LAW MATTERS

CONDUCT OF FINANCIAL INSTITUTIONS BILL: TWIN PEAKS OR EVEREST?

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THE financial industry is in a state of overhaul due to the phasing in of the "Twin Peaks" regulatory model. This model sees the consolidation of market conduct regulation under one body – the Financial Sector Conduct Authority and the regulation of financial institutions by the Prudential Authority to create a resilient and stable financial system.

The "Twin Peaks" changes affect "financial institutions" – including banks, insurers, medical aid schemes, pension funds, brokers and investment advisors who conduct activities in respect of "financial products" and aim to regulate a host of financial products, with the intention being to create uniformity in the regulation of the financial sector.

The latest legislative step is the Conduct of Financial Institutions Draft Bill, 2018 ("the Bill"), which primarily aims to revise the legal framework regulating market conduct. The Bill was circulated for public comment earlier this year and is expected to be tabled before Parliament later this year.

The Bill is drafted according to four underlying principles: activity-based; principles-based; outcomes-focused; and risk-based / proportionality.

Commentators have expressed concern that smaller financial institutions will not have the resources to comply with the stringent regulatory requirements of "Twin Peaks". The move away from prescriptive standards recognises that inflexible laws can stifle growth. Purposive regulation seeks to encourage transformation thereby providing opportunity for smaller institutions and new entrants in the industry. The challenge is to ensure that flexibility will not come at the expense of certainty.

The Bill introduces greater regulation of the contracts in respect of financial products.

Such contracts must be fair, reasonable and transparent.

The definition of "unfair" and "unreasonable" in the Bill, with reference to standards of unfairness and unreasonableness, is unhelpful and thus begs the question – in what circumstances will a term be "unfair"?

Generally, because fairness is a subjective concept our courts have avoided determining the validity of contractual terms with reference to exhaustive standards of fairness in outcomes of the enforcement of terms. Such an approach bears the risk of inconsistent application of the law which may in turn lead to uncertainty in interpretation and enforceability of contract terms.

Having regard to the wide powers to issue regulations to give effect to its provisions, it is likely that the full import of the Bill is yet to be felt.

The effect in the insurance industry is of particular interest to insurers and practitioners who rely on sound legal doctrines that preserve the underlying principles of insurance: for example, to avoid "pay-to-be-paid" contracts or wagers.

It is at the inception of a policy that an insurer determines the premium payable based on the risk to be insured. Limiting an insurer's ability to reject claims or repudiate policies in circumstances where the policy terms may be deemed to be unfair or unreasonable may result in a disconnect between the premium and the risk insured. The consequences of uncertainty in the new regulatory regime may give rise to increased premiums.

There is a risk that a blanket approach to regulation across a number of financial industries each with its own unique purpose and development may lead to legislation unsuited to effective operation of these industries. Consumer friendly regulatory frameworks, whilst well intended, could result in inadvertent consequences which will ultimately be borne by the consumer.

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