro-focused financial stability role of DNB in its domestic context, but more on how sound prudential and business conduct supervision of individual financial institutions could assist in achieving the goal of financial system stability. Since the decision to move to a Twin Peaks system in the Netherlands was taken quite some time before the GFC, the aspect of financial stability as an objective on its own appears not to have been so prominent and as a result it was not dealt with in detail in the legislation that introduced the Dutch Twin Peaks model, as discussed more comprehensively in paragraph 4.3 below. As indicated above, the preoccupation at this stage in the Netherlands appeared to have been more with the objectives of prudential supervision and conduct supervision and the establishment of the two peaks for prudential and market conduct respectively as well as the implementation of these supervisory frameworks.

However Kremers and Schoenmaker do make some comments that indicate that some attention was indeed given to DNB's role with regard to financial stability, despite it not being that evident from the legislative framework that subsequently introduced the new regulatory model. They indicate that two key improvements to the quality of financial supervision in the Netherlands were envisaged with the move towards a Twin Peaks model: By defining distinct objectives for each of the two supervisors and thus taking away the basis for turf battles, it was hoped that each supervisor would focus all its energy towards excellence in its own domain of supervision. Also, by combining financial system stability with microprudential supervision at DNB (and though more distantly, with monetary policy of the ECB), it was envisaged that DNB would be empowered to give full attention to financial stability and be innovative and internationally prominent in this area. They indicate that "[H]aving been given micro-prudential responsibility not only for banks, insurance firms and securities firms but also for very large pension funds with their huge financial market impact in the Netherlands, DNB became among the best placed of supervisors internationally to deal with this challenge."<sup>937</sup>

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<sup>937</sup> Kremers & Schoenmaker 2010 2.

### 4.3 Twin Peaks in the Netherlands: The *Wet op het financieel toezicht* (Wft)

#### 4.3.1 Introduction

The Netherlands was the second country, after Australia, to adopt a Twin Peaks model of financial regulation in 2002, thus pioneering the model in Europe.<sup>938</sup> The implementation of the Dutch model was however a lengthy process that took quite some time to implement formally. The reforms were being implemented in two phases. The first phase involved adapting certain regulations and concluding covenants between the two supervisors (DNB and AFM) to redistribute their respective supervisory responsibilities. This phase was completed in September 2002. During the second phase other laws had been amended to take account of this new situation.<sup>939</sup> When the first part of the *Wet op het financieel toezicht* (Wft) (Financial Supervision Act) was submitted to the *Tweede Kamer* on 3 August 2004, a comprehensive new legal framework was created with profound amendments to the regulation of the Dutch financial markets.<sup>940</sup> In 2004 the Financial Stability Department was founded in DNB.<sup>941</sup>

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<sup>938</sup> Schmulow 2017 no. 1 43; Mooij & Prast 2002 remark that in 2002, a major change took place in the institutional structure of financial supervision in the Netherlands. In the new model, financial supervision is organised not by industry, with each sector having its own supervisor, but on a cross-sector basis in line with its main objectives: systemic stability, prudential supervision and conduct-of-business supervision.

<sup>939</sup> European Central Bank “Opinion of the European Central Bank on a draft Financial Sector Supervision Act at the request of the Ministry of Finance of the Netherlands” (7 June 2004) [https://www.ecb.europa.eu/ecb/legal/pdf/en\\_con\\_2004\\_21\\_f\\_sign.pdf](https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2004_21_f_sign.pdf) (accessed 20 February 2018) 1-2.

<sup>940</sup> Dijk J & Oppelaar H *Voorstel van Wet op het financieel toezicht: Beschouwingen over de regulering van de financiële markten: Preadvies voor de Vereniging voor Effectenrecht 2004* (2004), hereinafter Dijk & Oppelaar 2004, at VII.

<sup>941</sup> De Nederlandsche Bank “Proceedings of the Symposium: Financial stability policy – challenges in the Asian Era” (25 – 26 October 2004) [https://www.dnb.nl/en/binaries/symposium\\_tcm47-144535.pdf](https://www.dnb.nl/en/binaries/symposium_tcm47-144535.pdf) (accessed 8 February 2018) 6.

The Wft<sup>942</sup> and the *Invoerings-en aanpassingswet op het financieel toezicht* (Implementation and Amendment Act on Financial Supervision)<sup>943</sup> eventually became law on 1 January 2007, just before the full force of the GFC hit the globe. The *Invoerings-en aanpassingswet op financieel toezicht* basically paved the way for the introduction of the Wft and covered three broad areas: transitional arrangements (section 1-111a); amendments to other legislation (section 112-169) and final provisions (section 170-180). In essence this implementation Act merely indicated in all three the aforementioned areas the changes that had to be effected to legislative provisions to incorporate references to the Wft and it did not set out a framework for introducing Twin Peaks in the Netherlands or indicate how the Twin Peaks model would work. The Wft however was the actual framework Act that set up the architecture for the Dutch Twin Peaks model. Seven existing financial supervision acts<sup>944</sup> (including the *Wet toezicht kredietwezen* 1992) that regulated financial enterprises and financial markets in a fragmented manner, were replaced by the Wft.<sup>945</sup> Silverentand accordingly points out that the Wft as framework Act was intended to serve as a central rulebook for the financial markets, although it did not consolidate all financial supervisory laws in effect in the Netherlands.<sup>946</sup>

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<sup>942</sup> *Wet op het financieel toezicht, Wet van 28 September 2006*; DNB issued a statement in De Nederlandsche Bank "Open Boek Toezicht - Introduction" (1 January 2007) <http://www/toezicht.dnb.nl/en/4/6/51-204722.jsp> (accessed 11 September 2015, hereinafter DNB Toezicht Intro 2007 at the introduction of the WFT indicating that the government had three fundamental objectives in mind when the legislative framework for financial supervision was amended by the Wft, namely transparency, goal orientation and market focus. Firstly, in striving for transparency, it was indicated that the Wft draws parallels between the various specifications applicable in the financial sector. Secondly in order to be goal orientated, the Wft gives a vivid understanding of the new supervisory model where it is explained in Part 1 of the Wft under General Provisions. The supervisory roles of DNB and the AFM are defined and their respective supervisory roles are thus clearly distinguished from each other. The third objective of market focus is achieved by the Wft in promoting the Dutch financial sector to be as good as possible compared to other financial sectors, both locally and internationally, by levelling the arena between national and international sectors. Furthermore the Wft reduces the administrative load and costs of supervision and creates a flexible, transparent and decisive supervisory system. It also improves legal certainty in the financial markets.

<sup>943</sup> *Invoerings-en aanpassingswet Wet op het financieel toezicht, Wet van 20 November 2006*.

<sup>944</sup> Bierman et al 2015 4: The seven acts that were taken up in the Wft, were the *Wet toezicht kredietwezen* 1992 (Wtk 1992), *Wet toezicht verzekeringsbedrijf* 1993 (Wtv 1993), *Wet toezicht natuura-uitvaartverzekeringsbedrijf* 1995 (Wtn 1995) (Act on funeral insurance), *Wet toezicht effectenverkeer* 1995 (Wte 1995) (Act on supervision of securities transactions), *Wet toezicht beleggingsinstellingen* 1990 (Wtb 1990), *Wet financiële dienstverlening* 2005 (Wfd 2005) (Act on financial services) and *Wet melding zeggenschap in ter beurze genoteerde vennootschappen* 1996 (Wmz 1996) (Act on notification of control in listed companies).

<sup>945</sup> DNB Toezicht Intro 2007.

<sup>946</sup> Silverentand in Van den Nieuwenhuijzen 2010 24 points out that some of the financial supervisory laws have remained in force, including, amongst others the *Pensioenwet* (Pension Act, *Wet ter voorkoming van witwassen en financieren van terrorisme* (Act on the prevention of money laundering

The Wft was subdivided into seven parts comprising of the following: Part 1: General Provisions regarding financial supervision in the wide sense; Part 2: Market Access of Financial Enterprises; Part 3: Prudential Supervision of Financial Enterprises; Part 4: Conduct Supervision of Financial Companies; Part 5: Conduct Supervision of the Financial Markets; Part 6: Provisions regarding the stability of the financial system; and Part 7: Final provisions.<sup>947</sup>

Notably the objective of the Wft was not laid down in the Act itself. Bierman points out that it can however be derived from the parliamentary history and sections 1:24 and 1:25 of the Wft as being the supervision of the soundness of financial enterprises and contribution to the stability of the financial sector; orderly and transparent financial market processes; good relationships between parties in the market; and handling of customers in a “careful manner”.<sup>948</sup>

#### **4.3.2 Mandates of the two peak financial regulators**

Thus, in the Dutch Twin Peaks model DNB remained responsible for financial stability in the Netherlands - a mandate that it derived by implication from the *Bankwet*. Its role as prudential regulator and supervisor was retained and this role was expanded to include prudential regulation and supervision of other financial institutions such as pension funds, in addition to the banks and investment companies that were already subject to its

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and terrorist financing), *Wet toezicht financiële verslaggeving* (Financial Reporting Supervision Act), *Wet toezicht trustkantoren* (Act on the Supervision of Trust Offices), *Wet inzake de geldtransactiekantoren* (Money Transaction Offices Act) and the (*Wet financiële betrekkingen buitenland* 1994 (External Financial Relations Act 1994); KPMG Meijburg & Co Netherlands partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative a Swiss entity “Supervision of investment undertakings: Financial Supervision Act (Wft) and other relevant legislation and regulations” 2010 *Netherlands - Regulation 1*, hereinafter KPMG Meijburg 2010: explains that the Wft is a framework act, which means it contains its own rules, in addition to forming an umbrella for secondary legislation and regulations. Four layers can be distinguished: the first layer is the Wft itself, the second layer contains the Orders in Council (the Decrees), the third layer comprises the statutory rules of the Ministry of Finance (for example the Wft exemption provisions and the Wft implementation decree), DNB and the AFM, and the fourth layer contains the policy rules of the Ministry of Finance, DNB and AFM.

<sup>947</sup> Wft; See further Busch et al 2010 20.

<sup>948</sup> Bierman et al 2015 6; See also Oppelaar “Van sectoraal naar prudentieel/gedragstoezicht” in Busch et al 2010 41.

jurisdiction. The limited prudential mandate that was contained in the *Wet toezicht kredietwezen* was replaced by a broader system-wide mandate that was set out in the Wft (which repealed the *Wet toezicht kredietwezen*). Although there was no specific section in the Wft which expressly stated that DNB is the systemic supervisor with the mandate for financial stability it can be argued that, apart from statements to that effect by authors such as Kremers and Schoenmaker, DNB's financial stability mandate in the Twin Peaks model can be inferred from the fact that the Wft did not impose such mandate on another entity and that this mandate was strengthened by its role as prudential supervisor as section 1:24(1) Wft, as set out below, indicates that the aim of prudential supervision is to contribute to financial stability. The Stichting Autoriteit Financiële Markten (AFM) represented the other peak in the Dutch Twin Peaks model, responsible for system-wide market conduct supervision and regulation which mandate was also set out in the Wft. The Dutch Twin Peaks model thus resembles the original Twin Peaks model proposed by Michael Taylor.<sup>949</sup> The Dutch Twin Peaks model did also not tamper with the other roles DNB had pre-twin Peaks: apart from the main responsibility for monetary policy that had been moved to the level of the ECB some years before the Netherlands adopted a Twin Peaks model, DNB further retained responsibility for monetary policy at national level together with its roles as supervisor of the payments and settlement system and lender of last resort.

It is further to be noted that the Wft also granted the Dutch Ministry of Finance a broader role in financial supervision than in most other comparable systems. For example, financial regulation was to a great extent written into the Wft or in Decrees for which the Ministry of Finance was responsible, and therefore DNB and the AFM were restricted in making such rules and regulations.<sup>950</sup>

The division of the prudential supervision mandate of DNB and the market conduct supervision mandate of the AFM, as the prudential and market conduct peaks

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<sup>949</sup> Although, on the other hand, according to Oppelaar in Busch et al 2010 42 the Dutch model differs from the pure Twin Peaks model advocated by Michael Taylor, in that DNB, as central bank, was given two supervisory goals, namely system stability and soundness of individual financial institutions; See also De Jager 2013 no 2 508; See further Chapter One paragraph 1.9.

<sup>950</sup> IMF 11/208 8; See also Bierman et al 2015 3.

respectively in the Dutch Twin Peaks model, is addressed in the General Provisions in Part 1 of the Wft.<sup>951</sup> The core determination for DNB's prudential supervision mandate was contained in section 1:24(1) of the Wft<sup>952</sup> which determined that prudential supervision was directed at the soundness of financial enterprises and the stability of the financial system; thus in essence a combination of micro- and macroprudential supervision.<sup>953</sup> This provision has to be read with the *Bankwet* 1998, as alluded to above, which formed the basis for the exercise of systemic supervision in the Netherlands by DNB - although it is to be noted that the *Bankwet* as enabling act laying down the parameters within which DNB functioned as central bank was not changed at this stage to provide for an express financial stability mandate for DNB.<sup>954</sup> Section 1:24(2) Wft extended the role of DNB as prudential supervisor by providing that DNB had the task, in terms of the Act, to exercise prudential oversight over financial enterprises<sup>955</sup> (not only banks and investment companies as it did pre-Twin Peaks) and to make rulings on whether financial enterprises may be admitted to the financial markets.

In terms of section 1:25(1) conduct of business supervision by the AFM had to focus on orderly and transparent market processes, integrity in relations between market parties and due care in the provision of services to clients. Section 1:25(2) further stipulated that the mandate of the AFM was to exercise the supervision of conduct of the financial markets and to decide on the admission of financial enterprises to those markets. Supervision by the AFM thus involved supervising market conduct in markets for investment, savings, lending and insurance, as well as supervision of the admission of businesses into these markets. The objective that the AFM was set to achieve was to establish financial market processes that were transparent and where the facts and information circulated by and amongst financial establishments were dependable. It would furthermore supervise the integrity of the financial markets by inter alia

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<sup>951</sup> KPMG Meijburg 2010 3.

<sup>952</sup> Busch et al 2010 41.

<sup>953</sup> Section 1:24(1) Wft.

<sup>954</sup> Busch et al 2010 10 and 15.

<sup>955</sup> Section 1:1 of the Wft defines "Financial enterprise" to include the following: a management company; a collective investment scheme; an investment firm; a depositary; a clearing institution; a financial service provider; a financial institution; a credit institution; and an insurer.

preventing unfair trade practices or insider trading and would be instrumental in ensuring impeccable relations between customers and financial institutions.<sup>956</sup>

Although the AFM did not have a financial stability mandate like DNB it is nevertheless clear that the AFM did indeed de facto assist with the promotion and maintenance of financial stability in the Netherlands through measures taken in its capacity as market conduct regulator.

### 4.3.3 Cooperation and collaboration

By the time the Wft came into operation the RFT as coordinating council between the regulators had been dissolved already and only Covenants were in place to facilitate the relationship between DNB and the AFM. However, in order to facilitate the smooth operation of the Twin Peaks model, cooperation and collaboration between DNB and the AFM as two peak regulators were dealt with extensively by means of hard law as per Chapter 1.3 of the Wft.<sup>957</sup> In terms of section 1:46 the supervisors were obliged to collaborate closely with a view to laying down generally binding regulations and policy rules, in order to ensure that these were equivalent wherever possible insofar as they related to aspects that were both subject to prudential supervision and supervision of conduct of business.<sup>958</sup> It was also required that the one supervisor had to provide the other supervisor with a reasonable term to submit its view before taking any measures such as the appointment of a custodian,<sup>959</sup> withdrawal of a licence,<sup>960</sup> imposition of a

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<sup>956</sup> Van Erp J “Regulatory Disclosure of Offending Companies in the Dutch Financial Market: Consumer Protection or Enforcement Publicity?” 2010 (32) *Law & Policy, The University of Denver/Colorado Seminary*, hereinafter Van Erp 2010, at 415.

<sup>957</sup> See also Busch et al 2010 48 regarding collaboration between DNB and the AFM.

<sup>958</sup> In terms of section 1:46(2) these matters include the use of powers listed in Part 1.4.2; the remuneration policy listed in Chapter 1.7; the trustworthiness referred to in sections 3.8 and 4.9; the controlled and sound operations referred to in sections 3:17(2)(a) and (b) and 4:14(2)(a) and (b) as well as such other matters as are specified by decree.

<sup>959</sup> Section 1:76. See the discussion below.

<sup>960</sup> Section 1:104.

prohibition referred to in sections 1:58,<sup>961</sup> 1:59(2),<sup>962</sup> 1:67(1)<sup>963</sup> or 4:4<sup>964</sup> and the designation under section 1:75<sup>965</sup> intended to dismiss a person determining or co-determining the policy of a financial institution, or intended to dismiss a person belonging to a body responsible for supervising the policy and general affairs of a financial institution.<sup>966</sup>

The AFM was further obliged to consult DNB before granting a licence to an investment firm which was a subsidiary of a credit institution, life insurer or non-life insurer in a Member State; a subsidiary of a parent company of a credit institution, life insurer or non-life insurer licensed in a Member State or controlled by a person that also exercised control over a credit institution, life insurer or non-life insurer licensed in a Member State.<sup>967</sup> If a supervisor had to make a “fit and proper” judgment regarding the competency of a person involved in determining the day-to-day policy or in the management of a financial institution, such supervisor was required to ask the advice of the other supervisor.<sup>968</sup>

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<sup>961</sup> Section 1:58: If certain financial enterprises having their registered office in a Member State (a state that is a member of the EU or of the European Economic Area Agreement), fail to comply with provisions laid down by the Wft, DNB or the AFM (the supervisors) may oblige such enterprise to adhere to a particular line of conduct within a reasonable term specified by the supervisor.

<sup>962</sup> Section 1:59(2): If a financial enterprise having its registered office in the Netherlands which provides services to another Member State from the branch office in another Member State and the enterprise has not complied with an instruction from a supervisor, the supervisor may prevent the enterprise from concluding new contracts in the other Member States.

<sup>963</sup> Section 1:67(1): If a clearing institution or a funeral expenses and benefits in kind insurer having its registered office in another State fails to comply with instructions issued by the supervisor as referred to in section 1:75, they may be prevented from concluding new contracts in the Netherlands.

<sup>964</sup> Section 4:4: Where a financial enterprise that has not been licensed by the AFM fails to comply with rules from the Wft, the AFM may prohibit that enterprise from performing the activities that are contrary to those rules.

<sup>965</sup> Section 1:75: If persons listed in this section fails to comply with provisions laid down by the Wft, the supervisor may oblige this person, by issuing an instruction, to adhere to a particular line of conduct within a reasonable time specified by the supervisor with regard to the instruction order.

<sup>966</sup> Section 1:47. In accordance with section 1:47(3) the view must be submitted in writing unless the urgent nature of the measure justifies deviation, given the interests involved. In such a case a verbally submitted view shall suffice, on the understanding that it will be confirmed in writing without delay.

<sup>967</sup> Section 1:47(a).

<sup>968</sup> Section 1:47(c).

If DNB, in processing an application referred to in sections 2:13,<sup>969</sup> 2:22,<sup>970</sup> 2:32,<sup>971</sup> 2:33,<sup>972</sup> 2:42,<sup>973</sup> 2:43,<sup>974</sup> 3:33<sup>975</sup> or 3:110(4) or (5)<sup>976</sup> was required to assess whether the applicant met the requirements laid down by or pursuant to Part 4, Conduct of Business Supervision of Financial Institutions, it was obliged to request the opinion of the AFM before rendering a decision on such an application. A similar obligation was imposed on the AFM in processing an application referred to in sections 2:67,<sup>977</sup> 2:68<sup>978</sup> or 2:99.<sup>979</sup> If the AFM, in the context of approval as referred to in sections 2:122,<sup>980</sup> 2:127<sup>981</sup> or 2:130<sup>982</sup> or in the context of a notification of change as referred to in section 4:26(1) or (2),<sup>983</sup> was required to assess whether the financial situation of the institution concerned was adequate, it was also obliged to request the opinion of DNB in this respect.<sup>984</sup>

If the one supervisor found that the fitness of a person determining or co-determining the policy of a financial institution licensed by the other supervisor or belonging to a body responsible for supervising the policy and general affairs of such an institution, was not or was no longer, beyond doubt, such supervisor was required to notify the other supervisor and make a recommendation as to the measures to be taken in this regard. This obligation also applied where a person involved in determining the day-

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<sup>969</sup> Application to DNB for licences by credit institutions.

<sup>970</sup> Application to DNB for licences by credit institutions.

<sup>971</sup> Application to DNB for a license to non-life insurers.

<sup>972</sup> Application to DNB for a license to non-life insurers.

<sup>973</sup> Application to DNB for a license to an applicant who wishes to conduct business in the Motor Vehicle Liability sector.

<sup>974</sup> Application to DNB for a license to an applicant who wishes to conduct business in the Legal Assistance sector.

<sup>975</sup> Application to DNB by a financial enterprise applying for extensions of the license.

<sup>976</sup> Regarding an applicant for a supervisory status certificate who intends to provide investment services or perform investment activities and who has to notify DNB and have to demonstrate that it will comply with certain provisions.

<sup>977</sup> Application to AFM for a license by a party who wants to offer units in a collective investment scheme.

<sup>978</sup> Application to AFM for a license by a party who wants to offer units in a collective investment scheme.

<sup>979</sup> Application to AFM for license to a party who wants to provide investment services or perform investment activities.

<sup>980</sup> Application to AFM by a party who wants to offer units in enterprises for collective investments in transferable securities for the first time.

<sup>981</sup> Application for approval by AFM by an investment firm who intends to provide investment services from a branch in another Member State.

<sup>982</sup> Application for approval by AFM by an investment firm who intends to provide investment services from a branch in a non-Member State.

<sup>983</sup> This section deals with financial enterprises who notify AFM of changes with regards to subjects on which data must be provided.

<sup>984</sup> Section 1:48.

to-day policy or in the management of the institution no longer had the required expertise.<sup>985</sup>

Given that the Netherlands is part of the broader EU structure, Part 1.3.2 of the Wft further dealt with collaboration between DNB and AFM and supervisors in other Member States in general where such collaboration was required for the performance of supervisory duties. It obliged DNB and AFM, on request, to supply a supervisory authority of a Member State with all data and information required for the performance of the duties of that supervisory authority.<sup>986</sup> Section 1:52 entitled DNB and AFM to demand information from any party for the fulfilment of its duties where this is required for purposes of fulfilling the duties of a supervisory authority in another Member State.

For purposes of prudential supervision as referred to in Part 3.6.4 DNB was specifically obliged to collaborate with relevant supervisory authorities of other Member States and required to provide such authorities with all relevant information if so requested and to furnish them with all essential information of its own accord.<sup>987</sup> Before rendering decisions regarding matters pertaining to changes in ownership, organization or management structure of a regulated institution or major sanctions or special measures in respect of a regulated institution, DNB had to consult the supervisory authorities of the other Member States responsible for supervising such institutions.<sup>988</sup> Section 1:55 provided that if a management company, investment firm, credit institution, life insurer or non-life insurer having its registered office in the Netherlands

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<sup>985</sup> Section 1:49. The notification and recommendation must be made in writing, unless urgent circumstances exist which justify deviation.

<sup>986</sup> Section 1:51.

<sup>987</sup> Section 1:54. This duty comprises at least the gathering and exchange of information with regard to the following aspects: Group structure of financial conglomerates; all the major institutions belonging to the conglomerate; applicable supervisory authority; the conglomerate's strategic policies; the conglomerate's financial situation (in particular on capital adequacy, intra-group transactions and risk concentration); the conglomerate's main shareholders and management; the operations at financial conglomerate level; the procedures for gathering information from the institutions in the conglomerate and the verification of such information; developments at regulated institutions or other group members of the conglomerate which could have serious detrimental consequences for the regulated entities; major sanctions and special measures imposed by the supervisory authorities of other Member States with regard to the conglomerate or parts thereof. DNB must request the holding company of the conglomerate, having its registered office in the Netherlands, for all information necessary.

<sup>988</sup> Section 1:54(3)(a) and (b). DNB may however omit to engage in such consultations in urgent cases or where the consultations may jeopardize the effectiveness of its decisions.

had a branch office in another Member State, the supervisor could, for purposes of the supervision of compliance with the Wft by that financial institution, request the supervisory authority of the other Member State to verify data or information or the branch office could itself verify such data or information if the supervisory authority in the Member State failed to do so.

The Wft also provided for cross-border collaboration in the context of enforcement, indicating that if certain financial institutions having their registered offices in another Member State, failed to comply with an instruction issued by DNB or AFM, the latter had to notify the applicable supervisory authority in the other Member State who then had to provide cooperation to DNB or AFM for purposes of enforcing measures against the recalcitrant institution.<sup>989</sup> Consultation between DNB and AFM with supervisory authorities of other Member States was further required prior to the granting of licences to certain financial institutions.<sup>990</sup> If a financial institution's license was withdrawn, the Dutch supervisor also had to inform the supervisory authority of the Member State where that institution had its registered office of such withdrawal.<sup>991</sup> Likewise the Wft facilitated collaboration between the Dutch supervisors and supervisory authorities of non-Member States<sup>992</sup> and provision of information by the Dutch supervisors to the European Commission.<sup>993</sup>

#### **4.3.4 Regulatory toolkit**

The WFT further provided both DNB and AFM with an extensive regulatory toolkit: Section 1:74 provided that a supervisor (thus DNB and AFM) could request information from any party for purposes of supervising compliance with the provisions of the Wft. Where a person failed to comply with a provision of the Wft, the supervisor could issue an "instruction" (directive) to such non-compliant institution, requiring it to adhere to particular conduct within a reasonable time specified by the supervisor in the

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<sup>989</sup> Section 1:58. See also section 1:59.

<sup>990</sup> Section 1:60.

<sup>991</sup> Section 1:61.

<sup>992</sup> See section 1:65 to 1:68.

<sup>993</sup> See section 1:69.

instruction order.<sup>994</sup> Important to note is that DNB could also issue an instruction to a financial institution in terms of section 1:75(2) where it detected signs of a development that “might jeopardize the equity capital, solvency or liquidity” of that institution.

DNB and AFM were also given the more intrusive discretion to appoint a custodian for a financial institution that failed to comply with the provisions of the Wft in the following instances: after the institution failed to comply with an instruction in terms of section 1:75(1) within the specified period; if the aforesaid violation seriously jeopardized the adequate operation of the institution; if the violation seriously jeopardized the interests of consumers or clients; or if DNB detected signs of a development that might jeopardize the equity capital, solvency or liquidity of that financial institution.<sup>995</sup> Failure to comply with a supervisor’s instruction could also result in the supervisor deciding to prevent the non-compliant financial institution from conducting its business from a branch office or through the performance of services, or from providing services in another Member State.<sup>996</sup>

DNB and AFM were further empowered to issue an order for incremental penalty payments in relation to a violation of regulations made under the Wft<sup>997</sup> and could also impose an administrative fine in respect of such violations.<sup>998</sup> The supervisors could also issue a public warning to a financial institution where necessary, stating the reasons for that warning.<sup>999</sup>

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<sup>994</sup> Section 1:75.

<sup>995</sup> Section 1:76. In terms of section 1:76(4) a decision to appoint a custodian could only be taken after the financial institution failed to comply, either fully or in part, with an instruction (directive) as referred to in section 1:75(2) within the specified term or if urgent intervention was required and the institution was previously provided with an opportunity to submit its view on the proposed decision to appoint a custodian.

<sup>996</sup> Section 1:77.

<sup>997</sup> Section 1:79.

<sup>998</sup> Section 1:80. The amount of the administrative fine is determined by decree but may not exceed 900 000 Euro. Regarding the procedure to be followed when imposing an administrative fine see section 1:82 to 1:84. The administrative fine must be paid within six weeks after the order in terms whereof it was imposed took effect. Section 1:93(1)(a) determined that DNB and AFM may supply confidential data or information in certain circumstances to the ECB or the national central bank of another foreign body. Section 1:93a determined that AFM may supply DNB with confidential data or information obtained in the performance of its duties as a contact point as referred to in the Markets in Financial Instruments Directive. Details of the imposition of incremental penalty payments or administrative fines may also be published in accordance with section 1:97.

<sup>999</sup> Section 1:94.

Notably DNB was empowered to apply to a court to declare emergency regulations applicable to a financial institution if the institution showed signs of a “dangerous development” and no improvement of that development could be expected within reason. On declaring the emergency regulations applicable, the court could then authorize the administrators of a financial institution to transfer all or part of the obligations of the institution or wind up the business of the institution or both.<sup>1000</sup>

#### 4.3.5 Powers relating to financial conglomerates

Given that the move by the Netherlands to a Twin Peaks model was to a large extent motivated by the difficulties in regulating financial conglomerates, Part 3.6.4 of the Wft set out specific provisions relating to prudential supervision of financial conglomerates.<sup>1001</sup> Such supervision was conducted by DNB via the holding company of the financial conglomerate. Where DNB had been designated as coordinator of the

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<sup>1000</sup> Section 3:160.

<sup>1001</sup> Section 3:290 states that a “financial conglomerate” refers to a group which satisfies the following conditions:

(a) The group is headed by

(1) a regulated institution having its registered office in a Member State which is:

- a holding institution of an institution in the financial market sector;

- an owner of a holding in an institution in the financial market sector; or

- affiliated to an institution in the financial market sector because of a central management or because the administrative, managing or supervisory bodies are composed for the majority of the same persons during the financial year; or

(2) an enterprise which is not a regulated institution, in which case the balance sheet total of the enterprises in the financial market sector exceeds 40 percent of the balance sheet total of the group as a whole;

(b) at least one of the regulated institutions in the group pertains to the credit institution and investment firm sector, and at least one of the regulated institutions in the group pertains to the insurer sector;

(c) as regards any subsector in the group, the average of the ratio between the balance sheet total of that subsector and the balance sheet total of the financial market sector, on the one hand, and the ratio between the required capital under the solvency requirements of that subsector and the total required capital under the solvency requirements of the financial market sector on the other, exceeds ten percent. A group which satisfies the conditions referred to in subsections (a) and (b) but which does not satisfy the conditions in subsection (c) shall also be a financial conglomerate if the balance sheet total of the smallest subsector exceeds 6 000 000 000 Euro; See also EC, Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate; See also EUR-Lex – 52012DC0785 – EN – EUR-Lex “Report from the Commission to the European Parliament and the Council: The review of the Directive 2002/87/EC of the European Parliament and the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate” (2012) <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex:52012DC0785> (accessed 2 May 2018).

supervision of a financial conglomerate that had its registered office in the Netherlands and also in other Member States, it had the following functions: it had to coordinate the collection and dissemination of information relevant or essential in normal circumstances and in emergency situations, including the dissemination of information important for prudential supervision; it had to supervise and assess the financial situation of the conglomerate as a whole; it had to supervise compliance with the regulations on capital adequacy, risk concentration and intra-group contracts and positions as well as compliance with the rules regarding the operations of the financial conglomerate and it had to plan and coordinate supervisory activities in normal circumstances and in emergency situations, in collaboration with the relevant supervisory authorities.<sup>1002</sup> The holding company of a financial conglomerate was tasked in terms of the Wft to ensure that the conglomerate complied on a consolidated or aggregated basis, with the rules relating to capital adequacy of the conglomerate.<sup>1003</sup> The holding company also had to report regularly regarding all significant risk concentrations at financial conglomerate level to DNB as coordinating supervisor.<sup>1004</sup> DNB could further lay down rules regarding the capital adequacy of a conglomerate as well as regards the quantitative limits or other measures to restrict the risk concentration in the conglomerates.<sup>1005</sup> The only obligation that the AFM has in terms of the Wft with regards to financial conglomerates, is that DNB shall communicate a decision to classify a group as a financial conglomerate to the AFM if the latter licensed a regulated entity of the financial conglomerate.<sup>1006</sup>

Finally it should be noted that prior to the GFC the Ministry of Finance and DNB entered into a Memorandum of Understanding in February 2007 wherein it was recorded that the final accountability for financial stability lay with the Ministry of Finance in that the Minister was authorised to inform the Lower House in general as to his conclusions regarding the stability of the financial system after consultation with DNB. If developments were such that it threatened financial stability in the Netherlands

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<sup>1002</sup> Section 3:294.

<sup>1003</sup> Section 3:296.

<sup>1004</sup> Section 3:297.

<sup>1005</sup> Section 3:297(3) and (4).

<sup>1006</sup> Section 3:291.

and it required measures by the Minister, the Minister would delegate a representative to the crisis management team formed by DNB.<sup>1007</sup>

A new Covenant between DNB and AFM, replacing the Covenant of 15 November 2004 (last amended on 9 March 2006) was also entered into on 2 July 2007.<sup>1008</sup> The mandates and objectives of both DNB and the AFM became a lot more precise after they entered into the 2007 cooperation Covenant. The supervisory authorities undoubtedly comprehended that they each had a specific role and specific responsibilities in terms of the Dutch Twin Peaks model of financial regulation which entailed “regulation by objective”.<sup>1009</sup>

#### **4.4 The Dutch Twin Peaks model during the GFC**

Given that the Dutch Twin Peaks model was introduced shortly before the 2008 GFC erupted with full force it meant that the model was almost immediately confronted with various challenges occasioned by the Crisis. Denters remarks that cutthroat competition between financial institutions led them to not only innovate but also to accept higher risks before the GFC that eventually caused severe financial disruption during the

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<sup>1007</sup> IMF 11/208 9. Memorandum of Understanding between DNB and Minister of Finance (February 2007) [https://www.dnb.nl/en/binaries/eng%20compleet\\_tcm47-146548.pdf?2017111811](https://www.dnb.nl/en/binaries/eng%20compleet_tcm47-146548.pdf?2017111811) (accessed 30 October 2017): On 12 February 2007, DNB and the Minister of Finance concluded an agreement in the form of a Memorandum of Understanding on the mutual exchange of information and consultations on financial stability and crisis management. The MOU refers to the functions of DNB as central bank, namely that it defines and implements monetary policy; it exercises supervision on the soundness of financial enterprises and pension funds; it monitors and contributes to the stability of the financial system; it promotes the smooth operation of payment systems; and it exercises oversight on the clearing and settlement systems for payments and securities transactions. The MOU also refers to the functions of the Minister of Finance, being that he bears political responsibility for the functioning of the financial system that includes the institutional structure of supervision and its underlying legislation as well as the decision-making on the use of budgetary means in crisis management.

<sup>1008</sup> Covenant between the AFM and DNB (2 Jul 2007) (Unofficial translation 15 September 2010) <http://www.toezicht.dnb.nl/en/binaries/51-213295.pdf> (accessed 15 October 2017) section 3.2; Instituut voor Onderzoek van Overheidsuitgaven “De samenwerking tussen DNB en AFM op basis van de Wft - Twin-peaks in de praktijk” (11 June 2010) <https://zoek.officielebekendmakingen.nl/blg-77022.pdf> (accessed 8 February 2018) 62: The renewal of the covenant was necessary because of the enactment of the Act on Supervision of Accountancy Organizations on 1 October 2006 and the Wft, the Pension Act and the Amended Act on Mandatory Occupational Pension Schemes on 1 January 2007. In this covenant the AFM and DNB has made further agreements on cooperation in the execution of these acts

<sup>1009</sup> IMF 11/208 8.

Crisis. National players in the Netherlands that had big financial problems during the GFC were ABN AMRO,<sup>1010</sup> Fortis,<sup>1011</sup> ING<sup>1012</sup> and SNS Reaal<sup>1013</sup> to name but a few.<sup>1014</sup>

Schmulow points out that 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” government intervention. He remarks: “...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.” He further points out that intervention in the Netherlands during the GFC took the form of measures to stimulate employment through: construction and housing (6 billion Euros); capital injections for banks and insurers (20 billion Euros); state guarantees for banks (200 billion Euros); a guarantee on all deposits up to 100 000 Euros; the nationalisation of Fortis /ABN Amro (16.8 billion Euros); the ING banking group (10 billion Euros) and the SNS REAAL insurance and

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<sup>1010</sup> ABN AMRO website (undated) <https://www.abnamro.com/en/index.html> (accessed 27 January 2018): *ABN AMRO* is an all-round Dutch bank that offered a full range of products and services to retail, private and corporate clients.

<sup>1011</sup> DNB Study perspective on the structure of the Dutch banking structure (undated) [https://www.dnb.nl/en/binaries/DNB-study%20Perspective%20on%20the%20structure%20of%20the%20Dutch%20banking%20sector\\_tcm47-323322\\_tcm47-334492.pdf](https://www.dnb.nl/en/binaries/DNB-study%20Perspective%20on%20the%20structure%20of%20the%20Dutch%20banking%20sector_tcm47-323322_tcm47-334492.pdf) (accessed 22 January 2017) hereinafter DNB on banking structure: *Fortis* was a Belgian financial company active in insurance, banking and investment management. In 2007 it was the 20th largest business in the world by revenue but after encountering severe problems in the financial crisis of 2008, most of the company was sold in parts, with only insurance activities remaining.

<sup>1012</sup> ING website (undated) <https://www.ing.com/Home.htm> (accessed 27 January 2018): *ING* is a Dutch retail bank and part of the *ING* Group, a global financial institution that provides banking, investment, life insurance and pension services.

<sup>1013</sup> DNB on banking structure: *SNS REAAL* was a Dutch financial institution in insurance and banking which focused on the private market and small to medium businesses and is since its nationalisation on 1 February 2013 a government-owned corporation. The services to private and corporate clients are mainly from SNS Bank and insurance brand REAAL.

<sup>1014</sup> Bierman et al 2015 1; Denters E “Regulation and supervision of the global financial system. A proposal for institutional reform” *2008-2009 Amsterdam Law Forum* 63, hereinafter Denters 2009, at 63 and 64. He remarks that shareholders put subtle pressure on chief financial officers to take excessive risks in order to earn big bonuses for themselves. These risks were often taken in the field of securities that are high-leveraged and rewarding. Denters thus blames greed in the banking sector for the condition of the financial markets after the GFC.

banking group (3.7 billion Euros). Thereafter the Dutch Government was forced to drastically reduce spending in order to reduce its deficit.<sup>1015</sup>

DNB's performance of its mandate for financial stability and prudential supervision came under scrutiny in the context of takeovers and failures of financial institutions that occurred during the GFC. In October 2008, the Icelandic bank Landsbanki, with a substantial Dutch customer base, found itself in acute financial distress. Icesave was the Dutch branch of Landsbanki and an internet-only saving scheme. When it failed DNB granted Landsbanki access to the Netherlands' deposit guarantee system and the Minister of Finance guaranteed savers' deposits. In 2010 the De Wit Commission was appointed to inter alia examine DNB's performance in the Icesave matter.<sup>1016</sup> The Commission found that the guarantee of Icesave deposits was a responsible risk that the Minister of Finance took, but the decision to grant access to the deposit guarantee scheme was not raised on time at the highest level within DNB and the Commission found that incomprehensible. The De Wit Commission subsequently recommended that in the light of the Icesave case, depositors should be given insight into the quality of banks and should carry out a certain degree of research before opting to entrust their savings to a particular bank. The Commission indicated that DNB should therefore proceed to publish solvency information about banks periodically.<sup>1017</sup> It

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<sup>1015</sup> Schmulow 2017 no. 2 400. Schmulow obtained these statistics from Masselink M and van den Noord P "The Global Financial Crisis and Its Effects on the Netherlands" 2009 (6) *ECFIN (Economic Analysis from the European Commission's Directorate-General for Economic and Financial Affairs) Country Focus* 3.

<sup>1016</sup> Report of Special Parliamentary Commission on Financial Crisis Issued (11 May 2010) <http://www.loc.gov/law/foreign-news/article/netherlands-report-of-special-parliamentary-commission-on-financial-crisis-issued/> (accessed 21 June 2017) hereinafter De Wit Report 2010: The De Wit Commission was a Dutch parliamentary group set up in 2009 with Chairman of the Commission Jan de Wit of the Socialist Party. They had to examine the cause of the credit crisis, structural problems and measures taken and had to review the period since 22 September 2008, the date when the government intervened in the Dutch financial sector. It published its findings on 10 May 2010. Dutch News (10 May 2010) [http://www.dutchnews.nl/news/archives/2010/05/de\\_wit\\_commission\\_report\\_into/](http://www.dutchnews.nl/news/archives/2010/05/de_wit_commission_report_into/) (accessed 21 June 2017) reported "The parliamentary commission set up to examine the cause and effect of the financial crisis in the Netherlands will publish its findings today. Commission members questioned over 40 bankers, financial service sector regulators, politicians and academics in January and February. In particular, central bank and financial service authority officials came under fire. Some general conclusions that the Parliamentary commission made were that banking culture, with its emphasis on profits, returns and bonuses, encouraged recklessness; and that there were gaps in the rule books and that supervision was not up to scratch and that more international cooperation is needed.

<sup>1017</sup> Committee of Parliamentary Inquiry into the financial system "Conclusions and Recommendations" (11 May 2010) [https://www.houseofrepresentatives.nl/sites/default/files/news\\_items/the\\_committee\\_of\\_parliamentary\\_inquiry\\_into\\_the\\_financial\\_system\\_conclusions\\_and\\_recommendations.pdf](https://www.houseofrepresentatives.nl/sites/default/files/news_items/the_committee_of_parliamentary_inquiry_into_the_financial_system_conclusions_and_recommendations.pdf) (accessed 21 January 2018), hereinafter De Wit Conclusions and Recommendations, at 17 - 18.

further found that DNB identified macro-economic risks but focused on action at individual institutions and therefore recommended that an additional macroprudential body had to be established.<sup>1018</sup>

The De Wit Commission also looked into the ABN AMRO takeover by Fortis and the subsequent failure of Fortis during the GFC. In the Commission's report DNB was criticized for not fully exploiting the opportunity available to safeguard financial stability. DNB was apparently of the opinion that it was not in a position to block the takeover but, from a legal perspective, the De Wit Report argued that DNB could have taken a blocking decision,<sup>1019</sup> given its responsibilities and instruments to its avail as allocated in the law.<sup>1020</sup> During this time DNB was also criticised for the "taxpayer-financed" rescue of Fortis.<sup>1021</sup> However Kremers and Schoenmaker remark that there are no indications that limitations in DNB's remit as micro- and macroprudential supervisor played a role in the ABN AMRO/Fortis case. They indicate that as DNB had oversight over all the Dutch entities involved in the case and, through its role as microprudential supervisor and participant in the ECB, the broader financial system stability aspects in the case were fully in scope.<sup>1022</sup>

The integrity of DNB was further reconsidered after an eminent bank, DSB<sup>1023</sup> with a high percentage of local customers, failed in 2009. After the collapse of DSB Bank, the Scheltema Commission in 2010 assessed the bank's failure and in its report severely criticised DNB for its handling of the supervision and subsequent failure of DSB.<sup>1024</sup> Kremers and Schoenmaker however remark: "Here again, no issues related to the Twin Peaks model have come to the fore. Instead the evaluation pointed to a

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<sup>1018</sup> De Wit Conclusions and Recommendations 30.

<sup>1019</sup> De Wit Conclusions and Recommendations 1: A consortium consisting of Royal Bank of Scotland, Fortis and Banco Santander acquired ABN AMRO Bank on 17 October 2007.

<sup>1020</sup> Kremers & Schoenmaker 2010 7.

<sup>1021</sup> Kamerstuk 31980 nr. 4 Tweede Kamer der Staten-Generaal "Parlementair onderzoek financieel stelsel" (10 May 2010) <https://zoek.officielebekendmakingen.nl/kst-31980-4.html> (accessed 22 January 2018): When Fortis put its share of ABN AMRO Bank up for sale and could not find a buyer, the Dutch government purchased the Dutch subsidiaries of Fortis on 3 October 2008 where a large amount of tax payers' money was involved.

<sup>1022</sup> Kremers & Schoenmaker 2010 7.

<sup>1023</sup> DSB Bank: Dirk Scheringa Beheer was a Dutch bank and insurer that failed in 2009.

<sup>1024</sup> IMF 11/208 10; Scheltema Commission *Rapport van de commissie van Onderzoek DSB Bank* (23 June 2010) <https://zoek.officielebekendmakingen.nl/blg-70732.pdf> (accessed 21 January 2018).

general need to strengthen DNB enforcement inter alia related to organizational culture.” The recommendation by the Scheltema Commission regarding change in its supervisory approach was accepted by DNB which proposed that measures would be put in place to change the regulatory culture of the Bank.<sup>1025</sup>

Kremers and Schoenmaker further indicate that the pensions crisis that occurred during the GFC hit the pension system (for which DNB was the prudential supervisor) hard. Fortunately DNB did a better job in dealing with this situation than with the collapse of DSB Bank, as it reacted to the pension’s crisis by inter alia requiring pension funds to submit recovery plans to indicate how they were planning to recover from future crises – and thus attempted to put measures in place to enhance the financial resilience of these funds.<sup>1026</sup>

The Netherlands underwent an IMF Financial Sector Assessment Program (FSAP), focusing on the Dutch Twin Peaks model, in 2011. The 2011 IMF FSAP Report<sup>1027</sup> indicated that generally the Dutch Twin Peaks model worked well during the crisis, as decisions were able to be made timeously to contain the banking crisis during the GFC, because of information sharing between DNB and AFM and also between DNB and the Ministry of Finance in the context of crisis management. The IMF FSAP 2011 Report referred to the 2007 MOU between the Ministry of Finance and DNB<sup>1028</sup> and pointed out that in terms of the MOU DNB acted as crisis manager and could take measures it deemed necessary if the urgency of the situation required it.<sup>1029</sup>

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<sup>1025</sup> Kremers & Schoenmaker 2010 7; Dijk & Oppelaar 2014 111: Dijk & Oppelaar was however of the opinion that DNB and the AFM had wide rule making powers. They remarked that: “In terms of the legislation they also had a lot of freedom in the performance of their supervision and the interpretation of the rules. When a rule that they made, was transgressed, they determined the sanction, which could have a punitive character like a fine. The way all these powers are combined together, concentrates the power very strongly.” According to Dijk & Oppelaar the necessary checks and balances were however lacking.

<sup>1026</sup> Kremers and Schoenmaker 2010 8.

<sup>1027</sup> International Monetary Fund Country Report No. 11/208 *Kingdom of the Netherlands - Netherlands: Financial Sector Assessment Program Documentation – Technical Note on Financial Sector Supervision: The Twin Peaks Model* (July 2011) <https://www.imf.org/external/country/NLD/index.htm?pn=3> (accessed 12 October 2015) (hereinafter IMF 11/208). In 2006 the Netherlands underwent its first FSAP, but the focus of the 2011 FSAP was more specifically on the Twin Peaks model of financial regulation.

<sup>1028</sup> Discussed in paragraph 4.3 above.

<sup>1029</sup> IMF 11/208 9.

The 2011 IMF Report indicated that DNB and the AFM collaborated well together in practice and especially during the GFC, attributable to the Covenant<sup>1030</sup> that they had entered into in 2007.<sup>1031</sup> In spite of the fact that the IMF Report found that the Covenant enhanced cooperation between DNB and AFM, the Report however highlighted the need for even closer cooperation between DNB and the AFM, given the lesson from the GFC that problems emanating from conduct of business practices can rapidly escalate to also compromise the prudential soundness of a financial institution. The IMF indicated that the Covenant agreement between DNB and the AFM set out general guidelines that the lead supervisor would defer to the opinions of the other supervisor but pointed out that it fell short in specifying a formal procedure for resolving differences in opinions.<sup>1032</sup>

The IMF further indicated that during the GFC a group in DNB responsible for coordinating measures pertaining to financial stability, increased its meetings from three to five times per year to weekly meetings. This group also expanded its members during the Crisis to include other role players that were not previously part of this group. Later a crisis management group was established where representatives of the Ministry of Finance and the AFM had daily meetings.<sup>1033</sup>

In the IMF's opinion it was possible to bring about adequate coordination between major establishments in the Netherlands during the Crisis because of a clear distribution of their duties into three categories: Firstly DNB administered liquidity assistance (lender of last resort) in the GFC to illiquid but solvent banks that could not easily sell their assets for cash without a substantial loss in value. DNB also provided corrective measures to banks with financial problems. It was in charge of all bank

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<sup>1030</sup>See more in paragraph 4.3 above.

<sup>1031</sup> IMF 11/208 8.

<sup>1032</sup> IMF 11/208 12. It indicated that such a procedure should assist to avoid escalation of conflict in public which could harm the credibility of both DNB and AFM. In this context it referred to an incident where DNB and AFM had opposite views concerning a fit and proper test result and remarked that in such case the Covenant agreement should set out specific guidelines as to whether the fit-and-proper test should be passed by both DNB and AFM.

<sup>1033</sup> IMF 11/208 10.

resolution measures and assisted failing banks with the transition to new management as well as restructuring of the banks. Secondly the AFM, although without specific expertise in respect of crisis management, provided assistance in making bank resolution measures more discreet and transparent. Thirdly the Ministry of Finance, having the final accountability for overall financial stability, provided official solvency support to establishments with financial problems.<sup>1034</sup>

The IMF Report specifically referred to the failure of Icesave, as mentioned above, and indicated that despite the aforementioned measures taken by the regulators, the GFC nevertheless seriously influenced the financial sector in the Netherlands. Although there were a number of bank failures occasioned by problems in prudential regulation there were also problems occasioned by business conduct. For example, insurance companies lost integrity because of conduct of business issues and also because of selling of insurance products at high commissions on a large scale.<sup>1035</sup>

Kremers and Schoenmaker also specifically explored in what areas the Dutch Twin Peaks Model assisted in preventing financial chaos during the GFC and in which areas where financial sector failure was experienced, possible improvements could be recommended.<sup>1036</sup> According to them DNB “had a challenge” to bring about microprudential stability of individual financial institutions during the GFC and moreover to ensure stability of the whole financial system.<sup>1037</sup> They point out that subsequent to the collapse of Lehman Brothers in the US in September 2008 that triggered the GFC, exchanges between banks became dysfunctional and came to a standstill because of severe liquidity problems. In the EU, the ECB and the National Central Banks of EU Member States (including DNB) as part of the ESCB took charge in resolving this standstill. Since DNB was a central bank tasked with both macro- and microprudential oversight, Kremers and Schoenmaker, like the IMF, indicate that DNB

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<sup>1034</sup> IMF 11/208 9.

<sup>1035</sup> IMF 11/208 9.

<sup>1036</sup> Kremers & Schoenmaker 2010 1.

<sup>1037</sup> Kremers & Schoenmaker 2010 7.

was (generally) able to act promptly and provide the Dutch banks with enough liquidity and to perform liquidity stress tests on them before the GFC.<sup>1038</sup>

From the aforementioned it appears that despite cooperating well with the AFM and acting swiftly to deal with some distressed banks, DNB's execution of its combined mandate as systemic and prudential regulator during the Crisis nevertheless fell short in the area of prudential regulation and supervision and that this aspect compromised financial stability in the Netherlands given the interlinkage between these two areas.<sup>1039</sup> There were some pertinent aspects relating to DNB's role as prudential supervisor in the Twin Peaks system during the GFC that significantly impacted on its ability to execute its financial stability mandate during the Crisis. Given that both micro- and macroprudential supervision were the responsibility of DNB as central bank, it was indeed possible for DNB to survey the entire financial system and the Bank was theoretically in a position to foresee possible negative consequences for the system that it could address swiftly. A drawback was however that although the Wft gave DNB sufficiently strong enforcement powers, DNB appeared to lack the regulatory will to enforce its prudential and financial stability mandates more strictly. As a result DNB took a "light touch" approach to its supervisory duties and enforcement powers which resulted in some spectacular bank collapses such as that of Landsbanki (Icesave) and DSB Bank as mentioned above.<sup>1040</sup> Notably Oppelaar remarks that because there were almost no bank failures in the Netherlands immediately prior to the GFC, not a lot was bargained on the results of prudential supervision by DNB before the GFC - which probably also explains the lack of more aggressive and intrusive prudential regulation by DNB during the Crisis.<sup>1041</sup> Nevertheless, it appears that it was not the Twin Peaks model per se that gave rise to the shortcomings in prudential regulation by DNB but rather the "regulatory culture" of DNB that saw it taking a rather laissez

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<sup>1038</sup>Kremers & Schoenmaker 2010 7.

<sup>1039</sup>See also Chapter One paragraph 1.4.3.

<sup>1040</sup> Giesen I "Regulating regulators through liability – The case for applying normal tort rules to supervisors" 2006 (2) *Utrecht Law Review* 8 indicates that Van der Hoop Bankiers N.V., a prominent Dutch bank, was also declared bankrupt on 16 December 2005.

<sup>1041</sup> Oppelaar (Chapter 3) in Busch et al 2010 40. He thus questions whether the power relations would have been different if the failures of banks such as Van der Hoop Bankiers N.V., Landsbanki (Icesave) and DSB Bank N.V. happened a few years earlier.

faire approach to prudential regulation instead of a more robust, pro-active and intrusive approach that would have been more appropriate in the context of the GFC.

It needs to be pointed out however that whereas DNB appeared not to have taken a heavy handed approach to prudential supervision, the AFM was a stricter supervisor. As indicated above, the AFM oversaw the conduct of market players in relation to savings, lending, investments, pensions and insurance. It was also the watchdog for the consumer credit markets, strongly focusing on measures relating to the prevention of over-indebtedness.<sup>1042</sup> The stricter approach to enforcement by AFM probably served to prevent more disasters in the Dutch Financial system as it at least contained risks emanating from the business conduct of financial institutions with the exception of those mentioned in the 2011 IMF Report.

On the positive side Kremers and Schoenmaker further indicate that insofar as avoiding supervisory overlap was concerned, DNB and AFM established an “overlap reporting centre” where issues of possible overlap could be reported and dealt with.<sup>1043</sup> A high-level committee of former bank executives was also formed to investigate supervisory overlap. Their finding was that DNB and AFM had full awareness at board level to prevent overlap, but not always at staff level. Consequently DNB and AFM embarked on an internal program to implement the new supervisory philosophy that underlies the Twin Peaks model, namely that of two distinct objectives (prudential and market conduct supervision, respectively) and to highlight the importance of avoiding overlap when planning visits and special investigations at supervised institutions.<sup>1044</sup>

According to Kremers and Schoenmaker, there were however some major points of concern regarding the Dutch Twin Peaks model to consider after the GFC inter alia

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<sup>1042</sup> Van den Nieuwenhuijzen 2010 24.

<sup>1043</sup> Tweede Kamer der Staten-Generaal “Het system van toezicht op de stabiliteit van financiële markten; Verkenning” (2009 – 2010) [https://zoek.officielebekendmakingen.nl/dossier/32255/kst-32255-2?result\\_Index=25&sorttype=1&sortorder=4](https://zoek.officielebekendmakingen.nl/dossier/32255/kst-32255-2?result_Index=25&sorttype=1&sortorder=4) (accessed 23 December 2017): The overlap reporting centre (*Meldpunt Toezicht Overlap*) was introduced as part of the evaluation of the Wft by the Ministry of Finance in 2009.

<sup>1044</sup> Kremers & Schoenmaker 2010 6.

the “construction of the management” of the prudential supervisor, which is essentially a corporate governance issue. They remark that it should be ensured that the prudential supervisor is constructed in such a way that it would be in a position to take tough decisions, specifically with regards to macroprudential matters. Kremers and Schoenmaker point out that a sole in-house managing board was entrusted with all the decisions in DNB regarding micro- and macroprudential matters including its recommendations for ECB monetary policy resolutions. They were of the opinion that consideration should be given to bringing major prudential decisions with possible systemic implications to a dedicated financial stability board - thus they supported the creation of an additional body that would focus exclusively on financial stability and would prevent financial stability issues from becoming merely another item on the agenda of a single board with responsibility for various other matters as well.<sup>1045</sup>

The IMF in its 2011 Report also indicated the following areas of reform for the Dutch Twin Peaks mode, pursuant to its experience during the GFC, to function optimally:<sup>1046</sup>

(a) Prior to the GFC microprudential supervision by DNB tended to rely on moral suasion:<sup>1047</sup> Although the Wft provided DNB with an extensive range of legal sanctions and powers to ensure compliance with laws and regulations, the IMF remarked that bank supervisors seemed to have been reluctant to use enforcement powers to the full and suggested that attention be given to this aspect.<sup>1048</sup>

(b) The IMF was of the opinion that the prudential supervision of internationally active financial conglomerates required improvement. It was pointed out that although the Dutch Twin Peaks model was designed specifically in response to the emerging

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<sup>1045</sup> Kremers & Schoenmaker 2010 8 and 9. They cite the Bank of England’s Monetary Policy Committee as an example. Kremers and Schoenmaker mentioned that during the GFC it was sensible for the Netherlands to separate supervision of conduct of business and microprudential supervision and in the Dutch experience, it worked well in practice. They however opine that the real test in the construction of the Dutch model lies in blending micro- and macroprudential regulation with monetary policy. If the design of the model could achieve such blending and linking, they are of the view that success with this model would be assured.

<sup>1046</sup> IMF 11/208 10.

<sup>1047</sup> Financial Times “Definition of moral suasion” (undated) <http://lexicon.ft.com/Term?term=moral-suasion> (accessed 3 May 2018): Moral suasion is the term to describe when a government or central bank uses persuasion rather than regulatory coercion to convince financial sector participants to take a particular course of action.

<sup>1048</sup> According to the IMF this may reflect a traditional banking supervision culture as well as a learning process on the part of supervisors about the extent of their powers under the Wft. However the IMF pointed out that the effectiveness of supervision is compromised where it relies largely on moral suasion.

dominance of large financial conglomerates the reality was that the supervisory instruments available for the supervision of these conglomerates were relatively limited.

(c) The IMF further indicated that DNB's legal authority over financial holding companies was constrained: For mixed financial conglomerates DNB's power was limited to giving instructions (directives) and it could not impose penalties in respect of holding companies that were judged as lacking inadequate risk management and internal control procedures. For insurance groups there were explicit restrictions against DNB imposing broadly applicable limits on intra-group exposures. In addition DNB had limited enforcement power against non-regulated holding companies.<sup>1049</sup>

(d) Although pension fund supervision appears to have been more pro-active, the IMF opined that further integration of the staff conducting supervision in the various sectors should enhance the synergy potential of having a single prudential supervisor, and should help foster the incorporation of the new supervisory culture.<sup>1050</sup>

(e) The IMF also pointed out that the GFC had underlined the importance of macroprudential regulation and supervision. In the Dutch context it indicated that the Financial Stability Department that was founded in 2004 in DNB, being primarily responsible for financial stability in the Netherlands, should ensure that macroprudential analysis is fully fed into policy changes and prudential surveillance. It indicated that in the run-up to the GFC, comprehensive analytical work was done by the Financial Stability Department that enabled the detection of emerging risks, but unfortunately this detection was not fully translated into surveillance work, partly because the lack of sufficient macroprudential tools. In response a separate department for macroprudential supervision was created within the Financial Stability Department to further improve the monitoring of macroprudential risks.<sup>1051</sup> The IMF however opined that for DNB to act more promptly to any emerging systemic risks and to mitigate boom-and-bust cycles, it would need to expand its macroprudential policy instruments in alignment with the FSB Macroprudential Policy framework.<sup>1052</sup> These

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<sup>1049</sup> IMF 11/208 10. Prudential supervision for significant banks shifted from DNB to the ECB in Frankfurt Germany on 4 November 2014. Prudential supervision for less significant banks are still carried out by DNB. See further par 4.6 below.

<sup>1050</sup> IMF 11/208 10.

<sup>1051</sup> IMF 11/208 10 and 11.

<sup>1052</sup> Joint FSB, IMF, BIS Paper "Macroprudential policy tools and frameworks – Progress Report to G20" (27 October 2011) <https://www.imf.org/external/np/g20/pdf/102711.pdf> (accessed 2 September 2017): The progress in implementing macroprudential policy frameworks is traced along three broad

include a resolution framework for failing banks, higher capital requirements, countercyclical buffers and the use of contingent capital and bail-out instruments. The IMF thus indicated that DNB should be more involved in the rule-making process or that it should at least have discretion to adjust the levels of designated macroprudential instruments to be more responsive to market developments. It further remarked that under the Wft DNB had relatively limited rule-making authority of its own as most of the regulatory instruments at its disposal were either directly contained in the Wft or in Decrees issued by the Ministry of Finance which was inter alia responsible for the setting of limits for mortgage loan-to-value (LTV) ratios. However the IMF suggested that given the important link between housing sector health and financial stability, DNB could be allowed to change the LTV ratios within a range set by the Ministry of Finance, or to require more capital to be held against high LTV loans.<sup>1053</sup>

(f) In order to avoid regulatory arbitrage, the IMF indicated that the perimeter of regulation would need to be extended to enhance the surveillance of shadow banking activities by for example hedge funds and insurance companies. It was suggested that DNB should apply uniform rules to prevent regulatory arbitrage between banks and non-banks and that it should co-ordinate closely with other regulators to minimize regulatory arbitrage.<sup>1054</sup>

(g) The IMF Report also stated that in recognition of the problem related to cross-border supervision DNB had taken measures to enhance the functioning of supervisory colleges in line with the recommendations of the FSB. For large banks with cross-border activities a multi-lateral agreement was signed between members of the respective colleges to provide for further formal arrangements for home and host country supervisors.<sup>1055</sup> The IMF thus remarked that the Dutch Twin Peaks model seemed well suited to the international aspects of supervision, with DNB as central bank being able to bring its wider international experience to the handling of cross border issues and the AFM being able to bring specialized conduct-of-business expertise to bear in its international relations. However the IMF submitted that greater

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lines, namely (i) advances in the *identification and monitoring* of systemic financial risk; (ii) the designation and calibration of *instruments* for macroprudential purposes; and (iii) building *institutional* and *governance* arrangements in the domestic and regional context.

<sup>1053</sup> IMF 11/208 10 -12.

<sup>1054</sup> IMF 11/208 11.

<sup>1055</sup> IMF 11/208 12. See Memorandum of understanding on cooperation between the financial supervisory authorities, central banks and finance ministries of the European Union on cross-border financial stability (1 June 2008) [https://www.ecb.europa.eu/pub/pdf/other/mou-financialstability2008\\_en.pdf](https://www.ecb.europa.eu/pub/pdf/other/mou-financialstability2008_en.pdf) (accessed 23 December 2017).

international cooperation, beyond the colleges of supervisors, needed to be undertaken by DNB and AFM in future.<sup>1056</sup>

Notably the IMF suggested, as future reforms in the context of the Dutch Twin Peaks model, the strengthening of macroprudential supervision by introducing financial stability as an explicit mandate for DNB. It also recommended the expansion of macroprudential regulatory toolbox accordingly to enable DNB to take swift action against any emerging systemic risks without first having to resort to legislative changes. It additionally proposed further intensifying of supervision of large financial conglomerates, with greater emphasis on group supervision and soundness of business models.<sup>1057</sup>

In conclusion the IMF Report indicated that although the GFC influenced the Dutch financial sector to a great extent, and a high percentage of the GDP had to be applied to support distressed financial institutions, the Twin Peaks model was still regarded as the best regulatory approach for the Netherlands. It also commented positively on the combination of systemic stability and prudential regulation in the remit of DNB and pointed out that this enabled DNB to take a systemic view over the whole financial playing field to detect issues that could affect the financial system and (generally) act forcefully and speedily during the crisis.

Finally note has to be taken of the opinion expressed by Van Hengel, namely that the problems experienced by the Netherlands during the GFC was not directly related to the Twin Peaks model but rather to the fact that the Netherlands has a large and internationally active financial sector that left it vulnerable to global developments.<sup>1058</sup>

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<sup>1056</sup> IMF 11/208 12.

<sup>1057</sup> In this regard it welcomed the steps taken by DNB toward a more proactive and decisive approach including timely on-site inspections and corrective actions that rely less on moral suasion.

<sup>1058</sup> Interview conducted with Marco van Hengel, senior policy advisor from DNB, dated 21 March 2018, hereinafter Interview Van Hengel 2018.

## 4.5 Reforms in the Netherlands subsequent to the GFC

The GFC was a significant learning curve for regulators and supervisors across the globe and especially so for the Netherlands where various actions and reforms occurred on an ad hoc basis post GFC.

Elderson indicates that in 2010 and 2011 DNB took to the task of developing a policy vision and toolbox and setting up a team, consisting of professionals from various disciplines such as governance, change management and organizational psychology, to supervise the behavior and culture in financial institutions in order to diminish excessive risk taking. Since then, DNB has performed more than sixty supervisory assessments at financial institutions (more than one third of which are banks), covering topics such as: board effectiveness, risk culture, capacity for change and including root cause analyses.<sup>1059</sup>

In response to the GFC DNB had issued two studies, “DNB Supervisory Strategy 2010–2014”<sup>1060</sup> and “From Analysis to Action”,<sup>1061</sup> with steps that could be taken in the Netherlands in the context of financial regulation which could lead to more pro-active and conclusive financial supervision. “From Analysis to Action” inter alia suggested

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<sup>1059</sup> Presentation Elderson 2016. In the presentation by Elderson he gave examples of this supervision: “Let me explain how this works in practice by zooming in on the most frequent assessment DNB did, on board effectiveness. The goal was to determine if behavior and group dynamics within the board of a financial institution may induce decisions that have harmful consequences for the financial solidity of the firm and its stakeholders. To this end they used a mixture of methods, such as surveys, self-assessments, interviews and board observations. In the latter case, two DNB experts attended a board meeting, focusing on questions like: How much room is there for divergent views? Who gets the floor from the chairman and who doesn't? Who impacts the discussion the most and why? Together with the image that emerges from the other tools, and after internal challenges, they discuss their findings and recommendations with the institution. Engaging in dialogue and challenging risky behavior is the key to how this is addressed.”

<sup>1060</sup> De Nederlandsche Bank “DNB Supervisory Strategy 2010 – 2014” (April 2010) [https://www.dnb.nl/en/binaries/DNB%20Supervisory%20Strategy%202010-2014\\_tcm47-238092.pdf?2017022513](https://www.dnb.nl/en/binaries/DNB%20Supervisory%20Strategy%202010-2014_tcm47-238092.pdf?2017022513) (accessed 21 June 2017), hereinafter DNB Supervisory strategy 2010-2014, at 13.

<sup>1061</sup> De Nederlandsche Bank “From Analysis to Action” (21 September 2010) <https://www.dnb.nl/en/publications/brochures/dnb239525.jsp> (accessed 21 June 2017) in IMF 11/208 13, hereinafter From Analysis to Action 2010: During the debate on the Scheltema Commission's report, the Lower House asked DNB to draw lessons from the credit crisis and its consequences for the financial sector, focusing on the cultural aspects of supervision. DNB has taken a critical look at its own work practices, decision making and corporate culture. The key issue in its analysis was how supervision can become more effective and especially more vigorous.

that DNB and the AFM should be afforded adequate legal protection for their official actions, except in cases of gross negligence or wilful misconduct.<sup>1062</sup> The concrete steps that were suggested by the two studies and taken by DNB to strengthen prudential supervision under the Twin Peaks supervisory framework included the establishment in DNB of an enforcement department for corrective actions and sanctions, thereby reducing reliance on moral suasion to ensure compliance.<sup>1063</sup> The VITA-project, as major project aimed at changing the regulatory culture, was introduced inter alia to encourage supervisors to consistently make more use of formal powers at their disposal and to bring supervisory tools more in line with supervisory best practice.<sup>1064</sup> Another initiative was that the department for macroprudential supervision in DNB was expanded to further improve the monitoring of macroprudential risks. The existing expertise relating to (illiquid) investments and innovative financial products were enhanced and specific knowledge was improved in the fields of risk, fair value reporting, governance and strategy.<sup>1065</sup> Risk analysis was strengthened and the risk analysis tool (FIRM)<sup>1066</sup> was improved to provide more scope for linking macroprudential risks with the assessment of individual institutions.<sup>1067</sup>

Other improvements included that cooperation and knowledge sharing between different departments in DNB were promoted through setting up of knowledge

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<sup>1062</sup> From Analysis to Action 2010 7.

<sup>1063</sup> From Analysis to Action 2010 9; Interview Van Hengel 2018: The main changes as a result of From Analysis to Action were more focus on qualitative aspects including strategy, culture, behavior and business models; more checks and balances with the creation of a separate intervention department and a department for quality control; and more comprehensive and intrusive supervision.

<sup>1064</sup> IMF 11/208 10: In this project bank supervisors had to start using the legal sanctions and powers that the Wft allows DNB for micro-supervision. Supervisors had to learn not only to rely on morally influencing financial institutions since that option became more and more ineffective.

<sup>1065</sup> From Analysis to Action 2010 18: The first action that DNB took was the in-house development of expertise among employees. This quality enhancement also meant that the recruitment policy had to be more focused on specific experience and knowledge. Where necessary, more professional knowledge had been insourced for specific projects. In addition, DNB assessed how the organisational structure could promote a more powerful role for the expertise centres and specialised policy departments in the supervisory process. The existing knowledge networks had been expanded to promote knowledge acquisition and sharing.

<sup>1066</sup> Financial Institutions Risk Analysis Method – FIRM- Manual chapter 1 (November 2005) <http://www.toezicht.dnb.nl/en/binaries/51-212099.pdf> and Firm Manual chapter 2 (November 2005) <http://www.toezicht.dnb.nl/en/binaries/51-212103.pdf> (accessed 16 January 2018). See further Schmulow 2017 no. 2 400 who indicates that the Australian approach with regards to the supervisory strategy of PAIRS and SOARS was adopted by DNB.

<sup>1067</sup> From Analysis to Action 2010 18. IMF 11/208 13.

networks. Group supervision for banks and insurance companies with large cross-border operations abroad was also intensified through establishing closer ties with host country supervisors. In this regard a day-to-day communication tool has been set up to enable fast and safe sharing of supervisory information between supervisors.<sup>1068</sup> The Netherlands also supported the move towards a consistent EU-wide supervisory network (as discussed in more detail in par 4.6 below).The quality of financial supervision in the Netherlands was further strengthened through peer reviews and random auditing.<sup>1069</sup>

With regard to the recommendations by the De Wit Commission, mentioned above, regarding the establishment of an additional macroprudential body,<sup>1070</sup> the Ministry of Finance accordingly announced the establishment of the Financial Stability Committee (hereinafter FSC) in November 2012 .<sup>1071</sup> The purpose of the FSC is to focus on the stability of the Dutch Financial system and macro-economic developments relevant thereto. As per Article 3 of the Ministerial Decree the FSC comprises of members from DNB, AFM and the Ministry of Finance. The members representing DNB on the FSC are the president of DNB (as chairperson of the FSC), the Executive Director for Supervision and the Executive Director for Monetary Affairs and Financial Stability; members for the AFM are the Chairman of the Executive Board and the Head of Strategy, Policy and International Affairs; and for the Ministry of Finance it is the Treasurer General and the Director of Financial Markets.<sup>1072</sup>

In terms of Article 4 of the Ministerial Decree that established the FSC the activities (functions) of the FSC are as follows:

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<sup>1068</sup> DNB Supervisory strategy 2010-2014 21: Open Book Supervision is an example of another external communication tool that operates as an internet knowledge window that is intensively used by supervised institutions. Yet another example is DNB Supervisory Themes which are published annually.

<sup>1069</sup> From Analysis to Action 2010 19.

<sup>1070</sup> See also discussion of De Wit Report above in paragraph 4.4

<sup>1071</sup> Decree establishing the Financial Stability Committee, Order of the Minister of Finance of 2 November 2012 establishing the Financial Stability Committee reference: FM 2012/1193 M. See also the 2017 IMF Report discussed in par 4.7 below.

<sup>1072</sup> FSB Peer Review 2014 14. See also DNB Annual Report (2014) [https://www.dnb.nl/en/binaries/jv2014%20uk\\_tcm47-319635.pdf](https://www.dnb.nl/en/binaries/jv2014%20uk_tcm47-319635.pdf) (accessed 9 December 2016), hereinafter DNB Annual Report 2014, at 100.

- “1. Information and analysis concerning the stability of the financial system shall be exchanged in the Committee in order to identify potential risks to the stability of the financial system.
2. The Committee shall discuss issues and ways of mitigating potential risks to the stability of the financial system as well as ways of strengthening the instruments available to DNB, AFM and the Minister in order to mitigate such risks.
3. The Committee may identify risks and make recommendations about them. These recommendations shall be made public, unless their disclosure might jeopardize financial stability.
4. The Committee shall not engage in the exercise of statutory powers of DNB, AFM or the Minister.
5. The members shall agree in the Committee on how the Netherlands can respond to alerts and recommendations of the European Systemic Risk Board.
6. The Minister shall pass on alerts and recommendations to the House of Representatives of the States General.”

The FSC thus deals with the main risks to financial stability in the Netherlands and advises the Minister of Finance about macroprudential tools, like LTV and mortgage interest rates. It does not have the power to make decisions on any policies, but provides a coordinated forum where various views can be discussed and unified and where priorities can be established regarding financial stability in the Netherlands.<sup>1073</sup>

The FSC also coordinates the reactions of the various regulatory bodies in the Netherlands on warnings and recommendations from the European Systemic Risk Board (ESRB) (as discussed in more detail in paragraph 4.6 below).<sup>1074</sup> While the various members of the FSC discuss aspects of risk assessment, DNB uses those meetings to consult with them and exchange information. In the end DNB does most of the risk assessment work as it has the financial stability mandate as well as

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<sup>1073</sup> FSB Peer Review 2014 14.

<sup>1074</sup> European Systemic Risk Board webpage (undated) <https://www.esrb.europa.eu/about/html/index.en.html> (accessed 18 November 2017): The ESRB was established in 2010 to oversee the financial system of the EU and prevent and mitigate systemic risk. In pursuit of its macroprudential mandate, the ESRB monitors and assesses systemic risks and, where appropriate, issues warnings and recommendations. See also Masciandaro D “Monetary policy and banking supervision: still at arm’s length? A comparative analysis” 2012 (9) *The European Journal of Comparative Economics* 349 at 350.

substantial analytical capacity. The macroprudential policy decisions in DNB are subsequently taken by DNB's Board. The FSC does however give support to the Board and coordinates these decisions by preparing a breakdown of the most important financial stability risks that exist and converting them into mitigating actions in the Overview of Financial Stability Report of DNB.<sup>1075</sup> Furthermore the DNB Supervisory Council is directly responsible for most microprudential matters.<sup>1076</sup>

Another important development in the context of financial stability in the Netherlands after the GFC was the introduction of the *Wet bijzondere maatregelen ondernemingen* (Act on Special Measures for Financial Corporations Act) (also known as the Intervention Act).<sup>1077</sup> This Act was accepted on 13 June 2012 but it came into force retroactively as of 20 January 2012. The Intervention Act authorizes DNB or the Minister of Finance to intervene when a bank or an insurance company that operates in the Netherlands is failing<sup>1078</sup> and empowers DNB to draft a "Transfer Plan" for the failing bank or an insurance company in order to preserve the critical functions of the failing institution and to prevent disruption to the financial system.<sup>1079</sup> The Intervention Act further authorizes the Minister of Finance to take preventative action without delay when the financial stability of the Netherlands is in "emergency crisis" for example

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<sup>1075</sup> Financial Stability Reviews has been issued by DNB since 2004.

<sup>1076</sup> FSB Peer Review 2014: The IMF pointed out that since the Netherlands is a Member State of the European Union, initiatives at the European Union plays an important part in the Dutch macroprudential policy framework.

<sup>1077</sup> Act on Special Measures for Financial Corporations STB 2012 241: Amendment of the Financial Supervision Act (*Wet op het financieel toezicht*) and the Bankruptcy Act (*Faillissementswet*) *Wet van 30 September 1893* as well as a number of other Acts in connection with the introduction of supplementary powers to intervene in financial corporations in difficulties. The Intervention Act chiefly amends the Wft and the Dutch Bankruptcy Act.

<sup>1078</sup> See section 3:159(c) of the Intervention Act.

<sup>1079</sup> Netherlands: Dutch Intervention Act in force. Article by Ruud Hermans from De Brauw Blackstone Westbroek NV. (25 June 2012) [http://www.mondaq.com/x/183050/Insolvency+Bankruptcy/Financial+Markets+Newsletter+Dutch+Intervention+Act+In+Force\\_\\_](http://www.mondaq.com/x/183050/Insolvency+Bankruptcy/Financial+Markets+Newsletter+Dutch+Intervention+Act+In+Force__) (accessed 24 August 2016), hereinafter Hermans 2012 indicates that a bank or insurance company is regarded as failing when there is evidence that the bank's own funds or its liquidity is dangerously low or an insurance company's funds or solvency are too low. The transfer plan for an insurance company will be drafted when a specific technical situation exists and also if it is reasonable to expect that this development will not be reversed sufficiently or soon enough. DNB, when drafting the Transfer Plan, looks for a third party purchaser for the failing bank or insurance company. If a purchaser cannot be found, the assets, liabilities, or shares of the bank or insurance company in distress is transferred to a bridge institution (*overbruggingsinstelling*). As soon as a private purchaser is found, the assets, liabilities, or shares of the bank or insurance company in distress are then transferred from the bridge institution to the private purchaser. See sections 3:159 a, 3:159 b and 3:159 e to 3:159 z and 3:159 aa to 3:159 ai of the Intervention Act for detail of what a "Transfer Plan" would entail.

when a Dutch financial establishment like a bank, insurance company or investment company encounters serious trouble. The Minister of Finance may then act against such bank or company by expropriating its assets or shares. He must however first discuss the situation with DNB and also needs approval from the Dutch Prime Minister for such drastic actions.<sup>1080</sup>

On 1 July 2012 DNB's prudential supervision mandate was extended by adding section 1:24(3) to the Wft.<sup>1081</sup> This section determined that where a regulation as referred to in Article 288 of the Treaty on the functioning of the European Union<sup>1082</sup> relates to the soundness of financial enterprises, the stability of the financial sector or to financial enterprises, DNB may be entrusted by Order in Council with the implementation and enforcement of rules set by or pursuant to that regulation. Section 1:24(4) was added to the Wft on 1 January 2013<sup>1083</sup> and it determined that by way of a ministerial regulation, further rules could be laid down for the implementation of binding EU legal acts with regard to the manner in which DNB exercises the task referred to in 1:24(2).

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<sup>1080</sup> Hermans 2012; Interview Rank 2016: Prof. Rank mentioned that after the GFC there were numerous legislative initiatives to remedy the flaws in the financial supervision in the Netherlands. All these initiatives were overhauled by European initiatives. For instance the Dutch Minister of Finance expropriated SNS Real (which was the financial conglomerate of SNS Bank and Real Insurance) on 1 February 2013 in terms of the Intervention Act because they were on the verge of collapsing. Since only the Netherlands had an Intervention Act, business people from other countries were concerned that if they entered into a repo agreement with a Dutch company and it becomes subjected to intervention measures by the Dutch government, whether they would be able to exercise their rights arising from the agreement.

<sup>1081</sup> This amendment was done in terms of the *Wijzigingswet financiële markten 2012* (Financial markets amendment law),

<sup>1082</sup> Section 288 of The Treaty on the Functioning of the European Union states that to exercise the Union's competences, the institutions must adopt regulations, directives, decisions, recommendations and opinions. A regulation has general application and it is binding in its entirety and directly applicable in all Member States. A directive is also binding, as to the result to be achieved, upon each Member State to which it is addressed, but leaves to the national authorities the choice of form and methods. Furthermore, a decision is binding in its entirety. A decision which specifies those to whom it is addressed is however binding only on them. Recommendations and opinions have no binding force.

<sup>1083</sup> This amendment was done in terms of the *Wet van 13 December 2012 tot wijziging van die Wet op het financieel toezicht en het Burgerlijk Wetboek ter implementatie van de richtlijn solvabiliteit II en invoering van een daarop gebaseerd regime voor bepaalde kleinere verzekeraars (Implementatiewet richtlijn solvabiliteit II)* (Act of 13 December 2012 amending the Act on Financial Supervision and the Civil Code to implement the Solvency Directive II and Introduction of a regime for certain smaller insurers) (Implementation Act for the solvency II Directive),

As indicated in Chapter One, the 2008 GFC was a global game-changer that revealed large gaps in financial regulation and emphasized the pursuit of financial stability as apex objective. This realization also dawned on the Netherlands where the initial regulatory energy in the context of the introduction on the Dutch Twin Peaks model appeared to be more focused on the structural division between DNB and AFM as prudential and market conduct regulators respectively and less specifically on DNB's role in the maintenance of financial stability. In the latter regard one of the main lessons that the Netherlands took from the GFC was to augment their (then) young Twin Peaks model by specifically addressing the aspects of DNB's financial stability mandate. Although it took some time to reach this point, initiatives by the European Systemic Risk Board (ESRB) in the context of macroprudential supervision in the EU, as explained in more detail in paragraph 4.6 below, led to legislative changes being made regarding the financial stability mandates of national central banks, and section 4 of the *Bankwet 1998*<sup>1084</sup> was eventually amended by section II of *Wijzigingswet financiële markten 2014*<sup>1085</sup> (Financial markets amendment Act) as of 1 January 2014, to provide that DNB has the task:

“(a) of supervising financial institutions on the basis of dedicated legislation;  
(b) to promote the efficient working of the payment system;  
(c) *to promote the stability of the financial system*;<sup>1086</sup>  
(d) to gather statistical data and compile statistics in accordance with dedicated legislation.”

Thus the 2014 amendment of the *Bankwet* reflects the roles of DNB in the Dutch Twin Peaks model more clearly and for the first time introduces an express financial stability mandate for DNB in its enabling legislation in alignment with the heavy regulatory focus post GFC on promotion and maintenance of financial stability as emerging core paradigm in financial regulation. It should however be noted that the amended section 4 gives DNB a mandate to “promote” financial stability and does not mention that it must also “maintain” financial stability. However it is submitted that section 4 should be interpreted broadly so that this mandate to “promote” financial stability also by

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<sup>1084</sup> Busch et al 2010. Compare with section 4 of the *Bankwet* before it was amended in 2014 as at 9 April 1998 in 4.1 above.

<sup>1085</sup> STB 2013 487.

<sup>1086</sup> Author's emphasis.

necessary implication includes the maintenance of financial stability. Van Hengel thus remarks that although macroprudential supervision had always been an implicit part of the work of DNB, it has only been explicitly recognised in recent years with the creation of the Financial Stability Department within DNB, the explicit financial stability mandate that was eventually captured in the Banks Act as well with the creation of the Financial Stability Committee.<sup>1087</sup>

#### **4.6 Developments in Europe that significantly impacted on the Dutch Twin Peaks model and the role of DNB**

It has to be appreciated that the developments regarding the role of DNB with regard to the promotion and maintenance of financial stability in the Netherlands did not take place in isolation given the fact that the Netherlands is an EU Member State. The position of the Netherlands as an EU Member State thus informs the broader context in which the Dutch Twin Peaks model must be considered specifically also with regard to DNB's financial stability mandate. On a supra-national level the EU has responded holistically to the challenges that emerged shortly before the GFC as well as challenges revealed during the GFC and accordingly one can only comprehensively gauge the scope and nature of regulatory and supervisory development in the Netherlands, and the developments regarding the role of DNB in the context of promoting and maintaining financial stability, against the backdrop of the main regulatory developments on an EU level immediately prior to and also particularly in response to, the GFC.

As already indicated in paragraph 4.1 above the establishment of the ECB and the assimilation of DNB into the European System of Central Banks (ESCB) added a supranational dimension to the institutional framework for financial regulation in the EU. Various other initiatives relating to financial regulation were also introduced on an EU level by means of Directives. In the Netherlands many of the rules contained in the Wft were the result of implementing these European Directives. An important

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<sup>1087</sup> As pointed out in Interview Van Hengel 2018.

European influence was the introduction of the Financial Services Action Plan that was communicated by the European Commission in 1999 already.<sup>1088</sup> A main strategic objective of the Financial Services Action Plan was to establish state-of-the-art prudential rules and supervision by introducing a large number of European Directives and Regulations with respect to the financial markets in a relatively short timeframe.<sup>1089</sup>

With regards to cooperation and collaboration on EU-level prior to the implementation of the Dutch Twin Peaks model, the banking supervisors and the central banks of Member States entered into a Memorandum of Understanding (MOU) in 2003 entitled “Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations”. The aim of the cooperation envisaged in the MOU was to pursue the common objective of ensuring the stability of the EU financial system. Accordingly the MOU, which was not a public document, aimed to enhance practical arrangements for handling crisis on EU-level. The MOU dealt specifically with the identification of the authorities responsible for crisis management, the required flows of information between these authorities and practical considerations for sharing information at cross border level.<sup>1090</sup>

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<sup>1088</sup> ‘Financial Services: Implementing the framework for financial markets: Action Plan’, Communication of the Commission (11 May 1999) [http://ec.europa.eu/internal\\_market/finances/docs/actionplan/index/action\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/actionplan/index/action_en.pdf) (accessed 18 December 2016).

<sup>1089</sup> Niewenhuijzen 2010 26. In Niewenhuijzen 2010 26 Silverentand remarks that since the Financial Services Action Plan proposed to introduce a large number of European Directives and Regulations in a relatively short timeframe, the Lamfalussy process was designed to improve the quality and effectiveness of EU financial services legislation and accelerate the legislative process. The Lamfalussy process was developed in March 2001 and named after the chair of the EU advisory committee that created it, Alexandre Lamfalussy. The Lamfalussy process consists of four levels, namely level one community directives and regulations; level 2 technical implementing measures; level 3 measures that have the objective to improve the common and uniform implementation and application of level 1 and 2 acts in the Member States; and level 4 that concerns enforcement, whereby the EC monitors the compliance of Member States with EU legislation and may take legal action against Member States if they are suspected of breaching Community Law.

<sup>1090</sup> ECB Press release: Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations (10 March 2003) [https://www.ecb.europa.eu/press/pr/date/2003/html/pr030310\\_3.en.html](https://www.ecb.europa.eu/press/pr/date/2003/html/pr030310_3.en.html) (accessed 20 December 2017).

On 18 May 2005 a further MOU, the “Memorandum of Understanding between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis Situations”, was entered into. This MOU was also not a public document - however in a press release on 18 May 2005 the ECB indicated that this MOU aims at supporting and promoting cooperation in crisis situations between the banking supervisors, central banks and finance ministries. The MOU on Financial Crisis situations consisted of a set of principles and procedures for sharing of information, views and assessments in order to facilitate the pursuance by the participating entities of their respective policy functions and to preserve the overall stability of individual Member States and also of the EU as a whole. The MOU also contained arrangements for the development, at national and cross-border level, of contingency plans for crisis management along with stress testing and simulation exercises.<sup>1091</sup>

The banking crisis in the EU during the GFC revealed serious flaws in the pre-GFC approach to EU banking regulation and supervision.<sup>1092</sup> The EU Commission’s expert committee led by Jacques de Larosiere considered these issues in a Report published in February 2009 that called for reform of European financial regulation and supervision by creating three new European supervisory agencies to establish a harmonized European rulebook for financial regulation while leaving Member State authorities with the responsibility for applying and enforcing the rulebook in day-to-day domestic supervision.<sup>1093</sup> Subsequently the European System of Financial Supervisors (ESFS) was implemented on 1 January 2011. In terms of this model four

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<sup>1091</sup> ECB Press release: Memorandum of Understanding on co-operation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis situations (18 May 2005) [https://www.ecb.europa.eu/press/pr/date/2005/html/pr050518\\_1.en.html](https://www.ecb.europa.eu/press/pr/date/2005/html/pr050518_1.en.html) (accessed 20 December 2017).

<sup>1092</sup> See further European Commission - Economic and Financial Affairs “Economic crisis in Europe: Causes, consequences and responses” (2009) [http://ec.europa.eu/economy\\_finance/publications/pages/publication15887\\_en.pdf](http://ec.europa.eu/economy_finance/publications/pages/publication15887_en.pdf) (accessed 23 January 2018).

<sup>1093</sup> Alexander 2015 161. See further High Level-Group on Financial Supervision in the EU (chaired by Jacques de Larosiere) Report Brussels: EU Commission (25 February 2009) [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf) (accessed 18 December 2017) [http://www.ec.europa.eu/finance/general-policy/docs/de\\_larosiere\\_report\\_en.pdf](http://www.ec.europa.eu/finance/general-policy/docs/de_larosiere_report_en.pdf) (accessed 18 December 2017).

new supervisors<sup>1094</sup> were formed on supranational level: the European Systemic Risk Board (ESRB) was established as the supervisor responsible for macroprudential supervision and the three other supervisors referred to as the European Supervisory Authorities (ESAs) were given the responsibility for microprudential supervision.<sup>1095</sup> The ESRB is thus responsible for the detection and prevention of systemic risks in the European financial system as a whole. Microprudential supervision on the European level is divided between the three ESAs on a sectoral supervision basis: supervision on the banking sector is done by the European Banking Authority (EBA), supervision on the pensions and insurance sector is done by the European Insurance and Occupational Pensions Authority (EIOPA) and supervision on the securities market and securities services is done by the European Securities and Markets Authority (ESMA). This new system of sectoral European supervision combines prudential *and* conduct supervision. Thus Joosen points out the sectoral nature of supervision on EU-level and remarks aptly that there is nothing to be seen of a move to a functional regulatory model (like Twin Peaks) on the European level.<sup>1096</sup>

In the context of maintenance of financial stability on EU-level specific note should be taken of the role of the ESRB. The ESRB has the power to issue warnings and recommendations, which are subject to a “comply-or-explain” mechanism<sup>1097</sup> that serves to address the accountability of the ESRB for its decisions and actions. It also

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<sup>1094</sup> Interview Van Hengel 2018: Marco Van Hengel from DNB explains that the ESAs are not “actual” supervisors in the sense that they interacted and oversaw financial institutions but rather that they issue guidelines and standards (Single Rule Book) for purposes of coordinated supervision on EU level.

<sup>1095</sup> Regulation 1092/2010 on EU Macroprudential oversight of the financial system and establishing a European Systemic Risk Board [2010] OJ L331/1; Regulation 1093/2010 establishing a European Supervisory Authority (EUROPEAN Banking Authority) [2010] OJ L331/12; Regulation 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pension Authority) [2010] OJ L331/48; Regulation 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) [2010] OJ L331/84.

<sup>1096</sup> Joosen E.P.M. Rogier Pieter Roos Van der Heijden Instituut and Vereniging voor Financieel Recht *Vijf Jaar Wet op het Financieel Toezicht: Preadvies Vereniging voor Financieel Recht 2013* (2013) 36, hereinafter Joosen et al 2013 and at 39 remark that after an evaluation of the functioning of the ESA's by the European Commission on 2 January 2014, it was clear that the European Commission was not making any plans to change from the current sectoral model to the functional supervising model.

<sup>1097</sup> European Commission - Green Paper - The EU corporate governance framework (5 April 2011) [http://ec.europa.eu/internal\\_market/company/docs/modern/com2011-164\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf) (accessed 22 June 2017) 18: Under the 'comply or explain' approach, a company which chooses to depart from a corporate governance code recommendation must give detailed, specific and concrete reasons for the departure. Its main advantage is its flexibility; it allows companies to adapt their corporate governance practices to their specific situation (taking into consideration their size, shareholding structure, and sectoral specificities). It is also thought to make companies more responsible by encouraging them to consider whether their corporate governance practices are appropriate and by giving them a target to meet.

has consultative powers in a broad set of areas. However the ESRB does not have the power to use macroprudential instruments directly as such responsibility lies at the national level but is subject to EU constraints.<sup>1098</sup> Thus the ESRB issues the necessary warnings and the national authorities must then take steps to deal with the risks or threats identified by the ESRB. One can indeed appreciate the necessity of having such a body on a supranational level that surveys risk on an EU wide scale and alerts Member States to such risk given the interconnectedness between the various financial institutions in the EU. Whereas the Netherlands may be in a position via DNB to quickly detect risks to financial stability emanating from financial institutions within the Netherlands the existence of the ESRB that views risk in the wider EU context serves to alert DNB to risks from outside the Netherlands that may spill over as a result of contagion and impact negatively on financial stability in the Netherlands. It is further submitted that although DNB has collaborative arrangements with supervisory agencies in other EU Member States the existence of a body such as the ESRB that has seats for all the Member States is able to provide comprehensive EU-wide systemic risk surveillance on a scale that DNB itself would not be able to do.

In pursuing the objective of financial stability on an EU level inter alia through strengthening the frameworks for macroprudential supervision in the individual Member States the ESRB subsequently issued “Guiding principles for core elements of national macroprudential mandates” in December 2011.<sup>1099</sup> These principles sought to balance the need for consistency in national approaches to macroprudential supervision across the EU with the flexibility to accommodate national specificities. It required that Member States should set out clearly that the objective of macroprudential policy was to safeguard systemic stability and to ensure a sustainable contribution of the financial sector to economic growth. Member States were asked to designate, in national legislation, an authority with responsibility for the conduct of macroprudential policy, with the central bank playing a leading role. It was required

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<sup>1098</sup> FSB Peer Review 2014 12.

<sup>1099</sup> European Systemic Risk Board “Recommendation of the European Systemic Risk Board on the macroprudential mandate of national authorities” ESRB 2011/3 known as “Guiding principles for core elements of national macroprudential mandates” (22 December 2011) [http://www.esrb.europa.eu/pub/pdf/ESRB\\_Recommendation\\_on\\_National\\_Macroprudential\\_Mandates.pdf?87d545ebc9fe76b76b6c545b6bad218c](http://www.esrb.europa.eu/pub/pdf/ESRB_Recommendation_on_National_Macroprudential_Mandates.pdf?87d545ebc9fe76b76b6c545b6bad218c) (accessed 22 June 2017).

that the aforesaid authority should be entrusted with the job of identifying and monitoring risks, and be given powers to gather information (including microprudential and securities market supervisors, and developments from outside the regulatory perimeter). It should further be tasked with acting to mitigate risks and should explain publicly its decision making, including its broader macroprudential strategies. While the national authority should be accountable to national parliament, the ESRB recommendation required that it should be operationally independent from political bodies. The ESRB issued a follow-up recommendation to national macroprudential authorities in April 2013,<sup>1100</sup> requiring them by the end of 2014 to define their intermediate objectives and to assess the macroprudential instruments available to them, and by the end of 2015 to develop a policy strategy.<sup>1101</sup>

As remarked in paragraph 4.5 above this initiative by the ESRB appears to have given momentum to progress in DNB's execution of its financial stability mandate and resulted in the abovementioned 2014 reform to section 4 of the Banks Act to include financial stability as an express mandate. It also provided the broader framework for the execution of such mandate which essentially encompasses the responsibility of DNB to maintain financial stability in the Netherlands and also the responsibility to contribute to the maintenance of financial stability on the wider EU level. Thus it appears that DNB actually has a double-layered financial stability mandate as it is in the first place responsible for maintenance of financial stability on domestic level and by doing so also has a responsibility that it collectively shares with other EU Member

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<sup>1100</sup> In reaction to the ESRB recommendation, DNB issued an official statement in June 2013: DNBulletin "New macroprudential instruments for DNB" (25 June 2013) <https://www.dnb.nl/en/news/news-and-archive/dnbulletin-2013/dnb293046.jsp> (accessed 11 February 2018): Based on European legislation, DNB will have several new macroprudential instruments for banking supervision at its disposal from the start of 2014 that will explicitly give substance to its stability task. In the Netherlands, DNB, the Ministry of Finance and the AFM are involved in the execution of macroprudential policy.

<sup>1101</sup> FSB Peer Review 2014 12. "Recommendation of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy" (ESRB/2013/1) (4 April 2013) European Systemic Risk Board [https://www.esrb.europa.eu/pub/pdf/recommendations/2013/ESRB\\_2013\\_1.en.pdf](https://www.esrb.europa.eu/pub/pdf/recommendations/2013/ESRB_2013_1.en.pdf) (accessed 18 January 2018). De Nederlandsche Bank "Deployment of macro-prudential instruments" (undated) <https://www.dnb.nl/en/about-dnb/duties/financial-stability/macroprudentiele-instrumenten/> (accessed 10 February 2018): Since 1 January 2014, DNB's aim to strengthen financial stability has been laid down in the Banking Act as one of their statutory tasks, which means that they have more options to promote financial stability in the Netherlands. Since then DNB had the authority to deploy a range of macroprudential instruments that are set out with their current status, on this webpage.

States to contribute to financial stability in the EU as a whole. The current reality of the Dutch Twin Peaks model is thus that it is a functional model that operates on a national/domestic level within the broader sectoral framework created on supranational level in the EU hence the role of DNB as systemic and prudential regulator cannot be viewed in isolation from the broader EU context.

Given that DNB is responsible for both financial stability as well as prudential regulation in the Netherlands - and in view of the symbiotic interaction between financial stability and prudential regulation<sup>1102</sup> - it also needs to be considered how EU developments in respect of prudential regulation may have impacted the role of DNB as prudential supervisor which role is critical in supporting its role with regard to financial stability. In this context the establishment of the European Banking Union - largely as a reaction to the eurozone banking and sovereign debt crisis that followed soon after the aforesaid ESAs were established - is of pivotal significance.

As remarked by Alexander, the formation of the European Banking Union represents one of the most important institutional and legal transformations in the EU.<sup>1103</sup> The events leading to the establishment of the European Banking Union began in 2012, when the European Council of Ministers issued a Decision to create a euro banking union designed to build a more effective banking supervision regime in the Euro area and across the EU by empowering the ECB to be the banking supervisor for the Euro area and other participating Member States.<sup>1104</sup> The Banking Union proposal

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<sup>1102</sup> See par 1.4.3 in Chapter One.

<sup>1103</sup> Alexander 2015 154. For a detailed overview of the historical evolution of the European Banking Union see Alexander 2015 154-155, 161-162. According to Alexander the European Banking Union represents an “unprecedented transfer of sovereignty from participating Member States to an EU institution”.

<sup>1104</sup> European Council: Conclusions (29 June 2012) EUCO 76/12 at 1. Alexander 2015 at 159 provides the following background to the creation of the European banking union: In June 2012, as eurozone sovereign bond markets were experiencing extreme volatility, EU policy makers and investors feared that a collapse of the Spanish banking sector was imminent and would cause contagion throughout the eurozone and seriously threaten the viability of the single currency area itself. During this time Spanish authorities were conducting negotiations with the EU Commission regarding the terms of a eurozone bailout of the Spanish banking system. Parallel with these negotiations, the President of the European Council, Herman Von Rompuy, issued a paper calling for a European banking union that had as its main objective the severing of the link between the banking crisis and the sovereign debt crisis. The Van Rompuy paper proposed the three pillars, as discussed in more detail below, on which the banking union was to be founded. See further Von Rompuy H “Towards a Genuine Economic and Monetary

consisted of three pillars: a unified banking supervisory regime (single supervisory mechanism), a bank recovery and resolution framework (single resolution mechanism) and a bank deposit guarantee scheme. These three pillars were considered necessary to stabilize the eurozone financial system by providing for the possibility that the European Stability Mechanism (ESM)<sup>1105</sup> could recapitalize ailing euro area banks on condition that these banks were subject to strict supervision and also provided for an orderly resolution of a bank in financial distress.<sup>1106</sup> In addition, the ESM provides a fiscal backstop for Member States in the European Banking Union by making available funds for the direct recapitalisation of banks as long as certain pre-conditions are met.<sup>1107</sup>

As pointed out above, as a result of operating as prudential supervisor within the Dutch Twin Peaks model, DNB has a system-wide prudential remit on national level, covering various financial institutions and not only banks. However on EU-level a sectoral approach is followed and the European Banking Union thus sets measures on supranational level insofar as the prudential regulation of banks are concerned - which measures must be observed by DNB as a national central bank within the European System of Central Banks. With the introduction of the Single Supervisory Mechanism (SSM) for bank supervision, Dutch banks are no longer primarily supervised by DNB, but by the ECB. Since 4 November 2014 the SSM is applicable to all, more or less 4900, banks that are operating in EU Member States.<sup>1108</sup> In terms of the SSM, a bank

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Union” Report EUCO 120/12 Brussels (26 June 2012) [http://www.ec.europa.eu/economy\\_finance/focuson/crisis/documents/131201\\_en\\_pdf](http://www.ec.europa.eu/economy_finance/focuson/crisis/documents/131201_en_pdf) (accessed 19 December 2017).

<sup>1105</sup> Treaty Establishing the European Stability Mechanism, T/ESM 2012/en [2011] OJ L91/1.

<sup>1106</sup> Alexander 2015 155.

<sup>1107</sup> Alexander 2015 157 and also: The Eurogroup (an informal body in which ministers from the euro area Member States discuss matters relating to their countries’ common responsibilities related to the euro) agreed in June 2013 on the main elements of the ESM’s bank recapitalisation instrument. On 10 June 2014 the President of the Eurogroup made a Statement “ESM direct recapitalisation instrument” [https://www.eerstekamer.nl/overig/20140613/esm\\_direct\\_recapitalisation/document](https://www.eerstekamer.nl/overig/20140613/esm_direct_recapitalisation/document) (accessed 24 January 2018): “Euro area Member States have today reached a political understanding on the operational framework of the ESM direct recapitalisation instrument. The instrument may be activated in case a bank fails to attract sufficient capital from private sources and if the ESM Member concerned is unable to recapitalise it, including through the instrument of indirect recapitalisation of the ESM.”

<sup>1108</sup> Bierman et al 2015 V and 18. On 12 June 2015 section 1:75 of the Wft was amended to also authorise the ECB (together with DNB and AFM) (see paragraph 4.3 above) to issue an “instruction” (directive) to a non-compliant institution that is supervised by the DNB or AFM or ECB, requiring it to adhere to particular conduct within a reasonable time specified by DNB or the AFM or the ECB in the instruction order. Furthermore section 1:77 was also amended to add the ECB to it. Section 1:93(b) and (c) and (d) was added with regards to procedure regarding confidential information that could be revealed in certain circumstances and that the AFM could also give the ECB confidential information in

is classified as a “significant” bank if the total value of the assets of the bank is more than thirty billion euros. In the Netherlands, the following groups were classified as significant banks: ABN AMRO Group N.V.; ING Bank N.V.; Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A.; SNS Reaal N.V.; N.V. Bank Nederlandse Gemeenten; Nederlandse Waterschapsbank N.V. and RFS Holdings N.V. The ECB is thus the direct prudential supervisor of these significant banks whilst the less significant banks fall under the direct supervision of DNB and the indirect supervision of the ECB. The ECB however has the power to decide at any moment to include some less significant banks under its supervision if it perceives that such a less significant bank may pose a threat to financial stability in some way or another.<sup>1109</sup>

Alexander points out that under the initial Commission proposal in September 2012 the ECB was given broad powers of prudential supervision - it could for instance monitor capital adequacy, liquidity buffers and leverage limits and approve bank recovery plans and transfers of assets between affiliates within banking groups or mixed financial conglomerates. However Council amendments in December 2012 compromised the use of macroprudential supervisory powers to national competent authorities. Subsequently however the European Parliament was of the view that it was inadequate that the ECB only had microprudential powers and indicated that it also needed to be given the use of “limited” macroprudential supervisory tools and

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certain instances. The ECB was further empowered to, like DNB previously, issue an instruction to a financial institution in terms of section 1:75(2) where it detected signs of a development that “might jeopardize the equity capital, solvency or liquidity” of that institution in cases where it is authorised to exercise supervision.

<sup>1109</sup> Heidebrecht S “Trying not to be caught in the Act: Explaining European Central Bank’s bounded role in shaping the European Banking Union” 2017 *Journal of Contemporary European Research* 1128. The SSM, acting through the ECB, only has jurisdiction to apply and enforce EU prudential banking law and regulatory requirements against “credit institutions” under EU law. Alexander 2015 164 explains that for instance, financial institutions that do not accept retail deposits are not defined as credit institutions under EU law and are not subject to the SSM. Similarly a credit institution subject to SSM jurisdiction for carrying on activities governed by EU prudential banking law is not subject to SSM jurisdiction for activities not subject to such law, such as brokering and dealing in securities or the marketing and sale of retail financial products. For such non-prudential activities the bank would be subject to other EU banking and financial laws such as conduct of business rules that are the sole responsibility of national competent authorities to monitor and enforce. The ECB acts through an executive board, the Single Supervisory Board (SSB) that is responsible for supervising the eurozone largest cross-border banks and the top three banks by size in each participating Member State. The SSB is also responsible for overseeing the supervisory actions of participating national competent authorities who directly supervise small and medium-sized credit institutions in the SSM regime. The ECB/SSB has ultimate discretion to decide when to intervene and take over direct oversight of small and medium-sized institutions that are ordinarily subject to direct supervisory control by national competent authorities.

thus final amendments to the SSM regulations were effected to enable the use of some macroprudential tools also by the ECB.<sup>1110</sup> The ECB's macroprudential tasks are set forth in article 5 of SSM Regulation of 15 October 2013 entitled "Macroprudential tasks and tools",<sup>1111</sup> which include the discretion to impose stricter prudential requirements, including higher capital buffers, on individual banks based on macroprudential factors in the country where the bank is based. Although the exercise of these macroprudential tools rests primarily with the national competent authorities, the ECB may intervene and utilise these tools "if deemed necessary", and in adopting a particular measure the ECB is then required to take the specific circumstances of the Member State's financial and economic situation into account as well as to "duly consider" any objection of a eurozone national competent authority that seeks to address a macroprudential risk on its own.<sup>1112</sup>

Finally mention also has to be made specifically of the fact that with regard to macroprudential instruments the EU Capital Requirements Directive IV<sup>1113</sup> and Capital Requirements Regulation<sup>1114</sup> (CRD IV/CRR) came into force in January 2014. These new rules provide EU Member States with a common legal framework and a set of macroprudential instruments (most of which were set out in Basel III) to mitigate systemic risk in the banking sector. The measures aim to improve resilience by requiring more and higher quality bank capital.<sup>1115</sup> The key elements of the CRD IV/CRR are: a higher quality capital base; higher minimum capital requirements and additional buffers, including a systemic risk buffer and a countercyclical buffer that can be varied through the financial cycle. The objective of the CRD IV/CRR is to provide a single set of prudential rules for institutions throughout the EU instead of a patchwork of national rules. The FSB however remarked that while a single rulebook is important for the single market, a certain degree of national flexibility in the use of macroprudential measures is still needed, as credit and economic cycles are not

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<sup>1110</sup> Alexander 2015 173.

<sup>1111</sup> Council Regulation (EU) – SSM Regulation No 1024/2013 of 15 October 2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions: Article 5(1) to (5): Macroprudential tasks and tools.

<sup>1112</sup> Alexander 2015 174.

<sup>1113</sup> Capital Requirements Directive IV: Directive 2013/36/EU.

<sup>1114</sup> Capital Requirements Regulation: Regulation (EU) 575/2013.

<sup>1115</sup> FSB Peer Review 2014 12.

synchronized across the EU.<sup>1116</sup> The new capital rules have procedures in place to check that the negative impact of certain national measures, if any, does not outweigh the financial stability benefits. These include legal requirements for the assessment of cross border effects and notification to the ESRB and EC, which in turn may issue opinions or recommendations depending on the case at hand.<sup>1117</sup> As such the introduction of the CRD IV/CRR further enables the promotion and maintenance of financial stability in Member States and also collectively on EU-level.

As indicated, the IMF FSAP Report in 2011 suggested that DNB has to expand its macroprudential policy instruments, including a plan for resolution measures for banks, higher capital requirements, countercyclical buffers, and bail-in instruments.<sup>1118</sup> These suggestions were made pursuant to the Financial Stability Board issuing its *Key Attributes for Effective Resolution Regimes for Financial Institutions* that in essence seeks to promote the orderly resolution of systemically important financial institutions which, if not resolved in an orderly manner, may severely compromise the maintenance of financial stability.<sup>1119</sup> The *Key Attributes* also import the notion of bail-in, as opposed to a bail-out with taxpayers' money, as the preferred manner in which to deal with resolution of financial institutions.<sup>1120</sup> The aspects dealt with in the *Key Attributes* have been addressed by the European Bank Recovery and Resolution Directive (BRRD)<sup>1121</sup> that was published on 12 June 2014. Subsequent to the BRRD

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<sup>1116</sup> This concern is even more relevant for Member States in the euro area that no longer have national monetary tools at their disposal.

<sup>1117</sup> FSB Peer Review 2014 12.

<sup>1118</sup> IMF 11/208 11; Bierman et al 2015 464; In an interview with Professor Michel Tison (Dean of the Law School at Ghent University, Belgium, on 26 January 2016, he pointed out that the main instrument that is now contemplated in European Law to save a failing bank is that of bail-in.

<sup>1119</sup> Financial Stability Board "Key attributes of effective resolution regimes for financial institutions" (October 2011) [http://www.fsb.org/wp-content/uploads/r\\_111104cc.pdf](http://www.fsb.org/wp-content/uploads/r_111104cc.pdf) (accessed 14 December 2017); These Key Attributes (KAs) were updated in 2014: Financial Stability Board "Key attributes of effective resolution regimes for financial institutions" (October 2014) <http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/> (accessed 14 December 2017). See also Chapter Two in paragraph 2.8.11 on "Key Attributes".

<sup>1120</sup> See also Chapter One in paragraph 1.2 on bail-in and bail-out.

<sup>1121</sup> EC, Directive 2014/59/EU of the European Parliament and of the Council [2014] OJ L173 [EU Directive 2014/59]; Chen V, Godwin A and Ramsay I "Cross-border cooperation in bank resolution: a framework for Asia" 2016 *Singapore Journal of Legal Studies* 1, hereinafter Chen et al 2016, at 20 state that regulatory harmonisation within the EU is facilitated through the BRRD. Under the BRRD, banks are required to draw up recovery plans while authorities responsible for resolving banks are required to prepare resolution plans. Recovery and resolution plans are prepared both at group level and individual institutions within the group. Harmonised resolution tools and powers in Member States ensure that they have common tools. The BRRD provides powers for a distressed bank's assets to be separated

the Single Resolution Mechanism (SRM) regulation was published that implements the BRRD in the eurozone and any other participating Member State.<sup>1122</sup> The BRRD and SRM amended the rules regarding the resolution of banks radically. In terms of the BRRD, financial institutions have to draft a recovery plan detailing which recovery measures the institution will take after a significant deterioration in its financial situation. This recovery plan has to be lodged at the ECB for significant banks and DNB for less significant banks. After that the settlement authority will draft a settlement plan in consultation with the competent authority. As such orderly bank resolution is a mechanisms designed to contribute to the maintenance of financial stability.<sup>1123</sup>

As a result of these developments on EU-level, supervision directed at financial stability and prudential regulation by DNB has thus been strengthened as DNB is held accountable not only on national level but also on supra-national level and its approach to executing its financial stability cum prudential regulation mandate is aligned with that of other EU Member States that share the collective responsibility for financial stability in the EU.

#### **4.7 More recent progress made in the Netherlands with regard to financial stability**

The progress made in the Netherlands in the context of improved financial regulation post GFC and specifically also with regard to DNB's role in promoting and maintaining financial stability has been discussed in paragraph 4.5 above. Further indications of

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and sold in whole or in part to another bank or bridge institution. Likewise, the essential functions of the bank may be transferred to other banks or bridge institutions. The BRRD also allows for statutory bail-in.

<sup>1122</sup> Bierman et al 2015 464; European Commission Press Release database 30 July 2014 <http://europa.eu/rapid/midday-express-30-07-2014.htm?locale=en> (accessed 8 December 2016). Chen et al 2016 20 indicates that The SRM is described as a "mixture of a centralized model where important powers are exercised at EU level" with decentralised implementation of decisions by national resolution authorities. If national resolution authorities fail to comply with the Single Resolution Board's decisions, the Single Resolution Board may intervene and execute the resolution action directly. The SRM, together with the Single Supervisory Mechanism, aligns resolution and supervision within the EU at a central level while involving national authorities.

<sup>1123</sup> Bierman et al 2015 465.

progress in this regard appear from recent Peer Review, Financial System Stability Assessment and FSAP reports by the FSB and IMF respectively.<sup>1124</sup>

A FSB Peer Review<sup>1125</sup> was conducted in the Netherlands in 2014. The main purpose of the Review was to examine two topics that are relevant for financial stability: the macroprudential policy framework and tools, and crisis management and bank resolution. It is to be noted that the FSB Report did not evaluate the Dutch Twin Peaks model as a regulatory model specifically in any detail but that observations were nevertheless made pertaining to certain issues that are relevant to the Dutch Twin Peaks model and the role of DNB as systemic supervisor within that model. Only those aspects of the FSB Peer Review that are relevant for this thesis will be mentioned here.

In its 2014 Report the FSB indicated that the legislative and organizational reforms implemented by the Dutch authorities have applied a comprehensive macroprudential policy framework that broadly addresses the FSAP recommendations as made by the IMF in its 2011 Report. It confirmed that cooperation and information exchange between the institutions responsible for safeguarding financial system stability have been strengthened via the creation of the Financial Stability Committee (FSC) in 2012. The FSB Peer Review Report further pointed out that under the amended Banks Act, DNB as central bank now has explicit responsibility for financial stability and had already as long ago as 2004 created a separate department to carry out this work. In addition DNB has been assigned the responsibility for calibrating and applying the macroprudential tools in the CRD IV/CRR. A formal risk assessment and decision making process for operationalising macroprudential policy has been formulated, and macroprudential risks are being integrated within the supervisory approach. The Dutch

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<sup>1124</sup> See below for references of FSB Peer Review 2014, IMF 17/79 and IMF 17/93.

<sup>1125</sup> Financial Stability Board – *Peer Review of the Netherlands* (11 November 2014) <http://www.fsb.org/2014/11/peer-review-of-the-netherlands/> (accessed 20 September 2015), hereinafter FSB Peer Review 2014. It is stated in the peer review that the analysis and conclusions of the peer review are based on the Dutch financial authorities' responses to a questionnaire and reflect information on the progress of relevant reforms as of September 2014. The review also benefited from dialogue with the Dutch authorities and private sector participants as well as discussion in the FSB Standing Committee on Standards Implementation.

authorities have further taken steps to address risks stemming from the housing market, also in response to FSAP recommendations.<sup>1126</sup>

In order to strengthen the maintenance of financial stability in the Netherlands the FSB recommended in its 2014 Report that the role of the Financial Stability Committee (FSC) within the macroprudential framework should be spelled out by the authorities and that they should specify and publicly set out the nature of the FSC's involvement in systemic risk assessment and macroprudential policy.<sup>1127</sup> The FSB further observed that an important driver of developments in this area has been, and will continue to be, European Union initiatives. According to the FSB the most important challenge for the Netherlands at the time of its 2014 Report consisted of deploying macroprudential tools effectively in specific contexts by embedding them in existing processes and developing the required analytical and operational capabilities.<sup>1128</sup>

In 2017 the IMF conducted a Financial System Stability Assessment (FSSA) of the Dutch financial system.<sup>1129</sup> The 2017 IMF FSSA Report examined the status in the Netherlands with regards to the key recommendations of specifically the 2011 IMF FSAP Report and made the following findings:

(a) the recommendation in the 2011 Report that priority should be assigned to developing macroprudential instruments, has been fully implemented through the CRD IV and CRR on 1 June 2014.<sup>1130</sup>

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<sup>1126</sup> FSB Peer Review 2014 23.

<sup>1127</sup> In an interview conducted with Maarten Willemsen, Senior Policy Advisor at De Nederlandsche Bank, and Cornelis Jansen, Manager Public and International Affairs of the *Stichting Autoriteit Financiële Markten*, in Amsterdam on 17 November 2016, hereinafter Interview Willemsen & Jansen 2016 they were of the opinion that the role of the FSC within the macroprudential framework should be embedded in legislation. Under the existing legal and institutional setting, they opined that this role should specify and publicly set out the nature of the FSC's involvement in systemic risk assessment and macroprudential policy. They pointed out that DNB has raised attention to this issue in its yearly regulatory letter in 2015; See further De Nederlandsche Bank "Wetgevingsbrief" (2 July 2015) <https://www.compliance-instituut.nl/wetgevingsbrief-financiele-markten-2015-is-gepubliceerd/> (accessed 28 January 2018) 6.

<sup>1128</sup> FSB Peer Review 5.

<sup>1129</sup> International Monetary Fund Country Report No. 17/79 *Kingdom of the Netherlands – Netherlands Financial System Stability Assessment (3 April 2017)* <http://www.imf.org/en/Publications/CR/Issues/2017/04/03/Kingdom-of-the-Netherlands-Netherlands-Financial-System-Stability-Assessment-44790> (accessed 8 June 2017) – (hereinafter in footnotes IMF 17/79).

<sup>1130</sup> IMF 17/79 6.

(b) With regards to Twin Peaks, the recommendation in the 2011 Report that DNB and AFM should be provided with greater discretion to put enforceable rules in place, has not been implemented.<sup>1131</sup>

(c) Continued integration of DNB staff across banking, insurance, and pensions functions has occurred.<sup>1132</sup>

(d) The recommendation in the 2011 Report to establish routine reporting requirements to strengthen monitoring and risk modelling, was partially implemented in that an internal project has been set up to strengthen data management within DNB.<sup>1133</sup> The Ministry of Finance has introduced a draft legislative proposal to strengthen the powers of DNB to collect and use data needed to fulfil its task of financial stability.

(e) The recommendation in the 2011 Report that supervision of large international financial institutions should be intensified, with greater emphasis on group supervision and soundness of business models, has been fully implemented with the creation of the European Banking Union in 2012.<sup>1134</sup>

(f) The recommendation in 2011 that DNB adopt a more proactive and decisive approach, including timely off-site inspection and corrective actions that rely less on moral suasion, was fully implemented.<sup>1135</sup> Changes were made in the organization of DNB, including the creation of a separate Intervention Department in 2011 to intervene

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<sup>1131</sup> See discussion above in paragraph 4.4 specifically subparagraph (e) regarding the 2011 IMF Report.

<sup>1132</sup> IMF 17/79 45: A new organizational structure has been implemented in DNB with the creation of a cross-sectional division that contains expertise centres for specific elements of supervision. In addition, a separate risk management department has been created to strengthen internal procedures and risk management. The governance of the Board was changed, effective on 16 February 2012, to emphasize the different responsibilities of DNB with the President responsible for central bank tasks and a Chairman of Supervision, primarily responsible for prudential supervision. This is supported by the creation of a Supervisory Council, where all relevant supervisory issues are discussed. The Supervisory Council is chaired by the Chairman of supervision, and contains all Division Directors from the different supervisory Divisions. The new Board of Directors of DNB has also renewed the Mission Statement of DNB. One of the pillars that have been identified is to strengthen synergy within DNB. This is further developed in an internal project with proposals to assign cross-sectoral responsibilities to one responsible Division Director. For example, Division Directors have been given a coordinating role in the most important cross-sectoral policy themes. Also, several initiatives have been set-up to promote job-shifting between Divisions. See discussion above in paragraph 4.4 specifically subparagraph (d) regarding the 2011 IMF Report. According to the 2017 IMF Financial System Stability Assessment Report 45 new legislation is in force since 1 July 2012 to limit the liability of DNB and the AFM. This legislation also affords protection to the members of the governing boards of the supervisors and to the staff.

<sup>1133</sup> See discussion above in paragraph 4.4 subparagraph (e) regarding the separate department for macroprudential supervision that was created in 2010 in the Financial Stability Department of DNB to improve the monitoring of macroprudential risks.

<sup>1134</sup> IMF 17/79 45. See discussion above in paragraph 4.4 specifically subparagraph (b) regarding the 2011 IMF Report.

<sup>1135</sup> See discussion above in paragraph 4.4 specifically subparagraph (a) regarding the 2011 IMF Report,

timely and effectively when needed. This Department coordinates the supervisory approach of troubled institutions and advises on the use of formal measures. In addition, a dedicated Risk Management Department has been set-up to strengthen internal control within DNB.<sup>1136</sup>

g) The 2011 recommendations that the institutional framework for crisis management be strengthened by:<sup>1137</sup> (i) shifting decision-making power from the judiciary to DNB in the context of bank resolution; and (ii) specifying more clearly the respective roles of the Ministry of Finance and DNB in bank resolution, were found to have been partially implemented through the amendment of the Intervention Act<sup>1138</sup> and the implementation of the BRRD in 2015.<sup>1139</sup> However the FSB pointed out that the powers of the Minister under the Intervention Act remain in place and the intersection between those powers and the Single Resolution Mechanism powers of the SRB and DNB is unclear.<sup>1140</sup>

(h) The 2011 recommendation that the framework for bank resolution be improved by establishing a single regime for resolving banks under official control; and that such regime should set appropriate objectives (including financial stability), as well as tasks and powers for the official administrators were only partially implemented.<sup>1141</sup> The FSB observed that although implementation of the SRM substantially strengthened the resolution framework, there is still no single regime given that the legacy powers of the Minister under the Intervention Act and other court-based resolution powers of DNB (i.e. the “Emergency Rule” under the Wft) coexist with the new regime. It was further pointed out that plans are in place to repeal the Emergency Rule.<sup>1142</sup>

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<sup>1136</sup> IMF 17/79 46.

<sup>1137</sup> See discussion above in paragraph 4.4 specifically subparagraph (e) regarding the 2011 IMF Report,

<sup>1138</sup> Act on Special Measures for Financial Corporations (Intervention Act) discussed in paragraph 4.6 above.

<sup>1139</sup> Lexology - NautaDutilh “Entry into force of BRRD in the Netherlands” (26 November 2015) <https://www.lexology.com/library/detail.aspx?g=7ab21fc3-ff2e-4c93-9acf-7c1c811539dd> (accessed 24 January 2018): With the entry into force of the Implementation Act, the European recovery and resolution framework now also applies in the Netherlands. The Implementation Act has primarily resulted in additions to and amendments of the Netherlands Financial Supervision Act. As a result thereof, the Netherlands Intervention Act will for the greater part cease to apply to banks and will only apply to insurers.

<sup>1140</sup> IMF 17/79 47.

<sup>1141</sup> See discussion above in paragraph 4.4 specifically subparagraph (e) regarding the 2011 IMF Report.

<sup>1142</sup> IMF 17/79 47. The emergency rule in terms of section 3:160 of the Wft in terms whereof DNB may ask a court to declare emergency regulations in respect of a credit institution in the interest of the creditors if the solvency or the liquidity of the credit institution shows signs of a dangerous development

The IMF found that institutional arrangements for macroprudential policy had indeed been strengthened.<sup>1143</sup> The Dutch authorities have also strengthened arrangements for financial sector oversight in the FSC with a macroprudential mandate and advisory powers.<sup>1144</sup>

Particularly microprudential oversight had been strengthened by important supervisory enhancements that have taken place: DNB's approach to supervision had become more intrusive, forward-looking and risk-based. The AFM's supervisory approach had also been enhanced, with early risk identification supported by dedicated teams that monitor market information. The IMF commented that information sharing and cooperation between DNB and AFM is well established.<sup>1145</sup>

The Report further highlighted that the SSM<sup>1146</sup> has significantly strengthened banking supervision in the Netherlands, though some elements of the framework such as decision making processes still need to be streamlined. It pointed out that the SSM introduced greater frequency and intensity of engagement with banks, particularly through onsite examinations and leveraging thematic exercises to encourage best practice. The IMF thus concluded that the response by DNB to the GFC was far reaching, including a revised strategic vision, greater resources, stronger regulations, and a more-assertive style of supervision.<sup>1147</sup>

The 2017 IMF Report however indicated that whilst greater engagement with the Supervisory Boards of financial institutions by the SSM and DNB commenced in 2013 and whilst progress is evident, more progress is needed, particularly in areas such as

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and no improvement of that development may be expected within reason, has not been repealed at the time of writing this thesis. See also paragraph 4.3 above.

<sup>1143</sup> IMF 17/79 6.

<sup>1144</sup> IMF 17/79 9. See above in paragraph 4.5 for discussion of the FSC.

<sup>1145</sup> IMF 17/79 20 and at 22: It indicated that a more active supervisory role in assessing loan classification is also needed to underscore prudent provisioning.

<sup>1146</sup> See more on SSM as discussed in 4.6 hereof.

<sup>1147</sup> IMF 17/79 21.

the Supervisory Boards oversight of the implementation of risk management frameworks and internal models.<sup>1148</sup>

Concerning orderly resolution of failing institutions as a mechanism to maintain financial stability, the IMF remarked that the Single Resolution Board's decision-making structure is complex and should be streamlined to ensure timely decision making for resolution of banks within its purview. Moreover, it pointed out that the roles of the Single Resolution Board and ECB in planning for and managing a domestic systemic banking crisis (as opposed to an individual bank failure) are yet to be defined. Accordingly the IMF recommended that at the national level, the Dutch authorities should ensure that domestic crisis management arrangements are up-to-date and appropriate to the new institutional environment. It recommended that ultimately, a formal coordination framework for crisis management involving the Dutch authorities, the ECB and the Single Resolution Board should be developed and tested periodically. It was further recommended that the Dutch authorities should also enhance the clarity of the Dutch resolution framework.<sup>1149</sup>

In 2017 the IMF also conducted yet another FSAP in the Netherlands.<sup>1150</sup> The 2017 IMF FSAP Report examined the status in the Netherlands with regards to the macroprudential policy framework and found that DNB has been actively addressing systemic risks stemming from interconnectedness and concentration in the banking system, by monitoring and regulating global systemically important institutions (G-SII),

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<sup>1148</sup> IMF 17/79 22.

<sup>1149</sup> IMF 17/79 26.

<sup>1150</sup> International Monetary Fund Country Report No. 17/93 *Kingdom of the Netherlands – Netherlands Financial Sector Assessment Program – Technical Note – Macroprudential Policy Framework* (April 2017) (<https://www.imf.org/en/Publications/CR/Issues/2017/04/13/Kingdom-of-the-Netherlands-Netherlands-Financial-Sector-Assessment-Program-Technical-Note-44818> (accessed 28 February 2018), hereinafter IMF 17/93.

other systemically important institution (O-SII),<sup>1151</sup> and systemic risk buffers (SRBs).<sup>1152</sup>

The IMF Report further indicated that the high cost of the GFC illustrated the importance of a strong macroprudential policy framework to support financial stability.<sup>1153</sup> The Report however pointed out that the new EU banking legislation and revised national laws have given the Dutch authorities and the ECB a wide range of macroprudential instruments to mitigate systemic risk in the banking system.<sup>1154</sup>

The Report also mentioned that, to support the FSC's activities, the AFM and the DNB made joint efforts to analyse systemic risk in the Dutch financial system as a whole, including financial market and asset management activities. It was pointed out that while the FSC discusses systemic risk and recommends policy actions, the use of macroprudential instruments remains the responsibility of the individual authorities. All the macroprudential instruments under the CRR and CRD IV have been explicitly assigned to the DNB.<sup>1155</sup> The IMF Report further stated that the FSC plays an important role in fostering coordination across member agencies since the FSC

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<sup>1151</sup> European Banking Authority “Guidelines on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs)” (16 December 2016) <https://www.eba.europa.eu/documents/10180/930752/EBA-GL-2014-10+%28Guidelines+on+O-SIIs+Assessment%29.pdf> (accessed 28 February 2018) at 1: Pursuant to Article 131(1) of Directive 2013/36/EU, competent or designated authorities in the Member States are obliged to identify European banks that represent a higher risk to the global financial system as Global systemically important institutions (G-SIIs) and article 441 of Regulation (EU) No 575/2013 requires G-SIIs to make public the values used for the identification and scoring process in accordance with certain uniform formats and dates specified in the draft ITS. At 3: The EBA issued guidelines on the assessment of O-SIIs. Under Article 131(3) of Directive 2013/36/EU (CRD), the EBA is mandated to issue guidelines to specify the criteria for determining the conditions of the application of that paragraph in relation to the assessment of O-SIIs. These guidelines establish a scoring process for assessing the systemic importance based on various indicators like size, importance (including substitutability and financial system infrastructure), complexity and cross-border activity and interconnectedness.

<sup>1152</sup> IMF 17/93 6. Moreover, the Report found that the authorities plan to impose a stricter leverage ratio (4 percent) than the Basel minimum with which systemic banks have to comply by 2018.

<sup>1153</sup> IMF 17/93 8.

<sup>1154</sup> IMF 17/93 9; The SSM Regulation (Council Regulation (EU) No. 1024/2013) confers to the national authorities and the ECB specific tasks relating to macroprudential instruments for the banking sector set out in the CRR (European Union Capital Requirement Regulations No. 575/2013) and the CRD IV (European Union Capital Requirement Directive 2013/36/EU). The ECB can apply higher requirements for capital buffers and more stringent measures than those applied by national authorities (“topping up power”), but cannot set lower requirements than those set nationally.

<sup>1155</sup> IMF 17/93 10.

provides a formal coordination mechanism across member agencies, which helps to internalize trade-offs (e.g. financial stability versus economic growth, systemic risk mitigation versus consumer protection). This is supported by the MOUs of 2007 on information sharing regarding financial stability between the DNB and the AFM and the Ministry of Finance, respectively (discussed in paragraph 4.3.5 above).<sup>1156</sup>

Since the FSC was established by means of a ministerial decree as opposed to primary legislation, the IMF pointed out that the ESRB assessed that the Dutch FSC is only partially compliant with recommendations concerning institutional design. Furthermore it was indicated that the FSC lacked a “comply-or-explain” mechanism that is needed to ensure the effectiveness of the FSC by enhancing transparency and public accountability.<sup>1157</sup> Therefore the IMF Report recommended an upgrade of the legal basis for the FSC from a Ministerial Decree to a primary law which should also include a “comply-or-explain” mechanism. It was opined that such a step would enhance the legitimacy of the FSC’s decisions, reduce the risk of delayed action due to political considerations, and strengthen the independence and accountability of the Committee.<sup>1158</sup>

Specifically with regard to DNB, the IMF Report found that because of the integrated supervision structure at the DNB, there is a strong coordination of micro- and macroprudential policy within the DNB. The integration facilitates the flow of information and brings together relevant expertise, enriching and fully exploiting complementarities between top-down and bottom-up risk analyses. The Coordination Group on Financial Stability, chaired by the director of the FSD, discusses macroprudential topics and has representation from both macro- and microprudential policy areas within the DNB. The Supervisory Council, which is mainly responsible for microprudential policy and supervision, also discusses macroprudential instruments under CRR and CRD IV and provides input on the Governing Board’s decisions. Outside the two policy functions, the Risk Management and Strategy Department in

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<sup>1156</sup> IMF 17/93 12.

<sup>1157</sup> IMF 17/93 12.

<sup>1158</sup> IMF 17/93 14.

the DNB provides an external check on macroprudential policy decisions. To enhance the coordination of technical staff between the two policy functions, the DNB further developed two intranet IT platforms, the so called “micro-macro register” and the “macro-micro register”, which are extensively used to share information across the various divisions in the bank.<sup>1159</sup>

The IMF Report pointed out the FSD is a dedicated department in DNB for systemic risk monitoring that consists of two departments (Macroprudential Analysis and Policy Department and International Financial Architecture Department). The DNB staff has published a number of high quality research and policy papers to discuss topical issues on financial stability and macroprudential policy. It was further found that the bi-annual FSR comprehensively covers macroprudential risks and policies in the Netherlands.<sup>1160</sup>

It was further pointed out that DNB and AFM actively share information with other European bodies and are involved in several joint projects by the ESRB (e.g. the ESRB risk dashboard, ESRB strategy paper on macroprudential policy beyond banking, and EU Shadow Banking Monitor).<sup>1161</sup> DNB and AFM also participate in several working groups within ESRB and the Financial Stability Board (FSB) to collaborate with other European authorities. Moreover, the risk assessment of the ESRB is partly based on input from the DNB and AFM, for example through a bottom-up survey and discussions with the ESRB and ECB staff.<sup>1162</sup>

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<sup>1159</sup> IMF 17/93 13.

<sup>1160</sup> IMF 17/93 15.

<sup>1161</sup> European Systemic Risk Board “ESRB Risk Dashboard” (undated) <https://www.esrb.europa.eu/pub/rd/html/index.en.html> (accessed 10 March 2018) 1: The ESRB Risk Dashboard is a set of quantitative and qualitative indicators of systemic risk in the EU financial system. It is published quarterly. European Systemic Risk Board “Macroprudential policy beyond banking: an ESRB strategy paper” (July 2016) [https://www.esrb.europa.eu/pub/pdf/reports/20160718\\_strategy\\_paper\\_beyond\\_banking.en.pdf](https://www.esrb.europa.eu/pub/pdf/reports/20160718_strategy_paper_beyond_banking.en.pdf) (accessed 10 March 2018); European Systemic Risk Board “EU Shadow Banking Monitor” (2 May 2017) [https://www.esrb.europa.eu/pub/pdf/reports/20170529\\_shadow\\_banking\\_report.en.pdf](https://www.esrb.europa.eu/pub/pdf/reports/20170529_shadow_banking_report.en.pdf) (accessed 10 March 2018).

<sup>1162</sup> IMF 17/93 13.

The IMF Report recommended that DNB should consider publishing a summary of the Governing Board meetings regarding macroprudential policy issues. The Governing Board has the decision-making powers related to the CRR and CRD IV instruments (except the limits on LTV and DSTI ratios). In the IMF's opinion the publication of the Board's discussions would help enhance the transparency of macroprudential policy and promote public support.<sup>1163</sup>

## 4.8 Conclusion

The Netherlands moved from a sectoral approach to financial regulation to a Twin Peaks model shortly before the GFC. In the pre-Twin Peaks dispensation DNB, as central bank established in 1814, was one of three main sectoral regulators together with PVK (that was responsible for supervision of insurance and pension funds) and STE (that supervised securities). DNB had the roles that central banks traditionally had insofar as monetary policy, oversight of the payments and settlement system and its lender of last resort function was concerned. Like many central banks it was also responsible for bank supervision. Although not mentioned specifically in any legislation or catered for in express terms by any legislative framework DNB was also the de facto guardian of financial stability in the Netherlands.

In the late 1990s the sectoral model of financial regulation in the Netherlands came under severe pressure – occasioned by turf wars between the regulators and the uncertainties caused by regulatory arbitrage. Regulatory concern also began to mount regarding the increase of complex financial conglomerates that became exceedingly difficult to supervise appropriately and which, due to their systemic importance, posed vulnerabilities in the financial system from where risks could propagate and evolve into potential systemic disruptions. The Dutch regulators were acutely aware of the challenges occasioned by trying to supervise these “Too-Big-To-Fail” institutions hence the move in the Netherlands towards a Twin Peaks model was mainly the result

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<sup>1163</sup> IMF 17/93 14.

of a desire to specifically deal with regulation and supervision of large, complex financial conglomerates in the Netherlands and to address existing gaps between prudential regulation and market conduct regulation and supervision.

Although not initially the Netherlands' first choice, the financial sector regulators combined to push for the acceptance of a Twin Peaks model in the Netherlands shortly after the decision to implement an "amplified" sectoral approach. Notably at the time that the move towards Twin Peaks in the Netherlands occurred in 2002 DNB as central bank did not have the main responsibility for monetary policy anymore as this responsibility was moved to the European Central Bank (ECB). The Dutch Twin Peaks model consisted of two peaks: DNB constituted the peak responsible for financial stability in the Netherlands and also obtained an expanded mandate for prudential supervision that not only included banks but also other financial institutions. The other peak was the AFM that was given the mandate of system wide market conduct supervision of a wide range of financial institutions. The legislative framework for the Dutch Twin Peaks model was introduced by the *Wet op het Financieel Toezicht* (Wft). This act set out the mandates, objectives and functions of DNB as prudential supervisor and AFM as market conduct supervisor. However, apart from stating that DNB has the prudential supervision entrusted to DNB by section 1:24 of the Wft was directed at soundness of financial enterprises and the stability of the financial system the Wft did not deal with DNB's financial stability mandate in any express terms nor did it set out a comprehensive framework facilitating the powers and functions of DNB with regard to financial stability.

It is interesting that the Dutch Twin Peaks model appears to have initially underplayed DNB's financial stability mandate and that it failed to amend the Banks Act at that early stage to give DNB an express mandate facilitated by a proper legal framework for such mandate. The reason for this is not clear unless one accepts, as pointed out by Domanski, Moessner and Nelson that the trend pre-GFC was generally not to encapsulate the financial stability mandate of central banks in express terms in

legislation.<sup>1164</sup> Another reason why the Netherlands did not at the time of introduction of the Dutch Twin Peaks model create a comprehensive legislative framework to enable and support DNB's financial stability mandate could possibly be ascribed to the fact that developments were already occurring on supranational Community level to facilitate cooperation between supervisors and central banks for purposes of financial system stability and the sentiment was probably that the MOUs entered into with the central banks of the member states during 2003 and 2005 catered sufficiently for cooperation and collaboration dedicated to the maintenance of financial stability.

The decision not to separate prudential regulation of banks and other financial institutions from DNB's mandate for financial stability is not necessarily surprising given DNB's historical expertise as central bank and the fact that pre-Twin Peaks it already fulfilled all the roles characteristic of central banks. As mentioned in Chapter One, there are many synergies and economies of scale and scope to be derived from keeping the mandates for financial stability and for prudential regulation within one institution.<sup>1165</sup> It is however submitted that this choice also had its drawbacks as clearly demonstrated by bank failures such as that of Icesave and DSB Bank where the inference can be drawn that DNB's light touch approach to prudential supervision probably compromised financial stability in the Netherlands to some extent. It is submitted that imposing both the responsibility for the promotion and maintenance of financial stability as well as for system-wide prudential regulation on DNB as a single institution which had to function as central bank (with all its other responsibilities) in a new Twin Peaks model most likely posed quite a challenge to DNB and it would obviously have taken some time to properly get to grips with such a heavy regulatory burden. The fact that DNB already established a Financial Stability Department in 2004, as part of the shift towards Twin Peaks in the Netherlands, was however a positive development that preceded the introduction of the Dutch Twin Peaks model.

Insofar as cooperation and collaboration between the two peak supervisors were concerned the Wft did not specifically make a distinction regarding cooperation for

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<sup>1164</sup> Domanski et al 2014 45.

<sup>1165</sup> As discussed in paragraph 1.4.3 above.

purposes of financial stability and cooperation within the broader Twin Peaks context. It is however clear that such cooperation and collaboration and also cross-border cooperation and collaboration between the Dutch authorities and their counterparts in Member States and non-Member States were viewed in a very serious light hence the large numbers of sections in the Wft dealing specifically and in detail with this aspect. It is interesting that the Netherlands chose to dissolve the RFT prior to implementing their Twin Peaks model and it is submitted that the lack of a central coordinating body such as the RFT probably explains why the Wft makes such extensive and detailed provision in hard law for how DNB and the AFM should cooperate. A welcome development in this regard was the new Covenant that was entered into between DNB and AFM during 2007, replacing the previous Covenant of 2004 that addressed the regulatory remit of each supervisor as well as how they would cooperate and collaborate on a practical level. A positive effect derived from this Covenant was the likelihood that turf wars and regulatory arbitrage would be put to an end that otherwise had the potential to divert the regulatory attention from the (stated in the Wft in the context of its prudential supervision mandate but not legislatively entrenched in express terms in the Bankwet) pursuit of financial stability as mandate of DNB. Nevertheless it is submitted that having a coordinating inter-agency body, in addition to the Covenants, is actually a necessity for the effective operation of a Twin Peaks model and especially during the GFC would have also aided better coordination between the regulators.

The fact that the Dutch Twin Peaks model was implemented at a stage when the GFC was imminent means that the GFC presented the optimal learning curve for the Netherlands insofar as refining their approach to financial supervision and reconsidering the role of the central bank with regards to financial stability was concerned. It is evident that the Netherlands has heeded recommendations by international standard-setting bodies such as the IMF and FSB and has made many improvements in the context of financial regulation since the GFC and that significant progress has specifically been made with regard to the role played by DNB in the Dutch Twin Peaks model. The culture in DNB changed so that pro-active prudential supervision and appropriate enforcement became more of a priority thus enhancing the safety and soundness of financial institutions as a necessary condition for financial

stability. The establishment of the Financial Stability Committee in 2012 as a dedicated interagency body focused on financial stability, was another significant step in the right direction.

As became evident the role of DNB in the Dutch Twin Peaks system cannot be viewed on an isolated national level given the status of the Netherlands as an EU Member State and part of the eurozone. The creation of the ECB and the European Banking Union were therefore also crucially important developments insofar as the central bank's financial stability mandate and the operation of the Dutch Twin Peaks model is concerned. The interaction between domestic supervision in the Netherlands and the responsibilities of DNB as regulator in the broader EU context is a rather complex and fluid landscape. In essence the Twin Peaks model in the Netherlands which entails regulation by objective now has to operate in tandem with the broader EU model which is currently sectoral in nature. It is submitted that this is not an ideal situation and may give rise to some regulatory disconnect. The ECB as mega regulator now also, since the adoption of the SSM, has moved from being mainly concerned with monetary policy only, to greater involvement in bank supervision.

However it is further evident that the intensified regulation and supervision that occurred on a supranational level also brought about some much needed changes in the context of domestic financial regulation and supervision in the Netherlands. The more dedicated focus by the ESRB on systemic risk management translated into an express financial stability mandate for DNB being incorporated into the *Bankwet*. The risk surveillance work on ESRB-level also augments the ability of DNB to address risks to financial stability. The fact that the ECB now supervises systemically important banks means that there is an additional layer of supervision from a body that is more removed from these banks than DNB as domestic supervisor. There is thus less chance that DNB will encounter conflict resulting in a toss-up between prudential regulation, easing monetary policy and maintaining financial stability should a systemic bank fail. DNB's role in bank supervision is further improved in that the SSM will most certainly have the result that the supervisory approaches of banks across the EU will be scrutinized and harmonized on the level of best practices.

Finally it should be noted that there are some authors who are of the view that the Twin Peaks model of functional financial supervision is no longer appropriate for the Netherlands whilst other authors are of the view that this model served the Netherlands well and remains relevant. For example, Oppelaar is of the opinion that the future of the Dutch Twin Peaks model has since the GFC been seen in another light. The introduction of the cross sectoral supervision was primarily done (as discussed above) because of the interpenetration (*vervlechting*) of banking-, insurance- and securities sectors. Oppelaar remarks that this trend has been changing radically after the GFC. Banks have now returned to concentrating more on their core business and tend to move away from non-banking activities. Financial conglomerates are also disappearing.<sup>1166</sup> Oppelaar is therefore of the view that if the supervision structure would always be based on the market structure, as was the thought after the changes of supervision in 2002 that a development towards a sectoral supervision structure would be obvious for the nearby future.<sup>1167</sup>

However not everyone shares Oppelaar's view. In an interview conducted with Maarten Willemsen of DNB and Cornelis Jansen of the AFM, in Amsterdam on 17 November 2016, they were of the opinion that although the financial supervisory architecture in the Netherlands has evolved considerably since the introduction of European System of Financial Supervision in 2011, the SSM in 2014 and the SRM in 2014 - the rationale for the Twin Peaks model has not changed. The most notable effect, according to them, of the introduction of overarching European supervision is that new financial supervisors at the European level have been created: the ECB overseeing banking supervision and the Single Resolution Board responsible for winding up institutions that are failing or likely to fail.<sup>1168</sup> They pointed out that the introduction of new supervisory bodies created new challenges in working together and sharing information. Willemsen and Jansen further indicated that the synergy

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<sup>1166</sup> For example, the biggest Dutch financial conglomerate, ING Group, has decided in 2009 to move away from all insurance - and asset control activities. Fortis, another mixed financial conglomerate, has been split into a bank (Fortis Bank Nederland) and an insurance company (ASR Nederland) before it was integrated into ABN AMRO.

<sup>1167</sup> Busch et al 2010 40.

<sup>1168</sup> For a discussion on the European supervision and specifically the SSM, see par 4.6 above.

between prudential supervision in the central bank and the micro- and macro perspective occasioned thereby, was found very useful during the GFC.<sup>1169</sup>

Van Hengel, Hilbers and Schoenmaker also come out in support of the Dutch Twin Peaks model. They state that it is clear that the Twin Peaks model has not been able to shelter the Dutch financial system from the consequences of the GFC. However they indicate that this is rather the result of the large and international character of the Dutch Financial system and cannot be ascribed per se to the model of supervision. They remark that “[O]n the contrary there is still strong support for the Twin Peaks model from the different stakeholders (Ministry of Finance, the supervisors themselves as well as the supervised financial institutions).....The opportunity should be used to further refine the model, based on the experiences during the Crisis.”<sup>1170</sup>

Finally, it should be borne in mind that financial regulation is not static and that it has to adapt to address issues that crop up in the ever-dynamic financial markets from time to time. Should it thus happen that the wave of regulation post GFC succeeds in changing the landscape of financial markets to such an extent that a Twin Peaks model is no longer appropriate, one has to keep an open mind regarding new regulatory frameworks. However, given all the effort that has been put into refining the Dutch Twin Peaks model it would be fair to state that in principle the model appears workable and resilient and rather than reinvent the wheel or return to a sectoral approach with its challenges of regulatory arbitrage and supervisory gaps and inability to adequately cater for supervision of financial conglomerates, the Netherlands would do well to rather just keep on refining their existing Twin Peaks model and the role of DNB in promoting and maintaining financial stability within the parameters of this regulatory model, in those areas where problems are still experienced. All in all, it appears that the Twin Peaks model has served the Netherlands well in the GFC and that, with time and experience, it can be honed into an even more effective and efficient model and DNB’s financial stability mandate as provided for in the WFT and *Bankwet*, can be

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<sup>1169</sup> Interview Willemen & Jansen 2016.

<sup>1170</sup> Van Hengel M, Hilbers P and Schoenmaker D *Financial Supervision in the 21st Century* “Experiences with the Dutch Twin Peaks model: Lessons for Europe” (2013).

tweaked to become more refined by setting out more clearly the processes by which DNB can seek to achieve its financial stability objectives.

## **CHAPTER 5**

### **CONCLUSIONS AND RECOMMENDATIONS**

- 5.1 Introduction**
  - 5.2 General conclusions regarding financial stability**
  - 5.3 The central bank and financial stability**
  - 5.4 Facilitating financial stability through an enabling institutional framework via the Twin Peaks model**
  - 5.5 The changed role of the South African Reserve Bank with regard to the promotion and maintenance of financial stability**
  - 5.6 Lessons from Australia and the Netherlands**
  - 5.7 Quo vadis South Africa?**
  - 5.8 Recommendations for reform**
  - 5.9 Topics for further research**
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#### **5.1 Introduction**

As indicated in Chapter One the research problem that was investigated in this thesis is how the legislative framework and institutional architecture introducing the South African Twin Peaks model of financial regulation has changed the role of the SARB as central bank of South Africa and whether it will serve to augment the role of the SARB in respect of financial stability to such an extent that financial stability in South Africa will potentially be better promoted and maintained under this new regulatory model than it was in the past.

In order to address this question the following research objectives were pursued:

- To give an overview of the historical evolution of the role of central banks in general and how it has changed as a result of the new regulatory paradigm that emerged post GFC, elevating the promotion and maintenance of financial stability as core goal of financial regulation and emphasising the role of the central bank as macroprudential supervisor.
- To examine the main approaches to financial regulation with specific focus on the Twin Peaks Model as initially proposed by Michael Taylor.
- To investigate legislation in South Africa (i.e. the Constitution and the SARB Act) regarding the role of SARB in promotion of financial stability prior to the GFC.
- To critically analyse and evaluate framework legislation enacted as a response to the GFC, namely the Financial Sector Regulation Act, 9 of 2017 in terms whereof a Twin Peaks model is introduced in South Africa, in order to eventually address the question as to how the role of the SARB with regard to financial stability has changed and whether this legislation and the institutional architecture that it put in place provides adequate measures for the SARB to promote and maintain financial stability;
- To do a comparative study on the role of the Australian Reserve Bank in relation to financial stability as it was dealt with in the Twin Peaks model of Financial Regulation in Australia prior to and after the GFC, especially considering that Australia had the foresight, approximately a decade before the 2008 GFC to overhaul their approach to financial regulation by pioneering the Twin Peaks model and to navigate and tweak their Twin Peaks system well before the Crisis.
- To do a comparative study on the role of the Dutch Central Bank in relation to financial stability as it was dealt with in the Twin Peaks model of Financial Regulation in the Netherlands prior to and after the GFC, especially considering that the Twin Peaks system in the Netherlands was implemented at a time when the GFC was imminent and thus the Dutch system had to face the challenges brought about by this worldwide crisis head-on.

Having addressed these research objectives this final chapter now endeavours to set out the conclusions of the study as well as some recommendations for reform.

## **5.2 General conclusions regarding financial stability**

The shaman of banking law, Goodhart, with all his years of experience of banking and financial law, sagely remarked that “there will always be crisis”.<sup>1171</sup> One can indeed agree that the threat of financial crises is continuously lurking on some distant or not so distant horizon, fed by the inherent cyclical nature of the financial system and the inability of man to pre-empt and contain all the sources of domestic and cross-border vulnerability that may erode the stability of a country’s financial system.

This thesis has pointed out that financial stability has over the years evolved from an unwritten traditional role of central banks to become a regulatory pursuit that steadily moved up the ranks to become the apex regulatory pursuit post GFC. Regulating a financial stability mandate is challenging as the “objective” or “condition” it pursues is difficult to articulate: despite many efforts to capture its essence, the concept of financial stability has consistently proven to be somewhat of an enigma, “fuzzy” and incapable of exact definition - a concept understood better by what it is *not* than by what it actually is. Maybe the notoriously abstract concept of financial stability is so difficult to grasp precisely because it is so multi-layered. As alluded to in this thesis, it has been said to underpin sound monetary policy, effective payments supervision and appropriate prudential regulation but, properly considered, financial stability itself is also underpinned by all these features.<sup>1172</sup> It would thus appear that rather than an isolated feature of a financial system, financial stability is the collective result of symbiotic cohesion between sound monetary policy, sound and well-functioning payments, settlement and clearing systems and prudentially safe and sound financial institutions and their interaction with various other aspects of the broader macro-economy. In short, financial stability is the sum of all its parts.

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<sup>1171</sup> Goodhart 2006.

<sup>1172</sup> See paragraph 1.4 above.

This probably explains why governments and regulators have for many years regarded the promotion and maintenance of financial stability as pivotally important yet generally failed to adequately and comprehensively entrench the concept and the processes by which it is sought to be attained, in legislation. Insight into the conditions necessary for the promotion and maintenance of financial stability has also evolved with time as crises revealed, for example, that sound monetary policy by itself is not sufficient to guarantee financial stability because even if a country's monetary policy is bespoke a failure in the payments system or a failure in prudential regulation may precipitate the collapse of the financial system. And the further truth has also been revealed, namely that even in the presence of sound monetary policy, sound payments and clearing systems and prudentially sound financial institutions, vulnerabilities may exist such as toxic market practices or shocks propagated from other sectors of the economy that can shake a financial system at its roots.

The pursuit of financial stability is thus not an endeavour to be undertaken by narrow-minded regulators. Its very essence requires a broader risk-based macro-focus. The use of the word "macro-focus" in this context is deliberate because although regulators tend to use the word "macro-prudential" quite loosely in the context of financial stability, it is submitted that merely requiring a macroprudential focus for purposes of financial stability is inadequate - system-wide prudential regulation alone will not be sufficient to guard financial stability. What is required is a system-wide focus that is both macro-prudential and macro-conduct oriented in nature.

### **5.3 The central bank and financial stability**

It is in the field of financial stability where the true value of the central bank is revealed. Central banks have over the years evolved to become a respected beacon for maintaining financial system stability. The regulatory make-up of central banks evolved to be such that central banks participated in all the roles necessary to enable financial stability as a regulatory outcome, namely responsibility for monetary policy, oversight of the payments system, prudential oversight of banks and its crucial

stabilizing role as lender of last resort. Coupled with its institutional knowledge of the workings of the broader economy and its data-collecting functions this gives the central bank a competitive advantage over other regulatory agencies which might also vie for the position as systemic regulator. Where financial stability is under threat it will inevitably trigger lender of last resort assistance from the central bank - a role that has historically been the exclusive domain of central banks. Notably the central bank's lender of last resort-role, like financial stability, has over the years been shrouded in mystery, never quite captured in legislation.

Financial stability is eroded, to a higher or lesser degree, by systemic events that can arise as a result of vulnerabilities within or outside a country - and within or outside of a financial system. The 2008 Global Financial Crisis was the ultimate systemic event that, through a process of widespread contagion brought the complex, interconnected global financial system to its knees. Sound monetary policy pursuing price stability, previously the favourite child of financial regulation, was - despite the fact that it had been perfected and narrowed down to a fine art - not sufficient to restore balance and stability to the financial systems of the countries that bore the brunt of the GFC. In their quest to process the causes of and the lessons from the Crisis, regulators stumbled upon an inconvenient truth - that although financial stability became an increasingly important item on the regulatory agenda pre-GFC, there was not enough regulatory momentum and not enough was done to ensure that financial systems were resilient enough to withstand and /or appropriately deal with the various shocks during the global financial meltdown.

Financial stability became the regulatory panacea that emerged as core paradigm after the GFC. With it came the realization that is not a state, condition or balance that merely has to be maintained - it has to be actively pursued and planned for - in short, it needs to be carefully curated. It was thus realized that the regulation of financial stability has to be approached holistically on an ex ante (promote), status quo (maintain) and ex post (mitigate, manage and restore) level, that prevention is better than cure and that measures have to be put in place to ensure the resilience of the financial system. A laissez faire approach to regulation with the central bank stepping

in to mop up the debris would no longer do. Regulating financial stability thus has to be approached strategically on various levels, namely promotion, maintenance, mitigation, management and restoration. To say that a central bank in the post GFC landscape has a mandate to maintain financial stability thus by necessity implies that the word “maintenance” should be interpreted to include all these aspects.

This realization regarding the broad mandate inherent in the pursuit of financial stability required a better appreciation of the concept of systemic risk and its causes and the need for micro-and macro-regulation and supervision to be integrated - both on a prudential and a market conduct level - failing which the financial stability might fall through the cracks. Thus, the pursuit of financial stability by necessity implies the adoption of a risk-based approach and measures to identify and monitor risks, to mitigate them and to manage their effects.

Informed by the lessons from the GFC the pursuit of financial stability has thus taken over the regulatory agenda post GFC. This new wave of regulation geared at targeting financial stability has taken the lessons from the GFC and translated them into the regulatory streams we now perceive: light touch regulation has been discarded and substituted with more aggressive, intrusive regulation; prudential regulation and market regulation have been recognized as twins to be located in peaks of equal importance; global cooperation to contain macro-economic imbalances are being facilitated by international standard setting bodies and the importance of swift regulatory action is now emphasized against the background of measures that are being put in place to make financial systems more resilient. “Too-Big-to-Fail” is a swearword to modern regulators. The GFC brought with it a major regulatory culture shift moving from a responsive bail-out culture of regulatory laxness and self-instilled helplessness in relation to the uncontained structural risk posed by SIFIs whose risky ventures were backed by government bail-outs - to a more responsible culture of heightened regulatory ex ante intervention and measures for recovery and orderly resolution of SIFIs where, despite efforts at keeping them sound, they encounter financial distress and failure. If one thing is clear from the GFC it is that, apart from the need to focus on the promotion and maintenance of financial stability, there *had* to be

a serious rethink of the essence of the approach to financial regulation and the institutional framework that best accommodates such approach.

Given the unique position of central banks within the financial system and considering the ways in which their various roles relating to monetary policy, payments systems, lender of last resort and prudential regulation as well as their accumulated knowledge of and expertise in the workings of the financial system and broader macro-economy has through the course of time located them in the institutional “sweet spot” best suited to oversee the promotion and maintenance of financial system stability. Their more focused and extended role with respect to financial stability after the Crisis thus appears to be a natural progression: being the guardian of financial stability in the post GFC landscape is the modern central bank’s destiny. As pointed out by Padoa-Schioppa it is part of the central bank’s “genetic code”.<sup>1173</sup>

Logic dictates that in order to regulate the central bank’s mandate for financial stability one needs, as a point of departure to have a clear idea of this objective that is sought to be achieved. Whether the lack of a universally accepted definition of financial stability is indeed problematic is a matter of opinion. Given the fuzzy nature of this concept it is submitted that it is doubtful whether such a generally acceptable definition will ever emerge - as we have seen some, like Allen, tend to favour quite a complicated definition of this concept whereas others, like Borio and Drehmann are satisfied to merely accept that it is the converse of financial *instability*<sup>1174</sup> - which, by the way, is also not a concept that lends itself to easy definition. The word “stability” itself denotes something that is stable and in balance - thus, not plagued by major disruptions. One thing that is certain about financial stability though, is that it is essentially a public interest objective - because having a stable financial system benefits the population of a country at large and having stability in the global financial system brought about by the stability of the financial systems in its component parts serves the global public interest. So it is submitted that not too much should be made of the lack of a generally accepted definition - there are enough indicators of financial stability to guide

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<sup>1173</sup> See paragraph 1.2 above.

<sup>1174</sup> See paragraph 1.3.5 above.

regulators to know what it is that they are seeking to achieve and to realize when such outcome is not met. That being said, it is nevertheless submitted that a legislative framework aimed at regulating with the objective of promoting and maintaining financial stability should ideally be predicated upon some workable definition of financial stability to guide the entity or entities clothed with such a mandate.

The same can be said of the concept of systemic risk. We know by now that its origins can generally be either structural, such as the risk building up in large, financial conglomerates; or time-dynamic in that it can build up over time such as credit or housing bubbles. What we do not always know, it is submitted, is exactly what shape a systemic event will take - but of its erosive impact on the financial system we are certain. It is therefore submitted that whenever the choice is made to define this concept in legislation intended to inform the execution of the mandate for financial stability, it would be best to have a broader definition rather than take a numerus clausus approach to the concept of systemic risk. What must be clear though from the legislative framework is that certain powers related to the financial stability mandate will be triggered by the occurrence of a systemic event. Capturing such triggers and the subsequent stabilizing powers that can be employed to address those triggering events in legislation will bring about legal certainty and obviate the need for the central bank to request permission in advance of taking certain steps. It is of the utmost importance that the central bank, as guardian of financial stability, should have clear emergency powers at its disposal to deal with systemic events and warn of financial system collapse. In crisis times there is no place for bickering about the central bank's powers to take stabilizing actions.

This thesis has thus interrogated the evolution of the role of central banks insofar as it concerns financial stability which itself, as a regulatory pursuit, has evolved as the years went by, and despite not losing its fuzziness, culminated in its position as core regulatory objective post GFC. Consideration was given to the GFC as a regulatory game changer specifically with regard to the fact that it revealed several hard lessons that emphasised the need to focus on financial stability as a holistic pursuit both from a macro- and micro-perspective which requires the lessons that emerged from the

Crisis to be addressed on various levels via a risk-based approach. The GFC was the cruel yet kind Rubicon event that changed the trajectory of financial regulation and exposed the accumulated dangers that had built up during periods of deregulation followed by laissez faire regulation. It is inevitable therefore that the GFC occasioned a fundamental rethink of the models by means of which financial systems are regulated as part of the measures that may serve to avoid or mitigate a future crisis. As indicated, it is also inevitable that whatever regulatory model is opted for in the pursuit of financial stability, the central bank, as of necessity, has a core role to play with regards to financial stability.

#### **5.4 Facilitating financial stability through an enabling institutional framework via the Twin Peaks model**

The pursuit of financial stability as a regulatory objective cannot be undertaken in vacuo. As such the regulation of financial stability always occurs within the broader context of a prevailing model of financial regulation. Considering the most suitable model of financial regulation is a multi-faceted endeavour but, as pointed out in this thesis, it is evident that a good basis to start at is to consider the legislative and institutional framework that provides the parameters within which such regulation is to be administered.<sup>1175</sup> It would be fair to conclude that, all main approaches considered, the Twin Peaks model of financial regulation as proposed by Michael Taylor appears best suited to facilitate the pursuit of financial stability in the post GFC landscape.<sup>1176</sup> This is because this model pertinently recognises the pursuit of financial stability as a peak regulatory objective hence its design is stemmed at facilitating effective systemic regulation in tandem with prudential regulation and market conduct regulation. Twin Peaks has both a macro-focus and a micro-focus - where the eventual regulation covers not only the prudential and market conduct soundness of individual components or institutions in the financial system but also their interaction with the financial system and the broader macro-economy as a whole. It accordingly contains the basic architecture as a first building block in the regulatory pursuit of financial

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<sup>1175</sup> See paragraph 1.8 above.

<sup>1176</sup> See paragraph 1.9 above.

stability. Moreover, Twin Peaks does not detract from the principal role that the central bank fulfils in a financial system but appropriately reinforces and facilitates it.

Twin Peaks is however not a silver bullet that can completely stave off any future crises. As pointed out it has its own set of problematic aspects that will have to be kept at bay and kept in check such as ensuring that the regulators are at all times clear on their objectives and jurisdictional remit and that effective and continuous interagency coordination is achieved failing which the model will not work.<sup>1177</sup>

As indicated in Chapter One the purpose of this thesis is not to argue for or against the Twin Peaks model of financial regulation. Twin Peaks for South Africa is a fait accompli. The Financial Sector Regulation Act 9 of 2017 importing the unique South African Twin Peaks model, is now part of the South African regulatory reality. Given this reality there exists no need for this thesis to win over support for the Twin Peaks model of financial regulation, which as demonstrated, has features that may differ slightly among jurisdictions. It merely needed to be considered whether this reality - namely the legislative and institutional framework created by the South African Twin Peaks model - appropriately accommodates the pursuit of financial stability. It thus needed to be considered how Twin Peaks has changed the role of the South African central bank in this context and whether it is a change for the better and if necessary, how it can be managed or improved to achieve the promotion and maintenance of financial stability.

Accordingly this thesis has provided an overview of the basic features of the Twin Peaks model as proposed by Michael Taylor. It considered the main philosophy behind Twin Peaks which is that a split between prudential and market conduct regulation and locating this responsibility in two separate regulators, enable objectives-driven, focused and system-wide regulation which, if properly coordinated and implemented, contributes to financial stability. Two important issues that typically arise pertaining to the role of the central bank within the context of a Twin Peaks model have been

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<sup>1177</sup> See paragraph 1.9 above.

addressed by this thesis, namely: should the central bank have the mandate for financial stability in the Twin Peaks model? And if the central bank has the financial stability mandate - should it also be the prudential regulator, especially given the expanded prudential regulation mandate in a Twin Peaks model that covers a wide range of financial institutions and not only banks? This thesis departed from the premise that indeed the central bank should have the financial stability mandate. It also sought to drive home the essential realisation that an effective Twin Peaks model as facilitating institutional environment for the promotion and maintenance of financial stability is deeply dependent on proper coordination and collaboration between all its constituent parts. Thus the thesis sought to interrogate how Twin Peaks facilitates the promotion and pursuit of financial stability specifically from the perspective of the central bank and also on a broader level by getting regulators and organs of state to cooperate and collaborate in order to create an effective system of financial regulation that supports and enables the financial stability objective.

Consideration was given to the institutional architecture of the South African Twin Peaks model specifically with regard to the SARB's financial stability mandate: in this context it was considered how this mandate is cast in the legislation; whether it is the sole purview of the SARB as central bank or whether there is some shared responsibility for the promotion and maintenance of financial stability or aspects thereof to be discerned from the legislative framework and how the effective execution of this mandate will be facilitated given that the sheer magnitude of the financial stability mandate means that cooperation and coordination between the SARB and the regulators and relevant organs of state is a condition sine qua non for promoting and maintaining financial stability.

## **5.5 The changed role of the South African Reserve Bank with regard to the promotion and maintenance of financial stability**

It is submitted that the thesis has appropriately demonstrated how the role of the SARB has changed post GFC and as a result of the shift to a Twin Peaks model of regulation. Like its Australian and Dutch counterparts, the RBA and DNB, the SARB is also a well-

established central bank that has been in existence for nearly a century. Being the fourth oldest central bank outside Europe it has earned its place in the ranks of central banks albeit that it functions in an emerging market as opposed to the well-developed markets of Australia and the Netherlands. Pre-Twin Peaks the SARB operated within a sectoral model of financial regulation where it had the roles traditionally undertaken by central banks, namely responsibility for monetary policy, payments system oversight; bank supervision; responsibility for the maintenance of financial stability and acting as lender of last resort. Unlike its other roles, its roles in respect of financial stability and lender of last resort was not explicitly captured in the SARB Act. This lack of legislative entrenchment was not extraordinary given that various commentators have pointed out that these two roles were generally not dealt with in legislation pertaining to central banks prior to the Global Financial Crisis.<sup>1178</sup> It was however clear that the SARB de facto exercised an implied financial stability mandate that made it responsible for the maintenance of financial stability in South Africa. That it was good at maintaining financial stability in the country is evident inter alia from the fact that the country did not suffer a major financial crisis at any particular time nor was it brought to its knees by the GFC and it also does not have a calamitous history of spectacular and regular bank failures.

It was pointed out that the 2008 GFC was not the personal watershed event for South Africa that it was for many other countries. However it did change the course of financial regulation in South Africa given that South Africa as G-20-member publicly committed to the global financial reform agenda post GFC. This is one notable aspect that has to be appreciated about the SARB - as a consequence of South Africa's longstanding involvement in the G-20 and Basel Accords - the SARB has always been a robust regulator, well-versed with the international regulatory agenda. In aligning its regulatory pursuit with the international agenda that fixed its focus on financial stability as apex objective, South Africa took the leap to convert to a functional Twin Peaks model of regulation by objective precisely because it was of the opinion not that not only was this the most appropriate model for the future regulation of its financial sector

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<sup>1178</sup> See paragraph 2.2 above.

but also because it was the model that would best enable the promotion and maintenance of financial stability.

South Africa, as the first emerging market to implement a Twin Peaks model, could do so from a position of considerable strength: it had the advantage of being able to look at Twin Peaks models of other jurisdictions such as Australia and the Netherlands to inform the design of the South African Twin Peaks model. Also, unlike Australia and the Netherlands that adopted their models pre-GFC, the South African model was adopted *after* the GFC hence South Africa adopted its Twin Peaks model in a milieu where financial stability had emerged as core regulatory paradigm. Accordingly the emphasis on financial stability comes through very strongly in the South African model - far more than in the Australian and Dutch models. South Africa further had the benefit that, in addition to observing how other jurisdictions implemented their Twin Peaks model and having access to extensive literature on this model, it could consider the lessons from the Crisis to further inform and augment the design of the South African Twin Peaks model. What eventually emerged was a distinct Twin Peaks model adapted to the needs of South Africa as emerging market with a preference for robust financial regulation captured in hard law but with the flexibility of a soft law overlay facilitated by regulatory memoranda of understanding.

The role of the SARB has thus significantly changed in the post GFC landscape with its adoption of Twin Peaks: its mandate for financial stability has been captured in explicit terms in legislation, put on par with its price stability mandate, and made clearer by indicating what is expected of the bank and by legislatively entrenching the broad powers necessary to achieve this expanded mandate. Importantly, the institutional context and regulatory milieu within which this mandate is to be exercised has been radically changed from what it was pre-Twin Peaks - moving from a narrow-minded silo-regulation model to a macro-minded functional model that clearly sets out the objectives of regulation and the functions that have to be fulfilled in order to achieve such objectives. In this model the mandate for prudential regulation has been removed from the SARB's remit with the result that the Christmas tree effect is avoided, conserving the SARB's regulatory energy to be directed more appropriately at its

expanded financial stability mandate which is inextricably interlinked with its responsibility for monetary policy and its role as lender of last resort. This move inter alia aims addresses the oft lamented problem that the tension between financial stability and prudential regulation, which - although mostly complementary - can generate conflicts in a central bank that has to oversee the stability of the financial system and also the individual soundness (and thus stability) of financial institutions.

The Twin Peaks model has further explicitly assigned responsibility for assistance with maintaining financial stability to the newly established PA and FSCA - that will provide such assistance through sound prudential regulation and supervision and sound market conduct regulation and supervision on a system-wide scale. The PA has a clearly demarcated regulatory remit concentrating on objectives relating to enhancing and promoting the safety and soundness of financial institutions and market infrastructures that coupled with its objective to protect financial consumers against risk that financial institutions may fail to meet their obligations, will serve its fourth objective, namely to assist in maintaining financial stability. The FSCA as separate peak also has a dedicated objective to assist in maintaining financial stability through enhancing the efficiency and integrity of financial markets and protection of financial consumers. Without having these two pillars to create regulatory conditions that will concurrently contribute directly to financial stability the SARB will most certainly not be able to effectively execute its financial stability mandate. It is further submitted that specifically capturing in legislation that the prudential and market conduct peaks must assist in maintaining financial stability obliges these two regulators to measure their regulatory and supervisory actions against this outcome - thus although their other core functions will have the de facto effect of contributing towards financial stability it is submitted that the express obligation to assist in the maintenance of financial stability will act as a prism through which they will view the objectives and effect of such actions.

Notably South Africa has heeded the caution to keep the prudential regulator close to the central bank - in fact, so close that for the man on the street there will probably be no perceived difference between the PA and the SARB. The many economies of scale

and scope and ease of information dissemination and collaboration that this synergistic arrangement will yield for South Africa as an emerging market is of course undeniable.

The legislative framework created by the FSR Act is pertinently aligned with the international regulatory agenda in that the pursuit of financial stability is afforded prominence by being cast in section 7 as the object of the Act and also by forming the subject matter of a dedicated chapter that precedes the chapters dealing with the prudential and market conduct peaks.<sup>1179</sup> Compared with its Australian and Dutch counterparts the SARB has a dedicated legal framework that focuses extensively on enabling the execution of the central bank's financial stability mandate. This framework provides guidance by broadly defining the object of its mandate, namely "financial stability" and its main threat, a "systemic event". The definition of systemic event subsequently serves to justify the triggering and exercise of stabilizing powers by the central bank so that regulatory and other red tape is avoided that would otherwise constitute hindrances at a time of emergency when swift regulatory action is vital. The risk-based approach and the responsibility and broad obligations that the SARB's financial stability mandate entails is legislatively entrenched making it clear what the SARB's main obligations *ex ante* and *ex post* are. These *ex ante* and *ex post* obligations are also fed through to the manner in which the contents of the financial stability review is to be compiled, ensuring that the risk-based approach is comprehensive and minimising the incidence of gaps. The FSR Act is also mindful of the demands on government funds that the SARB's dealings in relation to systemic events as core function execution of its financial stability mandate will entail: thus the FSR Act seeks to constrain the extent to which the SARB will be able to bind the National Revenue Fund.<sup>1180</sup>

The assistance with the SARB's financial stability mandate is not limited to the financial regulators but has also been extended to organs of state who may take actions

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<sup>1179</sup> Financial stability is dealt with in Chapter 2 of the FSR Act whereas prudential and market conduct regulation are dealt with in chapters 3 and 4 respectively.

<sup>1180</sup> See sections 15(2) and 16(2) of the FSR Act as discussed in chapter 2 at paragraph 2.7.4.

impacting on financial stability. In this way financial stability has become the all-encompassing context against which regulatory decisions in South Africa will have to be made.

Having been privy to the examples of other Twin Peaks jurisdictions, South Africa has also been mindful of the importance of proper structures for cooperation and collaboration between the SARB and the financial sector regulators and organs of state and the regulators themselves, not only to accommodate the effective functioning of the Twin Peaks model but specifically in the context of promoting and maintaining financial stability. It has chosen to design measures to avoid turf wars and recalcitrance by entrenching the obligation to cooperate and collaborate in hard law. When faced with an issue that may compromise financial stability the power to be able to extract information and mandate cooperation and collaboration is pivotal and where this power is entrenched in legislation it is submitted that it immunizes the central bank against deliberate (or undeliberate) inertia by regulators and organs of state.

Whereas the SARB pre-Twin Peaks had an implied financial stability mandate without any legislative framework pinning down some notion of what it is that the SARB has to seek to achieve or the manner by which it must execute this mandate; i.e. its objectives, functions and powers relating to financial stability – it is now clear from the FSR Act what the broad South African notion of financial stability mandate entails, what the objectives of SARB's financial stability mandate entail, that its approach should be risk-based, how it must approach the monitoring of risks and what must be covered in the financial stability review. All these measures make the SARB more accountable than in the pre-Twin Peaks era where its financial stability mandate was as fuzzy as the concept of financial stability itself. The FSR Act also gives explicit recognition to the ability of systemically important financial institutions to inflict systemic harm and the need for the central bank to “control” these institutions as part of its financial stability mandate. It does so by providing the SARB with the (new) power to bring these institutions (which are not limited to banks as in the pre-Twin Peaks dispensation) within its regulatory remit by designating them as SIFIs and by giving the SARB powers to direct the PA to heighten their prudential regulation. The SARB

has therefore become a more “powerful” central bank within the enabling structure of the South African Twin Peaks model as it can steer the course of financial regulation through a variety of directives aimed at enabling the effective execution of its financial stability mandate.<sup>1181</sup>

In this new regulatory milieu the SARB, having the main responsibility for financial stability, is given explicit powers that it can use to get other regulators and organs of state to do what is necessary for purposes of promoting, maintaining or restoring financial stability: it can in terms of section 12(b) advise financial sector regulators and organs of state of steps they must take to mitigate risk to financial stability and in terms of section 18 it can issue a mandatory directive to a financial sector regulator to provide it with relevant information and/or assist the SARB in dealing with a systemic event by acting in accordance with a directive of the SARB which may inter alia include supporting the restructuring, resolution or winding up of a financial institution; preventing or reducing the spreading of risk, weakness or disruption or increasing the resilience of financial institutions to risk weakness and disruption. So when SARB executes its financial stability mandate it is given the power first to advise regulators and organ of state of steps they should take to mitigate risks to financial stability but once risks reach a systemic level the SARB can actually force the financial regulators to provide it with information and take certain steps set out in directives - i.e. it is given emergency powers that it can use to oblige the regulators to take steps necessary for purposes of maintaining or restoring financial stability.

The FSR Act further observes the realization, gleaned from the experiences of jurisdictions such as Australia and the Netherlands, that the success of the Twin Peaks model is dependent on inter-agency cooperation and collaboration: it thus extensively provides for mechanisms enabling coordination and collaboration between the SARB and the financial regulators, the SARB and organs of state and between the financial regulators themselves. All these measures serve to enable the promotion and

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<sup>1181</sup> I.e. the directives that it can issue to financial sector regulators in terms of section 18 to ensure compliance with requests for information and the directives it can issue to the PA regarding prudential regulation of SIFs in terms of section 30.

maintenance of financial stability and also to facilitate the broader effective implementation of the Twin Peaks model – because it is inevitable that if the architecture for financial regulation in South Africa fails that can in itself be a systemic event. Various committees are established, each with a dedicated purpose - thus creating a dedicated and well conceptualized coordinating network in which regulatory overlap and duplication is minimized. The South African Twin Peaks model is aligned with that of Netherlands insofar as it has a dedicated inter-agency body to ultimately act as platform for the various regulators to concertedly focus on financial stability matters. Notably the FSOC will, in the context of financial stability, and with the systemic risk profiling assistance of the FSCF, fulfil the pivotal function of informing the SARB's decisions on financial stability whereas the Financial System Council of Regulators will coordinate the broader cooperation and collaboration necessary to make the Twin Peaks model perform optimally. The Financial Sector Inter-Ministerial Council will facilitate cooperation at government level and will ensure that financial sector legislation for which the policy decisions are taken at ministerial level do not endanger the objectives of financial stability or the broader objectives of financial regulation in accordance with the Twin Peaks model. Insofar as coordination is concerned it is submitted that entrenching the obligation to cooperate and collaborate in legislation is prudent and providing that the contents of such mandatory cooperation and collaboration be set out in MOUs is appropriate because this combination of hard law with soft law will ensure that the regulators observe their obligation to cooperate whilst retaining the necessary flexibility to tweak the MOUs to deal with new matters that may arise - without the cumbersome obligation of going through protracted parliamentary processes which can hamstring swift regulatory action necessary to maintain or restore financial stability.

As regards the toolkit for executing its financial stability mandate it is submitted that the SARB's pronounced powers to advise financial sector regulators and organs of state of steps to mitigate risks, to designate systemic events, issue directives to financial regulators regarding information needed and steps to be taken when a systemic event has occurred and to designate SIFIs will enable it to execute its financial stability mandate more effectively. Given that the effective execution of the SARB's financial stability mandate should further be enabled by the effective execution

of their respective prudential and market conduct mandates of the PA and FSCA and their express duty to assist in the maintenance of financial stability, it is submitted that the regulatory tools afforded to the financial sector regulators will not only enable the effective execution of the SARB's financial stability mandate but also the smooth functioning of the Twin Peaks model overall which is vital to the maintenance of financial stability in South Africa. Writing the requirement to assist in maintaining financial stability into the objectives of the two "peak" regulators reinforces the fact that although the financial stability mandate is ultimately entrusted to the SARB it is not a task that can be undertaken by the SARB alone but that it is actually a responsibility that is shared with the PA and FSCA and even though not stated in as many words, with all the other financial regulators and organs of state that may take actions that impact on the South African financial system. Expressing and expanding on the SARB's financial stability mandate to the extent catered for in the FSR Act ensures that the objective of promoting and maintaining financial stability is infused into, and permeates, the South African Twin peaks model on all relevant regulatory levels. The answer to the question whether the South African Twin Peaks model will better enable and facilitate the promotion and maintenance of financial stability in South Africa than the previous regulatory dispensation, is a resounding "yes" - given the new legal and institutional framework imported by the Twin Peaks model and the express detail in which the SARB's financial stability mandate is entrenched in the FSR Act - and there can be no doubt that South Africa has made a change for the better

Although the overall conclusion with regards to the changed role of the SARB as it now manifests within the Twin Peaks model introduced by the FSR Act is undoubtedly positive there are nevertheless issues that raise concern. It would thus be prudent to heed these matters in order to pre-empt the best way in which to address them:

The "separation" between the SARB and the PA in order to entrust system-wide prudential regulation of financial institutions appears, in the main, to be strategically sound, also from an economic perspective. Prudential regulation has over the years become more complex and burdensome and has especially since the GFC developed into a rather exact science that has accumulated macro-dimensions. As indicated the

establishment of a “separate” prudential regulator ensures that the SARB is not overburdened by the exigencies of prudential regulation that may dilute its regulatory focus but that it is also able to avoid the conflicts between financial stability and prudential regulation. However, although the PA is a separate juristic entity, and its composition and mandate is quite different from that of the former BSD of the SARB that did prudential regulation and supervision of banks only in the pre-Twin Peaks dispensation, its independence is questionable. Given that the PA is housed under the same roof as SARB and its steering committee is comprised entirely of SARB officials, namely the Deputy Governor (Financial Stability) as CEO with the Governor of SARB and other Deputy Governors and many of its officials will be persons previously employed by SARB, it is difficult to conceive how conflicts between financial stability and prudential regulation will be dealt with. It is accordingly submitted that this position may compromise the main objective for excising banking regulation from the remit of the SARB.

Given that the FSCA is a totally separate juristic person housed outside the SARB on whose steering committee SARB has no representation it is arguable that the SARB will have less “control” over the FSCA than over the PA and also that cooperation and collaboration between SARB and the FSCA might not be as smooth as that between SARB and the PA. Notably the regulatory culture that prevailed within the SARB pre-Twin Peaks can be expected to be continued within the PA to a large extent given that the PA will in a sense still be an “extension” of the SARB. However the regulatory culture in the FSCA will conceivably to a large extent remain that which was characteristic of the former Financial Services Board although some persons who were previously employed by SARB can be expected to be moved over to the FSCA to assist with the new task of supervising the conduct of banks. Thus the regulatory culture of SARB and that of the PA will be more aligned with each other as opposed to the quite distinct culture of the FSCA.

It will also be critical to the effective functioning of the South African Twin Peaks model to ensure the highest level of inter-agency cooperation. Given that the PA will have such close ties with the SARB it will have to be ensured that the PA and the FSCA

remain equal as the regulatory twins in this system and that the FSCA does not become the handmaiden of the SARB and PA, thus not acknowledging the very vital contribution of effective conduct of business regulation in the context of financial stability.

## **5.6 Lessons from Australia and the Netherlands**

This thesis also sought to establish what lessons could be learned by South Africa as a new Twin Peaks jurisdiction from the experiences in Australia and the Netherlands, specifically in relation to the changed role of the central bank and its expanded and more pronounced financial stability mandate and also in the broader context of Twin Peaks as a model for financial regulation?

### **5.6.1 Lessons from Australia**

Australia has set a prime example for other countries as to how to maintain financial stability and to successfully implement a Twin Peaks model of financial regulation. The lessons it yield relate not so much to how the central bank executes its financial stability mandate but more to how to make the Twin Peaks model work so that the execution of the central bank's financial stability mandate is effectively executed.

The architecture of the Australian Twin Peaks model differs from the South African Twin Peaks model in that whereas both models essentially have three peaks there is a bigger and more distinct separation between these peaks in Australia where the prudential regulator, like the market conduct regulator, is totally separate from the central bank. Further, Australia is a developed country with a strong and resilient economy and arguably the same constraints regarding maximising on resources and synergies that applies in South Africa, is not applicable to the Australian regulators. Thus the Australian model ensures greater operational independence for its regulators by locating them in three distinct and operationally separate peaks.

Although Australia, like South Africa, entrusts the financial stability mandate to the RBA as central bank, this mandate is a joint mandate shared by the RBA and APRA and in respect of which they are given equal but different and complementary responsibilities. It is submitted that there is a marked difference between giving the prudential regulator a financial stability mandate (as in Australia) as opposed to stating that the prudential regulator must “assist” in maintaining financial stability (as in South Africa) - the Australian prudential regulator would arguably regard its responsibility for financial stability as on par with that of the central bank thus would be likely to take a more firm stand in the event of conflict than would be the position where it merely has to ‘assist’ in the maintenance of financial stability. APRA as Australian prudential regulator is thus similarly accountable as the RBA as central bank for maintaining financial stability which informs its presence and visibility as a very prominent, strong and independent regulator. This arguably means that APRA takes prudential regulation as the measure by which to achieve the realization of its financial stability mandate more seriously than a regulator whose objective states that it has only has to “assist” in maintaining financial stability. Being responsible for maintaining financial stability and being responsible for assisting in maintaining financial stability are two different mandates, the former implying a greater level of accountability than the latter and it is submitted, a greater motivation to regulate so that financial stability is promoted and maintained.

However, not only the central bank and the prudential regulator is given responsibility for financial stability - ASIC as separate and independent market conduct regulator - also has a specific role to play in this regard by means of its obligation to contain risk in the clearing and settlement system. However the ASIC Act does not expressly confer a financial stability mandate on ASIC that is comparable to the financial stability mandates conferred on the RBA and APRA. Nevertheless the mere fact that ASIC attends to market conduct regulation is crucial in enhancing the promotion and maintenance of financial stability as sound prudential regulation by itself will not be sufficient to guarantee a stable financial system. Nor for that matter will any roles fulfilled by the RBA suffice to promote and maintain financial stability in the absence

of the crucial functions undertaken by the prudential and market conduct regulators respectively.

It is therefore submitted that the lesson in this regard is not that South Africa must now move its prudential regulator to a separate building far away from the central bank. The South African reality differs markedly from that of Australia and the implications of moving the prudential regulator in South Africa to a separate location in order to achieve greater operational independence would occasion great costs that may be put to better use elsewhere. The lesson is rather that by giving the central bank and the prudential regulator express and equally important financial stability mandates it may have the unintended consequence of downplaying the important role that the market conduct regulator fulfils in the overall context of financial stability. Thus South Africa is better off in “aligning” the objectives of prudential and market conduct supervision, as is indeed done in the FSR Act. It could however augment these objectives by indicating that the PA and FSCA must assist in the “*promotion and maintenance*” of financial stability.

Another lesson yielded by the Australian Twin Peaks model is the necessity of a “clean” approach to the objectives and functions of regulation. By this it is meant that the legislative framework facilitating the operation of the Australian Twin Peaks model clearly spells out the objectives and functions of each regulator, thus clearly demarcating their respective jurisdictional remits hence minimizing opportunity for overlap and duplication. South Africa would be well-advised to heed this lesson.

Probably the biggest lesson to be taken from the Australian experience is the role that cooperation and collaboration play in a Twin Peaks model as enabling institutional framework targeted at maintaining financial stability. Notably Australia has also demonstrated the importance of regulatory culture to the effective implementation of the Twin Peaks model and the fact that successful cooperation and collaboration can be achieved by means of a flexible soft law approach where the regulatory culture supports such an approach. This should be encouraging for South Africa because

although the general obligation to cooperate and collaborate is cast in hard law the practical implementation thereof will be by means of memoranda of understanding between the regulators. Australia has demonstrated that this is an approach that can work. It is further submitted that having regard to the contents of the MOUs between the Australian regulators may be instructive to the South African regulators. As these MOUs are living documents nothing prevents the South African regulators, even after they have already concluded their respective MOUs, to amend same if they note aspects in the Australian MOUs that can improve the practical measures for collaboration and cooperation between them.

Australia further yields the lesson of never becoming complacent about financial regulation. This is clear from the fact that it has pre-emptively chosen to shift to a Twin Peaks model in times that there was no crisis looming. It is also evident from the fact that it is currently again busy with a Royal Commission of Inquiry into its financial system.

Lessons can however also be taken from measures Australia failed to implement. Pertinent in this regard is the prudent suggestion during the 2014 Financial Inquiry that Australia should subject its system of soft law MOUs between the regulators to external review. It is submitted that such a process would have put Australia in a better position to detect where it could improve the system of collaboration and cooperation between its central bank and financial regulators thus addressing gaps in this network that could put Australia at a disadvantage in crisis times. It also appears that Australia does not have a dedicated body, consisting of various agencies, to support and advise the central bank on matters regarding financial stability such as the South African FSOC and the Dutch FSC and it is submitted that it is something that Australia should consider adding to their Twin Peaks model. Australia could possibly even take a lesson from South Africa insofar as creating a dedicated legal framework (such as that contained in the FSR Act) specifically aimed at the promotion and maintenance of financial stability is concerned.

### 5.6.2 Lessons from the Netherlands

The Netherlands is a developed jurisdiction with a strong economy and has over the centuries been prominent in the financial history of the world. The Netherlands also has a well - established central bank, established as long ago as 1814 already (thus making it much more established than its South African and Australian counterparts) and which pre-Twin Peaks operated within a sectoral model of financial regulation, thus very similar to the South African scenario pre-Twin Peaks.

Pre-Twin Peaks DNB had the same traditional roles as the SARB, namely responsibility for monetary policy (first on its own and later in conjunction with the ECB), bank supervision (including supervision of investment companies); oversight of the payments, clearing and settlement system, acting as lender of last resort and responsibility for the maintenance of financial stability. Its mandate for financial stability was implied and neither its role in relation to financial stability nor its role as lender of last resort was captured in legislation.

The Dutch Twin Peaks model, is a classic Twin Peaks model conforming to the original model as proposed by Michael Taylor. It has two peaks namely prudential and systemic regulation located in DNB and market conduct regulation located in AFM. Unlike the Australian model, it did not separate the responsibility for financial stability and prudential stability between two totally separate regulators but kept it under one roof in DNB. Given that DNB had been the systemic and prudential regulator all along before the move to Twin Peaks it appears that the regulatory sentiment was that keeping systemic and prudential regulation within DNB would not be too daunting and would very much be “business as usual” for DNB with the added obligation that its prudential supervision remit was expanded to include prudential regulation of not only banks and investment companies, but also other financial institutions. However it is submitted that getting an expanded mandate for financial stability as well as system-wide prudential regulation just before the GFC must have been very daunting even for an established central bank such as DNB.

AFM, was converted from STE that did the market conduct regulation pre-Twin Peaks with the difference that it now had a wider regulatory remit including system-wide market conduct supervision and regulation. Notably DNB's mandate for financial stability was at that stage (probably because it occurred pre-GFC and the focus was not yet as prominently on financial stability as post GFC) not dealt with in any specific detail in any legislation. The Dutch did however realize that to make Twin Peaks work it was necessary to have some measures in place to facilitate collaboration between DNB and AFM hence the 2007 Covenant was entered into by the two regulators.

The GFC did not leave the Netherlands unscathed as is evident inter alia from the banking failures that occurred in this time. DNB as systemic and prudential regulator seemed not to be appropriately equipped for the more intrusive regulation required to mitigate, contain and manage the challenges posed by the GFC. However it appears that this inability to properly execute its powers as prudential regulator was not to be ascribed to the Twin Peaks model per se but rather to the fact that DNB had a culture of "light touch" regulation.

So what are the lessons that South Africa can learn from the comparative study of the Netherlands?

First, the Dutch experience affirms that the Twin Peaks model is a suitable model for financial regulation as it was able to see the Netherlands through the GFC albeit that there were some regulatory failures. It however appears that these regulatory failures were not inherent in the Twin Peaks model itself but rather occasioned by the fact that DNB was not an aggressive regulator and that it operated more in a culture of moral suasion than actual intrusive enforcement.

The Dutch Twin Peaks model further recognized systemic regulation as pivotal to ensuring that the Dutch financial system remained stable but it appears that initially it

did not focus sufficient attention on this aspect - as is clear from the fact that it did not initially change the mandate of DNB as set out in the *Bankwet* to make its financial stability mandate more express. Thus, although DNB was the systemic regulator it appears that the necessary regulatory focus insofar as systemic regulation was concerned was lacking, at least in the initial phase of the Dutch Twin Peak's implementation. It is submitted that if more thought went into the Wft as framework legislation introducing the Dutch Twin Peaks model insofar as the promotion and maintenance of financial stability is concerned and DNB were provided with specific objectives, functions and powers directed at all three levels of mitigation, monitoring and management of the effects of systemic events and a support structure comprising of mandated cooperation and collaboration, it is likely that DNB's execution of its financial stability mandate would have been more pro-active and robust during the GFC. This more robust approach to its financial stability mandate would then most likely have spilled over onto its mandate for prudential regulation and we might have seen less prudential failures in the Netherlands during the GFC.

One also tends to wonder whether it was really such a good idea for the Netherlands to keep prudential regulation within the remit of DNB that had an established culture of non-invasive regulation. Of course such a decision would always involve a cost-benefit analysis considering the costs that can be saved and the synergies that are generated by keeping prudential and systemic regulation in one institution. However it unfortunately also has the effect of diluting the regulatory focus and energy - possibly in the end leading thereto that neither of these two mandates are executed optimally.

One also wonders whether it was such a good idea for the Netherlands to dissolve the RFT as inter-agency coordinating body. Granted, the obligations of the regulators to collaborate and cooperate have been captured extensively in hard law and has been given a soft law overlay in the form of Covenants but it is submitted that facilitation of such collaboration and cooperation would be better achieved if an inter-agency collaborative body drove the process. Fortunately the Dutch had the insight to provide in their legislation for regular review of the mechanisms for cooperation and collaboration. They also have a dedicated Financial Stability Committee which focuses

on facilitating the promotion and maintenance of financial stability and would possibly also fulfil some of the functions that an interagency body for purposes of facilitating broader Twin Peaks cooperation would fulfil.

It appears that the GFC was quite an eye-opener for the Netherlands as it revealed aspects in which its regulatory approach had to be improved to make the Dutch financial system more resilient. Accordingly South Africa can learn much in this regard as well namely that it is important to heed signs indicating regulatory shortcomings within the Twin Peaks model and to swiftly attend to necessary reform. It has the Dutch Twin Peaks history to its avail to anticipate future problems and effect the necessary reforms timeously.

Finally, one should be mindful that the Netherlands is in a sui generis position as an EU Member State where it is “cushioned” by the pro-active measures taken on EU-level to promote and maintain financial stability and that it also has the benefit of having an EU-wide entity such as the European Systemic Risk Board that can help it with detecting, monitoring and mitigating risks.

## **5.7 Quo vadis South Africa?**

This thesis has demonstrated that the role of the South African Reserve Bank as central bank with a de facto implied financial stability mandate in the pre-Twin Peaks dispensation has significantly changed after the Global Financial Crisis. It has further demonstrated that this express and expanded financial stability mandate of the SARB has been appropriately captured in the legislative and institutional framework provided by the Financial Sector Regulation Act that introduced the architecture for the South African Twin Peaks model. The SARB’s authority and powers to execute its more intrusive financial stability mandate is cast in legislative provisions that captures the main features of its elaborated mandate as opposed to older Twin Peaks jurisdictions such as Australia and the Netherlands who with time also realized the need to at least expressly capture the central bank’s financial stability mandate in legislation. The

South African legislative framework capturing the SARB's financial stability mandate can be regarded as progressive and can mainly be ascribed to the fact that South Africa was in the fortunate position of being able to learn from the lessons yielded by the GFC and from jurisdictions that have already implemented Twin Peaks models of financial regulation thus enabling South Africa to cherry pick from these experiences to inform the manner in which it dealt with the changed role of its central bank within the context of its new Twin Peaks model.

It is submitted that the value that this thesis hopes to add is that it has provided an informed view generally of the evolution and roles of central banks prior to the GFC and also how these roles have changed with the emergence of financial stability as core objective post GFC. It has demonstrated that it is indeed very difficult to regulate a financial stability mandate but that it is achievable - as is evident from the financial stability provisions in the FSR Act. It has provided scholars with material on the role of the South African Reserve Bank and the new South African Twin Peaks model that could be put to good use in future research, especially from a comparative perspective. By meticulously detailing developments regarding Twin Peaks in the Netherlands and Australia it has also endeavoured to create a sound basis that other scholars may refer to during comparative studies.

In conclusion, some recommendations are apt in order to ensure that South Africa's Twin Peaks journey, encompassing its central bank's expanded financial stability mandate, is a successful one:

On the face of it the South African model where systemic regulation and prudential regulation respectively is given to the SARB and PA as two separate entities located within one building and drawing on the same resource structures appears to address the problem of conflicts of interest insofar as the objectives of financial stability and prudential regulation are concerned. However, given the fact that the PA's main decision-making body, the Prudential Committee is comprised solely of SARB governors, it does raise concerns that this arrangement might be too close for comfort and that the opportunity for capture of the one entity by the other might be occasioned

by this “incestuous” arrangement. Given that the PA which was previously part of the SARB “family” (albeit with a very narrow prudential remit as bank supervision department) is now still operating “under the same roof” as the SARB that is in the current dispensation supposed to be concerned with overall system stability and not with the nitty gritty of prudential regulation, one can indeed ask whether keeping these two entities under one roof with the Prudential Committee comprising solely of SARB officials is the best way forward for South Africa. It is submitted that with this new arrangement there is the possibility of regulatory capture either way: on the one hand the SARB may become too involved with prudential matters even though it falls outside its new regulatory remit and may in the process compromise its reputation as independent systemic regulator if it inappropriately steps in to prevent prudential failures or collapse of financial institutions. On the other hand, the PA may be overstepping its regulatory boundaries and succumbing to conflicting interests if it tailors its approach to prudential regulation to appease the SARB rather than to ensure that it is properly serving the interests of prudential regulation. After all, the “boss” of the SARB used to be the “boss” of the person that will be the head of the PA in the Twin Peaks dispensation.

## **5.8 Recommendations for reform**

### **5.8.1 Recommendation One**

It is recommended that the composition of the Prudential Committee as “steering” committee of the prudential authority be revisited in order to minimize opportunity for “capture” of the PA by the SARB. It is inevitable that instances will arise where a conflict may arise between financial stability and prudential regulation and the South African public needs to have the assurance that it will be approached in a manner that does not entail the PA being steamrolled to preserve financial stability by SARB who “rescues” financial entities who should rather be left to fail and exit the financial system.

### **5.8.2 Recommendation Two**

In order to achieve a better blend between the regulatory cultures of the SARB, PA and FSCA for the sake of better cooperation and collaboration it is submitted that a rotation or secondment-system be devised in terms whereof selected personnel from the PA and personnel from the FSCA rotate on a regular basis in order to achieve more homogeneity in the regulatory cultures of the peak regulators.

### **5.7.3 Recommendation Three**

It is recommended that dedicated research be undertaken to consider specifically the role of the SARB as lender of last resort in the post GFC milieu which has witnessed significant developments in respect of this traditional role of central banks. This is arguably one of the SARB's most acute stabilizing powers and although some progress has been made in demarcating its scope and application, it remains to be determined how to "demystify" and legislatively entrench this particular role for purposes of legal certainty - without triggering moral hazard and eroding the very financial stability that the central bank seeks to protect.

### **5.8.4 Recommendation Four**

It is suggested that the SARB should also be empowered to make financial stability standards, like the RBA, in Australia to better foster a culture of promoting and maintaining financial stability in South Africa.

### **5.8.5 Recommendation Five**

Further to the issue of cooperation and collaboration, it is suggested that consideration could possibly be given to capturing immutable aspects of this obligation in legislation in addition to the requirement that the SARB and the financial regulators enter into MOUs. Although it is conceded that the flexible nature of MOUs are indeed beneficial

as they can be adapted easily to changing circumstances it is nevertheless submitted that casting some aspects such as conflict resolution and which entity will have the final say in such event will add to legal certainty. Crisis times are not time for regulatory stand-offs. On this note it could perhaps be considered whether Covenants, like in the Netherlands and which have a more binding nature, should not rather be entered into instead of MOUs.

#### **5.8.6 Recommendation Six**

It is recommended that the MOUs to be entered into by the SARB and the financial sector regulators should, in addition to setting out general arrangements for cooperation and collaboration, also focus strategically on crisis management so that there can be no confusion about the roles, functions and powers of the SARB and the financial regulators in times of financial crisis. It should further set out specific procedures for resolving conflicts between the regulators.

#### **5.8.7 Recommendation Seven**

Specifically with regard to the MOUs for collaboration and cooperation it is suggested that these memoranda be reviewed, not only locally, but also by international bodies such as the IMF that has a global perspective on the issues that should be dealt with in these documents. South Africa should also regularly consult such MOUs entered into by Twin Peaks jurisdictions such as Australia and the Netherlands to keep abreast of any new developments that may aid in achieving greater collaboration and cooperation.

### **5.9 Topics for further research**

Other aspects relating to roles of the SARB that impacts on its mandate for financial stability should also be investigated. As such further research is required on the interaction between the SARB's mandate in respect of monetary policy aimed at price

stability and its implications for financial stability. It is especially necessary to investigate how these two mandates will be exercised side by side without the one compromising the other. Likewise further research is necessary on the interaction between payments system supervision and the SARB's financial stability mandate. Prevention is better than cure thus it would be prudent to pre-empt conflicts that may arise and devise a workable solution to deal with such conflicts without eroding SARB's ability to effectively execute its financial stability mandate.

As the newly established Prudential Authority and Financial Sector Conduct Authority will respectively be undertaking prudential and market conduct regulation and supervision that is pivotal to financial stability in South Africa it is further suggested that research be undertaken to establish whether the fulfilment of the objectives of each legislator is effectively facilitated by the Twin Peaks framework legislation and subsequent changes effected to sector specific legislation. Various aspects of the regulatory objectives of each regulator, such as regulating the soundness and safety of financial institutions by the PA, or the FSCA's objective to ensure greater consumer protection through fair treatment of consumers and also consumer education and financial literacy programs as well as their functions also require more in-depth investigation. Such research can add value to improving the ability of the South African Twin Peaks model to enable effective and efficient financial regulation which in turn, will contribute to the promotion and maintenance of financial stability.

Finally the role of the National Credit Regulator in the Twin Peaks model and how it can be ensured that it contributes to the overall financial stability objectives as well as the broader Twin Peaks objectives, would make a useful and interesting study.

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Description	Citation
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<p>Commencement of amendments to Financial Markets Act, 2012, as contained in the Financial Sector Regulation Act, 2017, published in <i>Government Gazette</i> no. 41433 volume 632 of 9 February 2018 (Regulation Gazette no. 10802 – National Treasury notice 99 of 2018) <a href="https://www.greengazette.co.za/notices/financial-sector-regulation-act-9-2017-commencement-of-amendments-to-financial-markets-act-2012-as-contained-in-financial-sector-regulation-act-2017_20180209-GGR-41433-00099.pdf">https://www.greengazette.co.za/notices/financial-sector-regulation-act-9-2017-commencement-of-amendments-to-financial-markets-act-2012-as-contained-in-financial-sector-regulation-act-2017_20180209-GGR-41433-00099.pdf</a> (accessed 27 March 2018) 127</p>	
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<p>Insurance regulations in terms of section 291 of the FSR Act published for comment in <i>Government Gazette</i> no. 41523 volume 633 of 23 March 2018 (National Treasury Notice number 357 in terms of the Short-term Insurance Act, 1998 and</p>	

<p>National Treasury Notice number 358 in terms of the Long-term Insurance Act, 1998) <a href="http://www.treasury.gov.za/twinpeaks/Annexure%20A_Insurance%20Regulations%20for%20Comment_%20Gazette%20No_41523.pdf">http://www.treasury.gov.za/twinpeaks/Annexure%20A_Insurance%20Regulations%20for%20Comment_%20Gazette%20No_41523.pdf</a> (accessed 1 April 2018)</p>	
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<p>Department of National Treasury (Republic of South Africa) “A safer financial sector to serve South Africa better” (23 February 2011) <a href="http://www.treasury.gov.za/twinpeaks/20131211%20%20Item%202%20A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf">http://www.treasury.gov.za/twinpeaks/20131211%20%20Item%202%20A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf</a> (accessed 9 November 2015)</p>	<p>National Treasury Red Book 2011</p>
<p>Department of National Treasury (Republic of South Africa) and the South African Reserve Bank and the Financial Services Board (20 August 2015) “Strengthening South Africa’s resolution framework for financial institutions” <a href="http://pmg-assets.s3-website-eu-west-1.amazonaws.com/150813Resolution_Framework_Policy.pdf">http://pmg-assets.s3-website-eu-west-1.amazonaws.com/150813Resolution_Framework_Policy.pdf</a> (accessed 22 October 2017)</p>	<p>Strengthening resolution framework 2015</p>
<p>South African Reserve Bank – Financial Stability Department “A new macroprudential policy framework for South Africa (November 2016) <a href="https://www.resbank.co.za/Lists/News%20and%20Pucblications/Attachments/7660/Macroprudential%20policy.pdf">https://www.resbank.co.za/Lists/News%20and%20Pucblications/Attachments/7660/Macroprudential%20policy.pdf</a> (acessed 29 August 2017)</p>	<p>SARB Macroprudential Policy document 2016</p>
<p>South African Reserve Bank – Financial Stability Department “Designing a deposit insurance scheme for South Africa - a discussion paper” (May 2017) <a href="https://www.resbank.co.za/">https://www.resbank.co.za/</a></p>	

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South African Reserve Bank – The National Payment System Framework and Strategy Vision 2015 (2015) <a href="https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NPS)/Documents/Overview/Vision2015.pdf">https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NPS)/Documents/Overview/Vision2015.pdf</a> (accessed 31 December 2017)	

### Interviews, speeches and presentations

Description	Citation
Interview conducted with Marco van Hengel, senior policy advisor from DNB, dated 21 March 2018	Interview van Hengel 2018
Interview conducted with Dr Johann de Jager, General Counsel at the South African Reserve Bank, in Pretoria on 27 June 2017	Interview de Jager 2017
Presentation by Frank Elderson, Executive Director in the Governing Board of DNB, at a Symposium on Ethics and Moral Hazard in the European Banking Union held on 10 November 2016 at Leiden in the Netherlands, organised by the Hazelhoff Centre for Financial Law	Presentation Elderson 2016
Speech by Bernie Fraser, Governor of the Reserve Bank of Australia on 10 April 1990 at Sydney “Aspects of the RBA’s supervisory function”	
Presentation by Professor Andrew Godwin, University of Melbourne, at the Colloquium on Twin Peaks held on 28 September 2017 in Pretoria, organised by the Faculty of Law, University of Pretoria, entitled “The trek towards Twin Peaks in Australia”	Presentation Godwin 2017

<p>Presentation by Professor Nick Huls, Van Vollenhoven Institute, University of Leiden, at the Colloquium on Twin Peaks held on 28 September 2017 in Pretoria, organised by the Faculty of Law, University of Pretoria, entitled “Twin Peaks in a flat country: Observations from the Netherlands”</p>	<p>Presentation Huls 2017</p>
<p>Opening address by the Governor of the South African Reserve Bank, Lesetja Kganyago, at the South African Reserve Bank Financial Stability Research Conference in Pretoria on 26 – 27 October 2017</p>	
<p>Presentation by Jean-Pierre Landau, Associate Professor of Economics at SciencesPo (Paris) “A macroprudential approach to liquidity regulation” at the South African Reserve Bank Financial Stability Research Conference in Pretoria on 26 – 27 October 2017</p>	
<p>Address by Mboweni, Governor of the South African Reserve Bank at the Council for Businesswomen Pretoria 14 March 2000 “The role of the South African Reserve Bank in the economy” <a href="https://www.bis.org/review/r000321a.pdf">https://www.bis.org/review/r000321a.pdf</a> (accessed 31 December 2017)</p>	
<p>Presentation by Professor Justin O’Brien, Professor of Financial Regulation, Australian Centre for Financial Studies, Monash Business School, Australia at the Colloquium on Twin Peaks held on 28 September 2017 in Pretoria, organised by the Faculty of Law, University of Pretoria, entitled “Twin Peaks: Some contrary views”</p>	<p>Presentation O’Brien 2017</p>
<p>Presentation by Professor Gail Pearson, Professor, University of Sydney, at the Colloquium on Twin Peaks held on 28 September 2017 in Pretoria, organised by the Faculty of Law, University of Pretoria</p>	<p>Presentation Pearson 2017</p>
<p>Speech by Peter Praet, Member of the Executive Board of the European Central Bank at the 14<sup>th</sup> Annual Internal Banking</p>	

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Interview conducted with Professor dr. W.A.K. Rank, Advocaat-Partner NautaDutilh N.V. Lawyers, Civil law notaries and Tax advisers, and professor of Financial Law, University of Leiden in the Netherlands, on 16 November 2016	Interview Rank 2016
Presentation by Advocate Doctor Schmulow, Senior Lecturer, School of Law, University of Western Australia, at the Colloquium on Twin Peaks held on 28 September 2017 in Pretoria, organised by the Faculty of Law, University of Pretoria, entitled “Twin Peaks in Australia: Seismic activity and fault lines”	Presentation Schmulow 2017
C Stals “Monetary Policy and Inflation Targets” address at the AGM of the South Africa/Canada Chamber of Business, Johannesburg, 2 May 1996	
Address by Glenn Stevens, at the time Governor of the Reserve Bank of Australia, to the Australian Securities and Investments Commission (ASIC) Annual Forum, Sydney, 26 March 2013 on “Financial regulation – Australia in the global landscape”	Stevens 2013
Presentation by Dr Janet Terblanche, Head of Policy Division, Prudential Authority of South Africa, at the Colloquium on Twin Peaks held on 28 September 2017 in Pretoria, organised by the Faculty of Law, University of Pretoria, entitled “Twin Peaks South Africa: Some observations on the Prudential Authority”	Presentation Terblanche 2017
Interview conducted with Professor Michel Tison (Dean of the Law School at Ghent University, Belgium, on 26 January 2016	Interview Tison 2016

Interview conducted with Professor Nicola Viegi, South African Reserve Bank Professor of Monetary Policy Studies at the Department of Economics, University of Pretoria, on 25 August 2017	Interview Viegi 2017
Presentation by William White, Chair of the Economic and Development Review Committee, OECD, at the South African Reserve Bank Financial Stability Research Conference in Pretoria on 26 – 27 October 2017, Papers from presenters available at <a href="https://www.resbank.co.za/FINANCIAL%20STABILITY/FINSTAB_RESEARCH_CONFERENCE/Pages/Presentations.aspx">https://www.resbank.co.za/FINANCIAL%20STABILITY/FINSTAB_RESEARCH_CONFERENCE/Pages/Presentations.aspx</a>	
Interview conducted with Maarten Willemen, Senior Policy Advisor at De Nederlandsche Bank and Cornelis Jansen, Manager Public and International Affairs of the <i>Stichting Autoriteit Financiële Markten</i> , in Amsterdam on 17 November 2016	Interview Willemen & Jansen 2016

### Table of cases

<b>South Africa</b>
<i>Certification of the Constitution of the Republic of South Africa 1996</i> , 1996 (4) SA 744 (CC)
<i>South African Reserve Bank v Public Protector and Others</i> (Case number 43769/17) [2017] ZAGPPHC 443; [2017] 4 All SA 269 (GP); 2017 (6) SA 198 (GP) (15 August 2017)