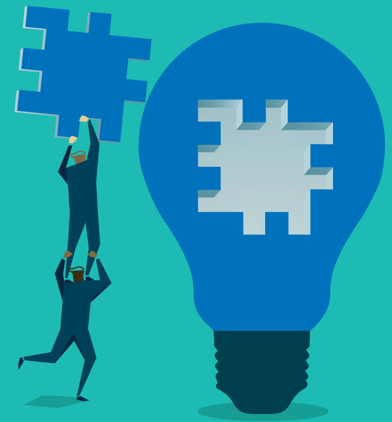
Market Conduct: Regulatory change is upon us and it cannot be avoided!



What is Market Conduct?

2017 will usher in the new Market Conduct regulatory framework, which will bring with it extensive regulatory change for all South African financial institutions. In fact, it is arguably the single most significant financial sector regulatory reform that South Africa has ever experienced. The introduction of a Market Conduct regulatory framework is part of the Government's decision to shift to a Twin Peaks model of financial regulation.

Essentially, the Twin Peaks model contemplates that the financial services sector will have two primary regulators, being a Prudential authority and a new Market Conduct regulator. The Prudential authority's primary objective will be to maintain and enhance the safety and soundness of financial institutions that provide financial products, whereas the Market Conduct regulator will be responsible for the regulation and supervision of the conduct of business of all financial institutions, and the integrity of the financial markets.

The Financial Sector Regulation Bill, which is currently before Parliament, is expected to be enacted during the first quarter of 2017. When enacted, the Bill will establish and give effect to the two new regulatory authorities. As it pertains to Market Conduct, the Financial Services Board ("FSB") will be dissolved and replaced by the Financial Sector Conduct Authority ("FSCA") who will assume their new Market Conduct regulatory mandate.

You would be correct if you think that this sounds similar to the FSB's existing Treating Customer Fairly ("TCF") programme. Market Conduct is very much an expansion and enhancement of the TCF approach. TCF dovetails-in very neatly with Market Conduct and it is envisaged that the TCF outcomes will be adopted by the FSCA as the blueprint for its regulatory mandate, with the aim to entrench the principles of the fair treatment of financial customers.

The FSB has been driving the TCF initiative for a number of years already, and their hope is that financial institutions will have already started the process of applying the TCF principles of fair treatment of customers. TCF requires all financial institutions to consider how they treat financial customers at all times, across the entire product value chain, from product design, approval, development, marketing through to advice, point-of-sale and after-sale support. TCF really attempts to drive the move from a product centric focus to customer centricity.

Why is it being introduced?

Market Conduct is not new in South Africa and our regulators have been grappling with how to ensure the fair treatment of customers for years through existing financial sector specific legislation. While there has been some progress in this regard, persistent and pervasive Market Conduct challenges and practices, unfair treatment of customers, and poor customer outcomes in South Africa's financial sector have highlighted the need for stronger regulatory oversight of how institutions conduct their business and treat their customers.

Weaknesses in the industry have been identified to include, among others, poor governance and control structures; weak corporate culture, mind-set and behaviour; inappropriate incentivisation; high, opaque and complex fee structures; lack of transparency and disclosure; design and sale of inappropriate products; reckless lending and poor collection processes.

The current legislative framework is considered to be fragmented, inconsistent, and incomplete across the financial sector and too institutionally focused (as opposed to functionally focused), which in turn compromises the effective supervision of Market Conduct by the regulators. It was determined that the potential for economic disruption and consumer hardship, should institutions fail to meet their "promises", means that the financial sector must be held to a much higher regulatory standards than generic consumer protection laws, in order to better protect customers, and standards must be applied consistently across the sector.

Ultimately, it was identified that the need for a holistic and co-ordinated Market Conduct regulatory framework that applies consistently across the financial sector can best be achieved through structural change to the regulatory framework and through the creation of a dedicated Market Conduct regulator – the FSCA.

What does it mean for institutions?

Maybe the first important requirement for institutions, is to accept the regulatory change. It will certainly bring additional burden and cost with it, and it is unlikely to be welcomed. But it is happening, Market Conduct is not going away, and as such, it cannot be avoided! No industry segment is immune and Market Conduct will impact directly across retail, wholesale and investment banking, insurance and investment management.

Market Conduct will introduce a distinct shift in the manner and approach to the regulation and supervision of the financial services industry by the FSCA, and a change in what institutions will need to do to ensure compliance.

The FSCA will move away from a rules based, reactive, tick-box compliance approach, to a principle based, forward looking, pre-emptive, outcomes focused and risk-based approach. They will be intensive and intrusive in their supervision.

The FSCA is going to want to see and understand institutions' governance structures, risk controls, corporate culture and their business practices. This will not just be a "tick-box" exercise, the FSCA is going to require institutions to objectively demonstrate to them how the institutions' governance structures, risk controls, corporate culture and business practices apply to ensure the fair treatment of customers. Quality management information is going to become critical. The FSCA is going to want to assess and analysis financial institutions' management information, to determine for themselves that institutions are meeting their Market Conduct obligations.

Institutions should, as a first step in their Market Conduct journey, perform an assessment of their business model and strategy with the aim of identifying and assessing those conduct risks prevalent in their business. To be able to manage, monitor and measure conduct risks, those conduct risks must first be identified and assessed.

Then of course, institutions should implement the necessary governance structures, policies, processes and procedures to be able to manage, monitor and control conduct risks. A Market Conduct risk framework should be established, within which the governance structures and policies will operate.

But it is not sufficient that institutions have the governance structures and risk controls in place to manage Market Conduct. It is not enough that management and staff are trained on these risk controls. To properly implement Market Conduct, all management and staff must understand and appreciate what Market Conduct is, the basis or rationale for it, and support the need for its introduction into the business. This is referred to as the organisations culture.

Regulators around the world are identifying that risk controls and compliance management systems are not enough to resolve misconduct issues. Culture is being seen as a root cause for continued Market Conduct failings. Improved Market Conduct requires improved corporate culture. The challenge is to reset the corporate culture. And institutions must be able to reflect that it is being taken seriously and being addressed. The FSCA will want to see institutions' commitment to improving their corporate culture and that the fair treatment of customers is central to it.

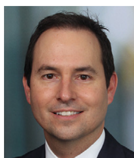
Market Conduct is not just about regulatory compliance. It is, in fact, more important to building a sustainable business. Business leadership needs to push the right cultural mind-set down into the business. Tone from the top is an important indicator of a good corporate culture and business leaders will be held accountable for this by the FSCA. For the right culture to pervade through a financial institution, business models and strategies must reflect the fair treatment of customers alongside profit maximisation. Market Conduct should be seen as one of a financial institution's top strategic and cultural drivers.

And all of this is going to have to be objectively demonstrable to the FSCA. We would reiterate the importance of quality data. Further, institutions will require management information tools to monitor, manage and measure Market Conduct risk. Institutions must understand what the management information is telling them – they must be able to analyse and interpret it. Importantly, institutions must be able to evidence that they have acted on their findings in respect of the management information, to mitigate against the Market Conduct risks and to enhance the customer outcome.

We are going to see significantly enhanced regulatory reporting requirements. The FSCA is going to require detailed data to assist them in this risk based approach in identifying their specific Market Conduct risks and trends. Like the institutions themselves, the FSCA will analyse and interpret the data to determine their own view of the Market Conduct risks and trends.

Having said all of the above, while the FSCA will be "intensive and intrusive" in its supervision, we understand that the regulator's intention is not to overburden the financial services industry unduly with regulatory rules and hurdles. Where the FSCA is satisfied and comfortable that there has been a change of culture and behaviour towards regulatory compliance and the proper adoption of the principle and outcome based approach, it is more likely to step back – if it has evidence and can trust that the corporate culture is healthy and that Market Conduct principles are being applied.

Confidence and trust does not only need to be restored with the customer, but with the regulator too!



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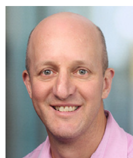

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