Failure of Financial Services Providers in South Africa

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ABSTRACT

During the 1990s, South Africa experienced the failure of the Masterbond group of companies which attracted approximately a billion rand by promising investors secured investment in the form of debentures. A public outcry led to the appointment of a commission of inquiry led by Justice Nel. Part of the findings of the Nel report pointed to the need to update the security laws existing at the time and to regulate intermediaries who are usually seen as a vital link between the public and investment companies offering securities, including instances where fraud is being perpetrated on the public.

Following the Nel inquiry, a number of steps were taken. A major step was the enactment of the Financial Advisory and Intermediary Services Act (Act No. 37 of 2002, known as the FAIS Act). The FAIS Act brought with it the relief that for the first time in South Africa, financial intermediaries would be regulated. Its main objective is to protect consumers and strengthen the integrity of the financial services industry. In furtherance of the above mentioned objectives, the FAIS Act provides for strict requirements for those who apply for licences to render financial services to the public; as well as codes of conduct for intermediaries. The FAIS Act only came into full operation on 30 September 2004.

South Africa has come a long way since the days of Masterbond; however, a number of financial services providers continue to fail. In the process consumers have been left with nothing but empty promises. The question is whether there are any regulatory factors that could possibly be influencing the failure of financial services providers. Elsewhere in the world, regulatory fragmentation, capture[1] and lack of capacity and information sharing amongst regulators have been

[1] Regulatory capture refers to a situation where regulators take on the objectives of management in the firms they regulate, thereby possibly losing sight of the ultimate objectives of regulation (Benink, H. A. and Schmidt, R. H. (2004) Europe's single market for financial services: views by the European Shadow Financial Regulatory Committee, *Journal of Financial Stability,* 1, pp. 157-198.

singled out as factors that undermine regulatory effectiveness. Could these factors be relevantly raised about the South African financial regulatory system?

DEDICATION

I dedicate this piece of work to my late friend, brother and colleague, Charles Pillai who encouraged and supported me to obtain my MBA. Thank you!

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Thank you to my supervisor, Professor Anthony Stacey for his support, guidance and invaluable help.

There are many people whose contribution made this dream a reality. I thank them. The people who agreed to be interviewed to share their experiences also contributed. They know who they are. To them I say thank you.

A heartfelt thank you goes to Jenni Croll and Wendy Force for their assistance and patience in editing the work.

I thank my family and colleagues for giving me the space and time to successfully pursue this important mission in my life.

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1.1 Purpose of the study

The purpose of this research is to establish the regulatory factors that influence the failure of Financial Services Providers (FSPs) in South Africa.

1.2 Context of the study

During the early 1990s South Africa experienced the failure of the Masterbond Group of companies which had attracted approximately a billion rand by promising investors secured investment in the form of debentures (The Republic of South Africa, 2001). A public outcry led to the appointment of the commission of inquiry led by Justice Nel to enquire into, and report on, the causes of the collapse (The Republic of South Africa, 2001).

Part of the findings of the Nel report pointed to the need to update the security laws existing at the time and the need to regulate intermediaries who are usually seen as a vital link between the public and investment companies offering securities, including instances where fraud is being perpetrated on the public.

The Nel report further recommended access by shareholders to corporate records, in line with the laws of the United Kingdom. This was to address the issue of dishonest, incompetent or astute directors who play fast and loose with the fortunes of a corporation and, in the process, enrich themselves and mislead investors and other stakeholders.

Included in the Nel report was the observation that some of the failed companies exploited gaps in legislation as they were neither conducting the business of a bank nor that of an insurance company and could not be regulated by either of the regulatory bodies, namely the South African Reserve Bank, (SARB) and the Financial Services Board (FSB), at the time. As such, the entities managed to escape the wrath of the law. In this regard, the Nel report pointed to the need to establish a single national regulator of financial services in South Africa.

Following the Nel inquiry, a number of steps were taken: A major step that was taken was the enactment of the Financial Advisory and Intermediary Services Act (Act No. 37 of 2002, known as the FAIS Act). The FAIS Act brought with it the relief that for the first time in South Africa, financial intermediaries would be regulated. Its main objective is to protect consumers and strengthen the integrity of the financial services industry. In furtherance of the above mentioned objectives, the FAIS Act provides for strict requirements for those who apply for licences to render financial services to the public; as well as codes of conduct for intermediaries. The FAIS Act only came into full operation on 30 September 2004..

South Africa has come a long way since the days of Masterbond. Following the Masterbond inquiry and after 2004, a number of financial services providers (FSPs) continued to fail. Leaderguard Securities (Pty) Ltd (LS), an entity that offered foreign currency denominated investments (forex) to the public was liquidated in 2005 (The Financial Services Board, 2006a). GAREK Group, an entity which offered shares at a phenomenally discounted price was found to have been nothing more than a lie to investors (The Republic of South Africa, 2006). Blue Pointer Group was already struggling to pay investors in 2007 (The Financial Services Board, 2006b); it was liquidated in 2008. Blue Zone Spitskop Villages went into liquidation in 2009 (South African Reserve Bank, 2009). Edwafin was liquidated in 2009 and lately, the Sharemax Group was stopped by the Reserve Bank in 2009 owing to the fact that it was conducting the business of a bank without a licence (South African Reserve Bank, 2009). A business rescue case is still before the courts in relation to Sharemax; it is clear that investors are unlikely to recover their full investment. It would appear that a similar experience has occurred in other parts of the world given the comment made by Valentine (2008) that when an investment vehicle fails, the promoters who are primarily responsible often have no resources as the assets have been transferred to family members, trusts, or superannuation funds and cannot be touched.

1.3 Problem statement

1.3.1 Main problem

The research problem is to establish the regulatory factors that influence the failure of financial services providers in South Africa.

1.3.2 Sub-problem 1

The first sub-problem is to identify the perceived regulatory factors that influence the failure of FSPs.

1.3.3 Sub-problem 2

The second sub-problem is to consider the differences in the responses across the different stakeholders within the South African financial services industry.

1.3.4 Sub-problem 3

The third sub-problem is to synthesise, from the suggestions and the opinions, a more effective regulatory framework to substantially minimise the failure of FSPs.

1.4 Significance of the study

The study fills a gap in that there is currently no research aimed at establishing whether regulatory factors influence the failure of FSPs in South Africa.

The study will benefit policymakers who wish to engage in debate about possible ways of improving the effectiveness of regulation in South Africa. The study will also benefit students who have an interest in financial services, compliance groups and other professional bodies with an interest in financial services.

1.5 Limitations of the study

This study will not look at failures of financial services providers before 1st January 2005. The study will not look at matters of financial discipline, accounting practices or possible criminal conduct of those behind the failed FSPs. The study is aimed at only those factors from which lessons can be learnt for the benefit of improving financial regulation. The study will not look at matters of failed FSPs that offered risk products to consumers. The study is aimed instead at those FSPs offering investments to consumers. This study is not concerned with failed discretionary or administrative FSPs. Rather, it is concerned with general FSPs that offered investments to the public. This study will not look at failed insurers even though they may have been licensed as FSPs. FSPs closed down by the regulator where no investors lost funds will also not be considered. The study excludes failed entities prior to the enactment of the FAIS legislation. The study excludes FSPs that have on their own volition closed their businesses without breaking promises to investors (for example, a sole proprietor FSP that decides to join a bigger FSP because he or she is overburdened by costs of compliance). The study is also not concerned with failed FSPs that did not collect funds from the public.

1.6 Definition of terms

(Refer to Appendix A)

1.7 Assumptions

The following assumptions are made throughout the research:

- respondents have adequate knowledge to respond to the questions;
- respondents will respond to the questions without fear or favour; and
- respondents will respond to the questions candidly and not protect any personal interest that may exist.

2 LITERATURE REVIEW

2.1 Introduction

In this section a background discussion which mainly comprises the case for regulating the financial services sector is presented first, followed by a brief, high level discussion on the South African financial services regulatory landscape on issues pertaining to the non-banking sector. The meaning of failure in relation to a financial services provider is presented followed by a discussion on the perceived regulatory factors that influence the failure of FSPs.

2.2 Background discussion

2.2.1 The case for regulating the financial services sector

Currently, there is a general consensus around the world that it is necessary to regulate and supervise financial institutions (Benink and Schmidt, 2004). These authors state that financial regulation and supervision are needed to protect the financial systemic risks which are encountered in a specific and potentially threatening form in the financial sector. A second objective of financial regulation according to the same authors is to protect consumers who are mostly not sufficiently informed to protect themselves. The authors add that consumers would find it overly costly to obtain the information they would need to safeguard their own interests. Adding weight to the underlying intent of consumer protection, Llewellyn (1995) states that the ultimate rationale of regulation designed to protect the consumer is not paternalistic but rather economic with the purpose of increasing the efficiency of market procedures. Llewellyn (1995) argues that were it not for regulation, consumers would be required to spend time, effort and resources in investigating and monitoring firms supplying financial services and contracts - something that would incur costs. However, he warns that it is not reasonable to be protected against all possibility of losing money or making mistakes because finance is necessarily about risk; therefore, to attempt to regulate to remove all risk from the consumer would regulate away the very function of finance and financial contracts.

Financial regulation, according to Blinder (2009), is necessary for four primary reasons:

- to protect consumers from anti-competitive behaviour;
- to protect consumers against fraud;
- to protect consumers from deceptive practices, and perhaps from their own foolishness and gullibility; and,
- to limit costs to taxpayers of the government's safety net for financial institutions. In this regard, one must remember that when an institution is rescued, public money is used (Blinder, 2009). The same author states financial regulation is about protecting the financial system against various systemic problems and limiting adverse spill over effects from financial shocks on the real economy.

The proximate goal of any financial regulation is to constrain the behaviour of client financial institutions (Kane, 2002). This author states that most societies assign government financial regulators three major tasks:

i) to limit risks of fraud, discrimination and contract non-performance in financial transactions;

ii) to operate a safety net designed to virtually eliminate risks of fire-sale losses associated with financial institution insolvencies; and,

iii) to operate fraud controls and safety nets honourably and at a minimum opportunity cost to taxpayers.

A further reason advanced by Benink and Schmidt (2004) for regulating the financial services sector is to secure the access of national, state and local governments to cheap, flexible and reliable sources of funding. Brownbridge and Kirkpatrick (2000), suggest there is widespread evidence that the development of financial markets and institutions plays a crucial role in economic growth and development. Brownbridge and Kirkpatrick (2000) further state that higher levels of financial development are significantly and robustly correlated with faster current and future rates of economic growth.

The financial services sector is about the economy but it is also about citizens (Cherednychenko, 2010). This author argues that financial services - particularly investment services - have become an essential part of the everyday life of European Union (EU) citizens. Such services facilitate citizens' full participation in the economy and enable them to plan for long-term and often unforeseen events of life (Cherednychenko, 2010). Apart from the fact that failure of FSPs is undesirable as it leaves investors destitute, such occurrences may negatively affect the financial stability of a country (Allen and Wood, 2006). Allen and Wood (2006) suggest that the financial services industry is about protecting financial stability. Financial stability is a vague and difficult concept to define; however, financial stability is about institutions not suddenly collapsing and causing damage to people who could not reasonably have been expected to anticipate the collapse (Allen and Wood, 2006). Regulation of financial services is useful in so far as it is concerned with assuring that suppliers on whom consumers rely, do not fail (Benston, 2000). However, Benston (2000) suggests regulation specific to financial services only is neither necessary nor desirable. In his view, the failure of a supplier of financial services is less costly than the failure of other types of companies. Helwege (2010) recalls the actions of the United States Federal Reserve and the Treasury in 2008 when they injected US$ 85 billion into the insurance behemoth, American International Group (AIG), while it was less enthusiastic about aiding General Motors which needed a bailout at the time. Helwege (2010) states that the actions of the government in ignoring General Motors were driven by the belief that the failure of a non-financial firm would not cause major macroeconomic repercussions by imposing losses on related firms. Helwege's (2010) view was that the government's decision was consistent with the view in macroeconomic research that financial firm bankruptcies pose a greater amount of risk than non-financial firm bankruptcies. The same author went on to argue that the contagious impact of a non-financial firm's bankruptcy can also be far larger than that of a financial firm like AIG.

One concludes from the propositions of the authors in this background discussion that it is necessary to regulate the financial services industry in order to protect the consumers, the industry and a country's financial stability. The precise ambit of how far regulation should go in so far as protecting the consumer may differ from country to country but the common view is that the industry has to be regulated. A further deduction to be made from the views of all the authors is that failure of financial institutions is neither desirable for consumer protection nor for the financial stability of a country. It is submitted by the writer that the collapse of financial firms, big or small, does not do well for consumer confidence. The views advanced by the authors in this background discussion would be equally applicable in South Africa which, like any other country, would want to promote economic growth, protect financial stability and ensure the participation of its citizens in the financial services sector.

2.2.2 South Africa’s financial services regulatory landscape

In so far as the financial regulatory landscape in South Africa is concerned, the system comprises various separate regulatory agencies such as the SARB, DTI, FSB, the Council for Medical Schemes (CMS), the Johannesburg Securities Exchange (JSE), Bond Exchange South Africa (BESA), the Financial Intelligence Centre (FIC), National Credit Regulator (NCR), Consumer Commission (CC) amongst others. Questions have previously been raised in other parts of the world as to the effectiveness, willingness and readiness of a regulatory system like the one South Africa has, namely, a fragmented system of regulation (Brown, 2005; Blundel-Wignall and Atkinson, 2009)

Views have been raised about the possibility of capture of smaller regulatory agencies by those who are supposed to be regulated (Brown, 2005). In this regard this author points out the possibility and ease with which lobby groups can influence the agenda of smaller agencies. Indeed, some regulators within the South African regulatory landscape are small in size and mandate. There are also entities that are small in size with mandates that cut across the entire economy like the Competition Commission. Regulatory capture is said to be a factor that tends to undermine the effectiveness of regulation (Kane, 1997; Brown, 2005).

A further factor that tends to generally undermine the efficacy of regulation is the lack of information sharing amongst regulators (Benink and Schmidt, 2004; Government Accountability Office, 2004). These authors argue that regulators are reluctant to share information, citing their mandate and sometimes strict legislative prescripts.

In other parts of the world, questions of competition and turf war amongst regulators have also been raised, as has the practice of regulators shielding their activities from scrutiny (Kane, 1997; Benink and Schmidt, 2004; Brown, 2005). Summers (2008) puts it more pointedly when he states there should be a strong presumption against having regulators competing to supervise particular institutions or activities. Experience suggests that even when firms do not have the option of switching, there are substantial risks that regulators may be co-opted (Summers, 2008). The same author adds that forum shopping exacerbates the problem. Issues of lack of capability among regulators have also been identified as responsible for weakening regulation (Rhee, 2009). An FSP is said to have failed where it cannot discharge its obligations to customers due to lack of resources (Benston, 2000). An insolvent entity cannot validly discharge its obligations to its customers; it therefore fails them (Benston, 2000).

2.3 Perceived regulatory factors that influence the failure of financial services providers

This section presents a discussion on factors perceived to be influencing the failure of FSPs in other parts of the world. First, it is highlighted that the term Financial Services Provider (FSP), as it applies to South Africa relates to anyone who, as a regular feature of their business, provides financial services to consumers (The Republic of South Africa, 2002). There are various strata of financial services providers in South Africa, namely, Administrative FSPs, Discretionary FSPs and General FSPs. As indicated earlier in this report, the focus is on General FSPs or simply FSPs. In other parts of the world, the name financial firm or financial institution may be preferred.

Competition amongst regulators and the notion of regulators shielding their work from scrutiny are briefly described but not dealt with as they are viewed to be symptoms of a fragmented regulation and part of the challenges pertaining to lack of capability.

2.3.1 Competition amongst regulators

Competition amongst regulators pertains to a situation where regulators are concerned with offering a convenient service to FSPs and do not take into account matters that advance protection of the consumer (Brown, 2005). The author refers to the observation made where various regulators in the United States of America (USA) were striving to achieve reciprocity in the area of insurance regulation. The regulators were said to have discarded checks and balances aimed at consumer protection in order to meet the lower standards offered by other states. The same author mentions that some states in the USA had opted to give up fingerprinting as a means of conducting in-depth criminal and regulatory history, background checks of agents, company owners and management, leaving consumers at risk and weakening regulation in the process. Blinder (2009) however, states that there will be some overlap involved in financial regulation and this is recognised by anyone who has been involved in such regulation. Blinder (2009) however, proposes that it is a good principle to minimize rather than maximize such overlap.

2.3.2 Regulators shielding their work from scrutiny

Regulators, according to Kane (1997), have a propensity to conceal past mistakes and discredit critics in watchdog institutions by twisting facts and covering up unfavourable information. Also, in stating the involvement of the European Shadow Financial Regulatory Committee in the work of the financial regulators, Benink and Schmidt (2004) mention that regulators, being national governments and governmental agencies, used to follow a policy of shielding their activities from scrutiny by their peers and members of the academic community rather than inviting critical assessment and an exchange of ideas.

2.4 Sub problem 1: Identify the perceived regulatory factors that influence the failure of FSPs

2.4.1 A fragmented system of regulation

The Oxford dictionary describes the word 'fragment' when it is a noun as referring to something that has a small part broken off or detached, an isolated or incomplete part (Soanes and Stevenson, 2006). From the same authors, fragment as a verb refers to breaking into small parts. A 'fragmented' regulatory system therefore would refer to a system that consists of several disjointed parts. In elaborating on the financial regulatory structure in the US covering banking, securities and insurance, Brown (2005:10) describes it as a 'hodgepodge' of federal and state agencies with overlapping authority.

Explaining how the regulatory system evolved over the years, Brown (2005) states that a financial crisis would occur due to some market failure and the state or federal legislators would respond by enacting laws and creating new agencies to regulate those particular aspects of the industry that gave rise to the market failure. Blundel-Wignall and Atkinson (2009), commenting on the origins of the 2008 financial crisis, refer to the US financial regulatory system at the time as a framework of complex rules and regulations by multiple agencies whose responsibilities have not always been clear or adapted to a changing world.

Although Briault (2002) does not quite describe the South African regulatory system as fragmented, he mentions South Africa amongst the countries that were considering moving towards a single financial services regulator at the time. In fact, in South Africa there is the SARB, the regulator of banks and the FSB, the regulator of the non-banking financial services sector. Banks are regulated by the FSB for their activities as FSPs. There is the DTI which registers companies and enforces amongst others, fair business practices rules, the NCR, CMS, and a few others. Essentially, there are a number of regulators within the financial services in South Africa. The question that first arises is whether the South African regulatory system can be described as a fragmented system.

2.4.1.1 Challenges of effectiveness, readiness and willingness raised about regulators in a fragmented system.

Advocating for a single regulatory system in the USA Brown (2005) described the current regulatory system as containing regulatory gaps. She criticises the sectoral responsibilities as capable of producing the same results as those which occasionally occur in baseball when two outfielders assume that the ball is heading towards the other's area of the field and so makes no attempt to catch it, the ball drops between the two of them, allowing the runner to get to the base or even score. The results in the financial services industry, however, can be disastrous for the consumer and the economy (Brown, 2005). She refers to the rescue from collapse of Long Term Capital Management (LTCM), the largest hedge fund in the USA at the time with assets of US$120 billion and capital of US$7.3 trillion in year 1997, where the Federal Reserve authorities brokered a deal to save LTCM from collapse. According to the author, none of the agencies in the USA regulated hedge funds at the time and the Federal Reserve was acting without a mandate.

Brown (2005) further goes on to state that as a result of this balkanised regulatory structure, USA regulators are ill-equipped to handle the challenges posed by the financial services industry. She notes that in almost none of the recent financial crises that were tested, did a single existing regulator have the necessary resources, authority or jurisdiction to handle the crises by itself. According to Brown (2005), multiple regulatory authorities sometimes hindered the ability of the federal government to identify financial crises in their early stages and to monitor crises once they began.

Crotty (2008) traces the causes of the global financial crisis back to the unwillingness and readiness of regulators at the time. Crotty (2008) postulates that while the subprime mortgage market would have triggered the crisis, its deep cause is to be found in the flawed institutions and practices of what is often referred to as the New Financial Architecture[2], (NFA). Crotty (2008)further argues that the NFA practices stimulated aggressive risk taking, increased financial fragility[3] and facilitated the creation of unprecedented financial market complexity and opaqueness. In the meantime, adds the same author, regulators responsible for overseeing financial markets not only failed to prevent the excesses of the boom, but with some notable exceptions, assured investors that the high yields and low risk spreads of the period were permanent, thus sending an incorrect message to investors. This, states Crotty (2008), the regulators did by allowing private rating agencies like Fitch, Standard and Poor (S&P) and Moody's to give risky financial products, amongst which was the Collateralised Debt Obligation (CDO) AAA[4] ratings. While Crotty (2008) does not specifically attribute the blame for lack of action to the multiplicity of regulators in the financial services arena at the time this occurred, he states that investment banks, commercial banks, small and large stockbroker outfits, hedge funds and others which are regulated by different regulators, were all participating in the peddling of the risky products, yet none of the regulators responsible were concerned with restraining the firms.

[2] The term NFA refers to the integration of modern day financial firms and markets with its associated regime of light government regulation.
[3] Financial fragility refers to the vulnerability of the financial system to problems that appear anywhere within it.
[4] AAA ratings are judged to be of the highest quality, subject to the lowest level of credit risk

When the regulators failed to act and allowed themselves to rely on the rating agencies, financial firms became totally unconcerned with interrogating the risk aspects of the CDOs. Lang and Jagtiani (2010:309) state:

> 'In many cases, even sophisticated financial firms will do little independent analysis of the credit risk of a security if it has an AAA rating. Firms may believe that it is an inefficient use of resources to independently analyse these AAA-rated securities. Seventeen agency ratings of CDOs were viewed as an efficient form of informational intermediation (at least until the beginning of the financial crisis). It is now evident that the default and downgrade performance of asset-backed CDOs performed much worse than could have been expected, given the history of corporate bonds with similar ratings.'

Later on when regulators were inspecting the banks' books it became clear that banks had been exploiting many regulatory loopholes (Crotty, 2008). Had the regulators been checking banks' trading books all along, the crisis might not have reached systemic proportions, adds the same author. From this point onwards, the road to the collapse was clear (Crotty, 2008). The dire consequences of the failure by regulators to stop financial firms from pursuing dangerous strategies can be seen from this extract:

> 'Noriel Roubini showed how easy – and how dangerous – it was to develop hyper leverage under the NFA. "Today any wealthy individual can take $1 million and go to a prime broker and leverage this amount three times; then the resulting $4 million ($1 equity and $3 debt) can be invested in a fund of funds that will in turn leverage this $4 million three or four times and invest them in a hedge fund; then the hedge fund will take these funds and leverage them three or four times and buy some very junior tranche of a CDO that is itself levered nine or ten times. At the end of this credit chain, the initial $1 million of equity becomes a $100 million investment out of *)* which $99 million is debt (leverage) and only $1 million is equity. So we got an overall leverage ratio of 100 to 1. Then, even a small 1% fall in the price of the final investment (CDO) wipes out the initial capital and creates a chain of margin calls that unravel this debt house of cards' (Crotty, 2008) quoting (Roubini 2007).

Addressing the Federal Reserve Bank at the Boston conference after the global crisis, Blinder (2009) reminded the delegates that the regulatory system should not leave gaps large enough to allow important activities escape regulation. In this regard, Blinder referred to the highly innovative and ingenious people that work in the financial services industry whose innovations ought to benefit society; however, when their prodigious talents are turned towards escaping regulation, the social consequences can be calamitous (Blinder, 2009).

Briault (2002) refers to draft regulation in Germany with the intention of creating an integrated financial services regulator; the draft states that regulatory structures of a country need to reflect the realities of the financial services sector which sector has become more dynamic and more complex over the past few years. He further states that developments in financial markets are associated with increased risks to their stability which can be best countered in the future not only through improved collaboration between the regulatory authorities but integrated regulation.

After the global crisis of 2008, Corden (2009) recalled a proposal by Robin (1987) where he advocated for preserving regulatory distinction, remarking that at the time, investment banks were uninsured, broadly unregulated but subject to disclosure requirements. Brown (2005) states that in a regulatory space designed to have several regulators, there is always the chance that one regulator may be of the view that another regulator is overseeing the activities of a particular financial institution when that may not be the case. It is those gaps that may be exploited by some participants in the financial services industry, effectively weakening regulation, adds Brown (2005).

Debating the issue of whether the EU should change to a single agency regulating financial services, Benink and Schmidt (2004) state that there may be good reasons for not establishing a single agency. Although the reasons advanced are about a supranational agency, one reason may still be valid even to a national single regulatory agency and that is the fear of concentrating authority in one agency which might then be plagued by problems that are typical of a big bureaucracy (Benink and Schmidt, 2004). Indeed, Briault (2002) states that there is no one model that is optimal for all countries in all circumstances, because financial markets have developed and will continue to develop differently in different countries.

It is unclear whether the issue of regulatory gaps may be relevantly raised about the regulation of financial services in South Africa. One recent case may go a long way towards answering this question: Blue Zone, a licensed FSP and little known group of property syndication promoters was aggressively offering investments to the public from as early as 2005 through a property syndication vehicle. Amongst the schemes run by Blue Zone was a scheme known as the Spitskop project which saw Blue Zone struggle to pay investors the promised income. Blue Zone was later stopped by the SARB in 2009 (South African Reserve Bank, 2009) for conducting the business of a bank without a license. The investment offered through the property syndication consisted of unlisted shares and debentures. An entity within the group bought a piece of land from a farmer for about R1 million in an area that lies close to Limpopo/Mpumalanga border. The same land was sold to investors for R118 million without any development. Promising to develop the land by building residential units for workers (for rent or sale) on a nearby mine, the group started soliciting investments from the public through the property syndication. The piece of land in question was the subject matter of a land claim which had not yet been adjudicated. At the same time, one of the mining companies had exploration rights which covered a substantial piece of the land. In short, there was no prospect that there could ever be building on that piece of land. The early investors who purchased the shares from Blue Zone were claiming to have been paid above market rate returns from their investment.

Sometime in 2009, the South African Police stepped in to warn the public that the group was engaged in illegal activities in that it was doing the business of a bank without licence. At the time Blue Zone Spitskop was liquidated, it had collected about R387 million of investors' funds. The only asset remaining in the scheme is the piece of land (South African Reserve Bank, 2009).

The question that arises out of the foregoing discussion centres on whether there was any one regulator that was specifically tasked to regulate Blue Zone for its activities or was Blue Zone an example of an entity exploiting a regulatory gap in the system?

2.4.2 Regulatory capture

Crotty (2008), who blames the NFA for the structural causes of the global financial crisis, states that under the NFA, regulators allowed giant banks to measure and manage their own risk and set their own capital requirements and, because of the excessively large incentives, firms preferred excessive risk taking. In this regard, Crotty (2008) went on to say, the Bank for International Settlements (BIS) in 1996, sanctioned the idea that as of 1998, regulatory authorities should shift responsibility for setting limits on giant banks' risk to the banks themselves. Not only did regulators shift their responsibility to banks, they then began allowing each financial institution to use their own version of statistical models to assess whether they were complying with the rules pertaining to capital adequacy (Crotty, 2008). In essence, the same author argues, regulators effectively ceded to banks crucial aspects of regulatory power, in the same way they did to private rating agencies. The result, Crotty (2008) concludes, was that neither the bank conglomerates themselves, nor those who were obligated to regulate them, could reliably estimate how risky they had become in their reckless pursuit of high profits .

The argument that is often used is that it is difficult for regulators to appreciate the business of the regulated; without this there is no way they can regulate effectively (Benink and Schmidt, 2004). The same authors state that it is a common phenomenon in all areas of regulation that regulators become captured by the industry they regulate; meaning, they take on the objectives of management in the firms they regulate, thereby possibly losing sight of the ultimate objectives of regulation. The complexity of the banks' regulation and the role assigned to national supervisors make an arm's length relationship between the regulator and the regulated nearly impossible (Benink and Schmidt, 2004). Further, the same authors state, since the banks have an advantage in both technical competence and the knowledge of their specific techniques, supervisors will have to acquire corresponding knowledge or remain unable to supervise properly. It needs to be mentioned that in the USA, before and during the period leading up to the global crisis, mortgage lenders employed hard sell tactics, pushing many households to take on debt they could not afford (Evans and Wolf, 2007). Out of this, Evans and Wolf (2007) add that banks turned the mortgage loans into mortgage-backed securities which were then transformed into complex CDOs designed to obscure the true risks from view. From this, the same authors describe how banks generated spectacular profits for the financial sector. The point to stress here is that not a single regulator would have been able to appreciate what risks the banks were taking, apart from the statements that they showed no interest (Evans and Wolf, 2007). It would seem the financial sector uses innovation to get beyond regulatory reach (Benink and Schmidt, 2004; Crotty, 2008). This statement from Tett (2007:1) captures it well: “Welcome to one of the most pernicious problems now haunting markets, namely, the utter inadequacy of modern regulatory structures to cope with the shape of 21st century finance”.

Crotty (2008) points to regulators not only failing to curtail the excessive risk taking the financial firms were engaging in but allowing banks to hide risk off-balance sheet in order to evade capital requirements, lowering their capital/asset ratio and increasing their risk. Since capital had to be held against on-balance sheet assets only, the regulatory system induced banks to move as much of their assets off –balance sheet as possible concludes Crotty (2008).

On this score, Kane (1997) adds that a regulator’s trustworthiness may be undermined by opportunistic counterparts who are willing to use incentive- based compensation to tempt the regulator to compromise its fiduciary responsibilities. How much value a regulator creates and how beneficially this value is distributed, depends on the incentives under which institutional managers and top regulators operate (Kane, 2002). These incentives, Kane (1997) states, vary across types of firms, across societies and from era to era.

Regulatory capture appears to be a reality that can occur in many ways and may potentially affect regulators around the world. A question that needs to be explored is whether this issue may be germane to regulators in South Africa.

2.4.3 Inadequate regulatory capability

To be able to appreciate the meaning of regulatory capability, this comment by Rhee (2009:364) in relation to the financial crisis of 2008 is instructive:

> ‘If this crisis was a failure of regulation, and if regulators are lawyers, then it follows that lawyers in a complex world must have an awareness and basic knowledge of the nature of this complexity. Explicitly, it is difficult to see how a

> lawyer regulator, from the most senior to the most junior rank and file can purport to regulate complex financial instruments and markets without having a detailed understanding of these matters beyond legal definitions, qualitative intuitions and half guesses..'

The piling of risky assets on bank balance sheets was stimulated in part by inept regulation (Crotty, 2008). In illustrating the point, this author states that borrowing short to fund long-term liquid assets without a strong capital base was a dangerous game and competent regulators committed to preventing excessive risk would never have sanctioned them. In this regard, this same author refers to an instance several years ago when a group of Spanish banks approached their central bank asking permission to set up a network of Special Investment Vehicles (SIVs) that would allow them to profit from off-balance sheet holdings of CDOs without setting aside capital to support them, the Spanish central bank demanded that they post an eight percent capital charge against the SIV assets just as they would have to do if they were on balance sheet. This decision prevented the spread of SIVs to Spain (Crotty, 2008).

To further show that matters of capability are also recognised by regulators, Briault (2002), then part of the Financial Services Authority of the United Kingdom (FSA), refers to the leverages the FSA had gained through the single regulator initiative. He states the FSA had achieved a significant and valuable degree of integration through the establishment of a single division to supervise the fifty or so of the largest and most complex financial groups in the United Kingdom (UK). Briault (2002) mentions that the activities of the groups cover all aspects of the FSA's regulatory requirements. In essence, this author is referring to the advantage that came about with centralisation of skills which hitherto resided within different agencies and the benefits thereof.

Rhee (2009) refers to the Bernard L Madoff Ponzi Scheme (Madoff) and its collapse. Rhee (2009) believes the Madoff case merits academic comment because the scandal provides the best documented episode and case study of how lawyers failed to understand the market they regulate and the non-legal complexities surrounding their work. According to the author, on 24 January 2006, the Securities Exchange Commission (SEC) opened an investigation into Madoff's business activities. On 24 November 2007 it closed the investigation on the basis that its staff had found no evidence of fraud. In December 2008 Madoff was arrested and later pleaded guilty to various offences. Had the SEC acted in time, argues Rhee (2009), billions of dollars invested by innocent consumers would have been saved.

Madoff ran a securities business known as Bernard L Madoff Securities LLC, (Madoff Securities) where he claimed to provide execution services only to a limited number of clients. Madoff claimed he was making use of a technologically enhanced approach to a traditional trading strategy which was known as the 'split strike forward conversion' (Rhee, 2009:368). As a result of this approach, Madoff claimed he was making consistent annual returns of 12% at virtually no risk to his clients with a beta portfolio risk of 0.06%. Inconsistent and puzzling as Madoff's claims were, the regulator was only concerned with the question of disclosures made or omitted by Madoff in relation to other aspects of his business. In fact no attention was paid by the SEC to the claims that Madoff was involved in fraudulent activity, according to Rhee (2009). In this regard, Rhee attributes the reason for the dismal performance of the SEC to lack of capable staff at the SEC to do the investigative work.

Lack of capability on the part of a regulator can undermine its effectiveness (Briault, 2002; Benink and Schmidt, 2004; Crotty, 2008; Rhee, 2009). What has to be explored is whether the same point could be relevantly raised about South African financial regulators.

2.4.4 Lack of information sharing by regulators

Financial regulators in the US face challenges in accessing and sharing information relevant to their oversight responsibilities, including information related to criminal history data, regulatory enforcement actions and consumer complaints (Government Accountability Office, 2004). The Government Accountability Office (GAO) report stated that many state insurance regulators, unlike their counterparts in banking, securities and futures, lacked legal authority to access the FBI's nationwide criminal history data. The consequence, concluded the report, is that some regulators cannot be sure that they are protecting insurance consumers from fraud by keeping individuals previously convicted of serious behaviour out of the business. The GAO report refers to the case of Martin Frankel who masterminded the theft of over US$200 million from several insurance companies during an eight year period. The implication is that Frankel managed to steal money from consumers but successfully remained in the financial regulatory system by exploiting gaps in the system. Had there been proper information sharing arrangements, Frankel may have been thwarted in his efforts.

The GAO report further states that financial regulators generally did not have ready access to all relevant data related to regulatory enforcement actions taken against individuals or firms because data are maintained by various financial regulators on separate information systems. What this situation meant, according to the report, is that financial regulators are hampered in their ability to detect and prevent unsuitable individuals or rogues from migrating from one area of the financial services industry to another. Brown (2005) also alluded to the fact that the USA lacked a single forum in which all the state and federal financial services regulators could meet to share information, assess risks that cross traditional regulatory sectors and develop and co-ordinate regulations to address such risks.

According to the GAO report, financial regulators support better information sharing; however, they also cited barriers and some concerns. These concerns centred on protecting confidential regulatory information from public disclosure. Another issue raised in the GAO report is that one of the important functions of a financial regulator is licensing or approving the people who apply to work in the industry. The first line of defence against fraud is to keep known criminals and other inappropriate individuals out of the business, particularly when that business is handling other people's money.

The report also states that criminal behaviour is not the only reason for a regulator to bar an individual from participating in a regulated industry. A sanction, states the report, could be imposed banning an individual from returning to work in the industry or state where they broke the rules. If regulatory information about an individual is not widely known or made available, there is little that can prevent that rogue from moving to a different financial services industry.

Yet another interesting view raised by the GAO is that regulators generally fear sharing information with fellow regulators where the conduct pertaining to an individual applicant is not one sanctioned by a court of law for fear of a backlash from the individuals involved. It is submitted by the writer that the need to share information to enhance proper regulation is a public interest that needs to be balanced with the interests of an individual.

What is worth exploring is whether the South African regulators could be facing the same challenges.

2.4.5 Proposition 1

South African regulators are operating in a fragmented system challenged by the possibility of capture, lack of capability, and lack of information sharing.

2.4.6 Proposition 2

There will be different perceptions about the factors that influence the failure of FSPs across the different stakeholders.

2.4.7 Proposition 3

It is feasible to synthesise from the suggestions and the opinions a more effective regulatory framework to substantially minimise the failure of FSPs.

2.5 Conclusion of literature review

At least four factors pertaining to regulation are perceived to be influencing the failure of FSPs. The existence of multiple regulators could bring about fragmentation which in turn gives rise to gaps. Gaps in regulation are open to exploitation to the detriment of consumers and the integrity of the financial services industry. Regulatory capture is also a factor that is perceived to influence the failure of FSPs. The link here is that a captured regulator is a weak regulator which can, under certain circumstances, lead to the regulated entities behaving in an unusual manner. One of the consequences could be the demise of the FSP. Inadequate capability and lack of information sharing by regulators are also perceived as undermining effective regulation. A point that needs to be stressed is that while any of these suggested weak points in regulation may allow financial institutions to thrive and be seen to be helping any country’s economy to sprout, the case for effective regulation will always stand. A question that arises is whether any of these factors, or all of the perceived factors, could be prevalent in South Africa.

3 RESEARCH METHODOLOGY

This section sets out the research methodology that was followed including justification as to why the particular methodology has been chosen. Following the discussion on research methodology is a brief section on research design and data collection, analysis and interpretation. Matters of reliability, validity and limitations of the study are dealt with.

3.1 Research methodology / paradigm

The methodology chosen is qualitative research. According to Creswell (2009), there are three considerations that need to be taken into account in making a decision as to the choice of research methodology. These are: the research topic, the personal experiences of the researcher and the audience. In so far as the research problem is concerned, Creswell (2009) suggests that where a concept or phenomenon needs to be understood because little research has been done on it, it merits a qualitative approach. Where the researcher does not know the important variables to examine, qualitative research is suggested (Creswell, 2009).

For advocacy and/or participatory writers Creswell (2009) suggests that there is undoubtedly a strong stimulus to pursue topics that are of personal interest, issues that relate to marginalised people, and creating a better society for them. Qualitative research methodology is further grounded in a philosophical position which is broadly interpretive in the sense that it is concerned with how the social world is interpreted, understood, experienced, produced or constituted (Mason, 2002).

Qualitative approaches, according to Leedy and Ormrod (2010) have two things in common:

First, they focus on phenomena that occur in natural settings, that is, in the real world. Second, they involve studying those phenomena in all their complexity. According to Leedy and Ormrod (2010), qualitative researchers believe that that the researcher's ability to interpret and make sense of what he or she sees is critical for understanding any social phenomenon. In this sense, Leedy and Ormrod (2010:135) state, "the researcher is an instrument in much the same way that an oscilloscope, sociogram, or rating scale is an instrument".

The bases for choosing this particular research methodology are, firstly, the concept of regulatory factors influencing the failure of FSPs needs to be explored in order to be understood. There is no evidence that suggesting that research specifically aimed at this particular problem has been undertaken. In addition, there is a need to understand which variables from the four espoused in the literature review may be important enough to warrant further examination. The researcher leads an important entity in the regulation of financial services in South Africa. The focus of the researcher's responsibilities in financial services is the resolution of complaints lodged by consumers against financial services providers. There is some advantage in this regard in that the researcher will be able to identify the appropriate persons to interview who will enrich the study. Although not guaranteed, it is likely that respondents might be willing to be interviewed by a person who is familiar with the workings of their industry. The persons will be interviewed on an individual or group basis. .

Finally, the researcher will be able to provide background data through which the audience can better understand the topic (Creswell, 2009). The researcher believes the audience for whom this report is written will support the choice of methodology.

3.2 Research Design

Semi-structured interviews were conducted. The inquiry took the form of in-depth interviews with participants on a one-on-one basis (Creswell, 2009). This method according to Creswell, (2009) allows the interviewer to control the line of questioning. The author cautions however, that possible limitations pertain to the fact that the presence of the researcher might bias the responses. He adds that not all people are articulate and perceptive.

3.3 Population and sample

3.3.1 Population

The population are all the people involved in financial services in one way or another, including financial services regulators, FSPs, compliance firms and consumers.

3.3.2 Sample and sampling method

The method used to select the sample was purposive sampling. Leedy & Ormrod (2010:212) describe this as choosing people who are ‘typical’ of a group and those who represent a diverse perspective on an issue. In this regard people who represent diverse views within the financial services industry were chosen. The sample comprised twenty (20) people from various sections within the financial services industry. In all instances the chosen participants were invited by e-mail to participate. Follow up telephone calls were made where respondents did not respond. In the event of a selected respondent being unavailable at the last minute, effort was made to replace the individual with another suitable person.

Table 1: Profile of respondents

Description of respondent type	Number to be sampled
Key personnel dealing with regulation from the Independent Communications Authority, South Africa (ICASA)	1
Key personnel from the Financial Services Board, (FSB)	2
Key personnel from the legal and compliance section from South African Reserve Bank (SARB)	2
Key personnel from Old Mutual (big FSP)	2
Key personnel from the Association of Savings and Investments South Africa (ASISA)	2
Key personnel from Uranus (small) and Alexander Forbes (big FSP)	2

Key Personnel from the brokerage fraternity (small brokerages)	2
Key personnel from Standard Bank (medium FSP)	2
Key personnel from Public Investments Corporation, (PIC)	1
Members of the public	2
Key people from big compliance organisations, Moonstone and Masthead	2
TOTAL	**20**

3.4 The research instrument

In qualitative research, the researcher is the key instrument (Creswell, 2009) in that she or he collects data through interviewing participants. According to this author in terms of an instrument for collecting data may be used but the researcher is the one who is actually gathering information. A research questionnaire, as appearing in appendix A, was used and formed the basis of the interview. Questions covered the conclusions drawn from the literature review. Face to face interviews were conducted and participants were in natural settings (Creswell, 2009).

3.5 Procedure for data collection

Qualitative research operates from the perspective that knowledge is situated and contextual and therefore the job of the interviewer is to ensure that the relevant contexts are brought into focus so that the situated knowledge can be produced (Mason, 2002).

Knowledge is at the very least reconstructed, rather than facts simply being reported in interview settings (Mason, 2002). Creswell (2009) suggests that qualitative researches gather data using multiple sources such as interviews, documents and observations.

3.6 Data Analysis and interpretation

Data collection and analysis must be a simultaneous process in qualitative research, states (Creswell, 2009). Creswell (2009) states that data analysis involves making sense out of text and image data. Data analysis, according to Creswell (2009), involves collecting open-ended data based on asking general questions and developing an analysis from the information supplied by participants. The following steps recommended by Creswell were followed:

- Data was prepared and organised for analysis.
- Data was read to obtain a general sense of the information to reflect on its overall meaning and to pick up general ideas conveyed by participants, the tone of ideas and impression of overall depth.
- Data was analysed, organised into chunks or segments of text before bringing meaning to information.
- Data was ultimately interpreted.

3.7 Limitations of the study

The study was based on interviews of a small sample. The responses of the interviewees could have been influenced by the desire to protect personal interests. Finally, each respondent used their perception of what the regulatory factors are that influence the failure of FSPs and these may be influenced by their personal circumstances, personal interests, and level of knowledge of the financial services industry. Interest and the level of knowledge vary across the board. The lack of previous quantitative research is a limitation to those who may prefer to examine the variables of this study in a numerical manner.

3.8 Validity and reliability

Validity is concerned with congruence, or goodness of fit between the details of the research, the evidence and the conclusions drawn by the researchers (Kalof, Dan and Dietz, 2008). Qualitative validity means the researcher checks for accuracy of the findings by employing certain procedures (Creswell, 2009). It is, according to Creswell (2009), one of the strengths of qualitative research and is based on determining whether the findings are accurate from the standpoint of the researcher, the participant or the reader of an account. Relevant documents were read to confirm the conclusions.

3.8.1 External validity

External validity is concerned with the ability to generalise from a study to a larger population (Kalof et al., 2008). These authors suggest that, because experiments usually require somewhat artificial circumstances which may produce atypical behaviour of the subjects and often mean drawing on non-representative samples, the ability to generalise from experiments to the rest of the world may be problematic; as a result experiments have a limited external validity. Creswell (2009) states that the value of qualitative research lies in the particular description and themes developed in context of a specific site. This study is specifically meant for the improvement of South African regulation. There is no need to extend it to regulators around the world or beyond what has been studied.

3.8.2 Internal validity

Internal validity means the study is drawing appropriate conclusions from the data at hand (Kalof et al., 2008). For example, the authors explain, if the variables in a study do not measure what they were intended to measure, there are problems with invalid operational definitions. Essentially, Kalof et al (2008) state, internal validity is concerned with whether the study measures what the theory describes.

On the question of bias, it is conceivable that the researcher, as part of the South African financial services regulation may have brought her own perspectives to the study during interviewing and analysing of data. It is also possible that respondents may have responded in a protective way, given the role of the researcher as a colleague. All of these may have biased the study. To validate the findings, information from the literature review and several relevant documents was used. .

3.8.3 Reliability

Reliability is concerned with consistency (Kalof et al., 2008) Reliability is also about ensuring stability or consistency of responses (Creswell, 2009). In order to maximise reliability, Creswell suggests transcripts be checked to ensure they do not contain obvious mistakes made during transcription. A further step recommended by the last author is that researchers document as many steps of the procedure as possible.

Interviews were taped and later transcribed. Transcripts were checked and cross rechecked to identify mistakes that may have occurred during transcription.

4 ANALYSIS OF RESULTS OF THE STUDY

In this chapter the results of the interviews are analysed and a graphical representation of the responses is shown after the discussion of the various themes. Interviews were held with each individual respondent at their chosen venue. A total of twenty respondents were interviewed. Respondents consisted only of people of high rank, either as regulators, heads of FSPs, and heads of organisations responsible for educating consumers within the financial services. In two instances, two respondents were interviewed simultaneously. The sampling format chosen was a purposive sample. It was considered appropriate for its potential to yield useful and appropriate information.

The interviews revealed a range of issues and opinions from the respondents. These have been arranged into themes covering specific areas of the regulatory sector.

4.1 Themes

4.1.1 Gaps in regulation

4.1.1.1 Certain entities and or behaviour fell between the cracks

The issue of entities that are still unregulated was raised by respondents so many times as to suggest this is the single biggest flaw that undermines the efficacy of regulation. Undoubtedly many respondents felt it influenced the failure of financial services providers. Sixteen of the respondents alluded to this point even when they were answering other questions. One respondent, for example, made the point that notwithstanding the efforts made by regulators, there were still entities that were clearly unregulated. This respondent raised the issue of the now embattled Sharemax[5] stating that no regulator in South Africa (SA) has taken a view on Sharemax. This respondent elaborated by stating that none of the regulators had endorsed or approved the product Sharemax was selling. He gave the example of a washing machine, stating that for

[5] Two schemes promoted by Sharemax, the Zambezi and The Villa are the latest property syndications failures. The two have not paid income to investors since 2010. Investors are also unable to access their capital. The entire Sharemax is under a business rescue plan which was recently sanctioned by the High Court.

South African consumers to know that they were buying a product of quality, the washing machine would have the South African Bureau of Standards' (SABS's) approval. In the case of Sharemax, it did not happen.

Another respondent spoke of a gap between regulators and policy makers. For this respondent, regulation starts at policy making level. The disconnect between the two meant a disconnect in regulation. One respondent indicated that with multiple regulators, there is always of a chance that certain institutions would fall between the cracks. This respondent referred to cases of property syndications, such as Blue Zone, an FSP that was offering investment by means of property syndication to the public. Blue Zone succumbed in 2008 when it stopped paying income as promised to its investors. Questions of non-compliance, lack of transparency and fraud were raised about the company. In this case, the South African Police issued a public warning to the South African public indicating that Blue Zone was contravening the Banks Act. The point made by this respondent was that the entity was not regulated by any of the regulators in SA. This same respondent referred to the case of Sharemax and pointed out that each of the regulators may have thought that another was regulating Sharemax and Blue Zone.

Another respondent made the point that because there is an emphasis on specific areas while other financial services are left unregulated. He saw this as a weakness. He referred to the now defunct Fidentia[6] which was placed into liquidation during 2007, stating, 'Fidentia was not on anyone's brief'. Another respondent mentioned that there are entities that are actually cutting and designing products in such a way that they fit neither the FSB's nor SARB's mandate. In other words, these organisations are exploiting the loopholes in regulation. Another two respondents saw gaps in respect of micro-insurance and community based savings clubs, otherwise known as stokvels. In this regard, the two mentioned that regulators need to know there are different needs and appreciate the differences in approach to regulation. Respondent number sixteen saw no gaps in the law but in the interpretation. Gaps, according to this respondent, were caused by complacency and apathy. He cited the example of credit insurance, which he

[6] Fidentia collapsed sometime in 2006 amid claims of violating the law in that it was alleged to have invested funds in entities it was not allowed to invest in like soccer clubs. Fidentia was not a general FSP. It has an administrative and discretionary license. The mere fact that it had these two types of licences means it falls outside the ambit of this study which is has its focus on general FSPs.

claims brings no value to the life of a consumer. In this regard, this particular respondent stated that the regulator of the non-banking industry has still not taken a stance on this issue despite the product (credit insurance) having been exposed to be of no value to consumers[7]. He mentioned that credit insurance is actually three times if not more expensive than ordinary life insurance. (According to this respondent, this is where the regulator is really falling short, in its inability to protect vulnerable people from abuse by powerful financial giants; this is where the gaps become glaring. One respondent only identified the gaps with reference to unregulated entities only. The remaining four respondents had interesting examples to illustrate gaps in the system. For respondent number seven, the gap existed in the failure of the regulator to test the financial products offered to the public. Respondent number eight mentioned, “the innovative nature of the financial services industry will always see our regulatory system having gaps. Gaps are not only created by the non-existence of a regulator but by an instance of an ineffective regulator. For example, there is an upward spiral right now in terms of short term unsecured credit. This is because credit grantors can see the National Credit Regulator (NCR) is not looking. The Estate Agency Affairs Board is another example.”

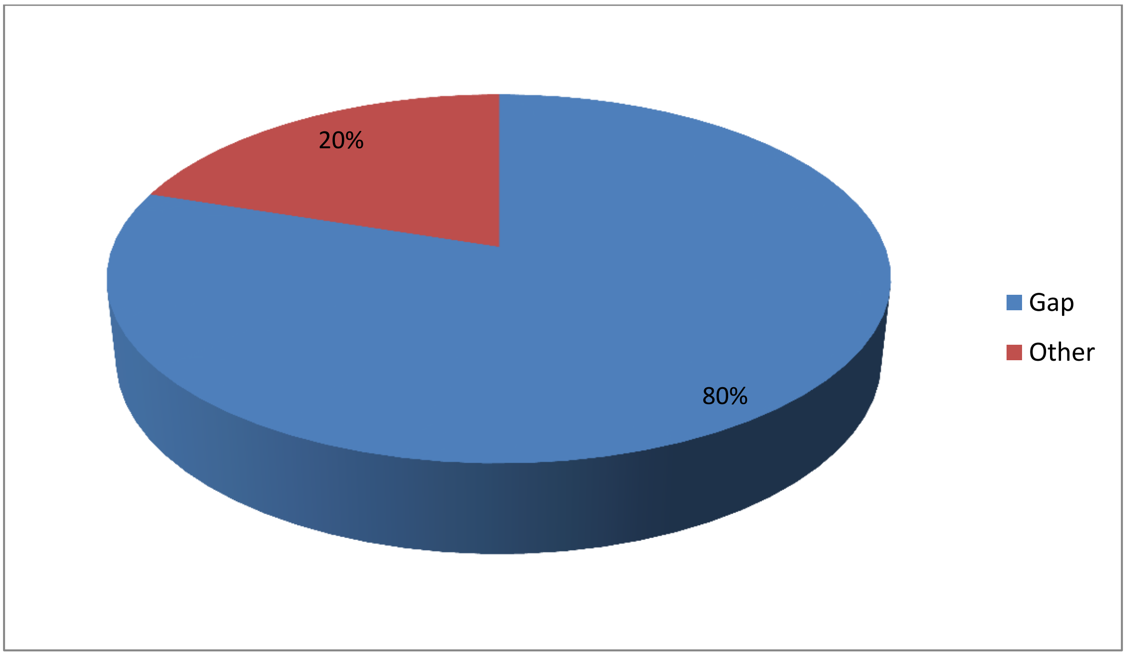

Figure 1: Gaps in regulation

[7] This example affects the lower income groups. Lenders raise the issue of high risk when it comes to lending to these income groups, requiring the credit seeker to take out credit insurance at often very expensive rates.

4.1.2 Gaps pertaining to licence issues

About ten respondents saw gaps pertaining to the licensing process. Two mentioned the need to improve the fit and properness test to filter applicants for licences for an FSP. The fit and properness test forces regulators to confront issues of personal character, integrity and honesty in relation to applicants for licences. That test is already part of the South African law; however, two respondents are of the view that there is a need to do more in this area and make the test more stringent. Of the two respondents, one went a step further and mentioned the need to test the product that is going to be offered to the public by the applicant firm. This particular respondent mentioned that the licence will also have to spell out in the future what a person or entity is licensed to do.

Another respondent spoke about the need for the regulator to be circumspect in terms of the granting of licences. This respondent mentioned that regulators do not have the capacity to verify the information supplied by applicants. For this respondent the gaps pertain to the process followed before applicants are granted a licence.

Another three respondents raised gaps pertaining to the licensing process. Out of the three, one mentioned that any regulator who does not filter potential applicants cannot effectively regulate. By filter, the respondent added, the regulator “must not only look at the credibility of the individual but must check the solvency, sustainability and most importantly, the business case of the applicant.” Two respondents mentioned that the regulator does not appear to be verifying the information from the applicants. A graphical presentation of the responses provided during the interviews is shown here below.

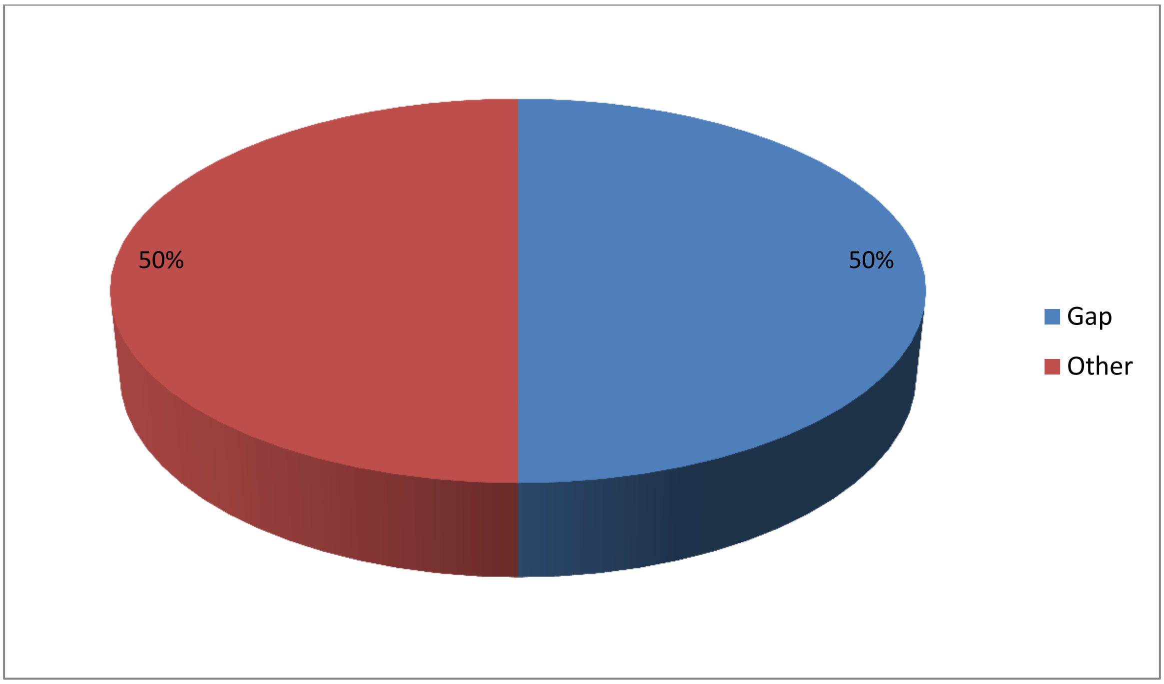

Figure: 2 Gaps in the licensing process

4.1.3 Gaps in monitoring and enforcement

About fourteen respondents referred to the lack of, or poor efficacy in the area of monitoring and enforcement. One respondent specifically mentioned that historically, the regulator operated in a reactive way. He gave the example that one would apply for licence and upon obtaining it, one would never again hear from the regulator. Effectively, the respondent was highlighting the extent of lack of monitoring. Another respondent stated that the regulator, in particular the regulator of the non-banking sector appears to be burdened by bureaucracy. According to the respondent, this is the reason the regulator cannot effectively monitor institutions.

Another respondent started off by stating that “the regulator of the non-banking industry is too busy licensing people instead of enforcing the laws”. According to this respondent, this was one of the main problems. Another respondent replied that, “There is no regulatory oversight for some entities even though they are running collective investment schemes.” Another made a startling statement that regulators are not there to save parts of a system. They are there to look after the whole system. This respondent stated that a regulator can ignore an entity even though signs of failure are evident until it collapses. Regulators, according to this respondent, have a duty not to ignore such signs or evidence that the business model and practices of the entity are not sustainable. He referred to the now defunct Fidentia as an example of this. . The same respondent made a point about monitoring and evaluating in a rather refreshing way. He mentioned that regulators are too trusting. Pressed to elaborate on the trust issue, this respondent mentioned the current episode involving a company known as Trilenear[8], a case whose details he is familiar with. Were it not for the trusting nature of the regulator, the respondent felt that Trilenear would have been saved. When asked to expand, the respondent mentioned that the regulator relied on Trilenear to take corrective steps, even though the regulator had been furnished with information of violations of the law by those in charge of the entity. No corrective action was ever taken. He went on to talk about the shifting nature of penalties where penalties are borne by companies instead of the heads of organisations. According to this respondent, until the penalties are borne by the heads of organisations, companies will continue to evade the law. One respondent mentioned that regulators do not appear to be going "deep enough to understand what is going on." In this regard, this particular respondent referred to the cases of two companies, namely, Corporate Money Managers and NFP. NFP, according to the respondent, went outside of the terms of its licence but regulators could not pick that up. Corporate Money Managers did the same. The same respondent further referred to a company known as Edwafin, which was operating out of KwaZulu-Natal, in Durban. The company sold debentures, promising investors "exotic returns". He queried why the regulator did not investigate the basis of their claims. Edwafin was liquidated in 2009.

Respondent seventeen stated that the biggest problem she sees is that regulators do not understand the business of the regulated and for them to effectively monitor, they need to understand that. Respondent eighteen and nineteen pointed out that FSPs were failing because they were overburdened by the costs of compliance. The last respondent in this group saw the problem as the regulators' approach to regulation. According to this respondent, many regulators around the world were moving away from a rules based form of supervision to risk based supervision. Another respondent proffered the idea that "the process is not stringent enough to keep unprofessional FSPs out". He cited the

[8] Trilenear is a discretionary FSP that is said to be facing liquidation amidst claims of irregularities involving theft of funds by those in charge.

examples of Fidentia and Blue Zone stating, ‘it took very long for the regulator to get rid of Fidentia”. There is, according to this FSP, a gap when it comes to compliance issues. “Churning[9] of financial products is still a problem.” There are also gaps in respect of audits or checks for compliance in that the compliance process is not helping to improve advice dispensed to consumers of financial products. ‘It is a tick box approach to comply with legislation.” There are also gaps in terms of prosecuting offenders. In this regard, this respondent referred to the case of Blue Zone asking, “Where is the deterrent?” Gaps, according to another respondent, are caused by legislative mandate and “the fact that no one monitors the work of regulators.” Another respondent mentioned that gaps are caused by the constant innovation by the regulated, “forcing regulators to play a catch up game” in order to effectively regulate.

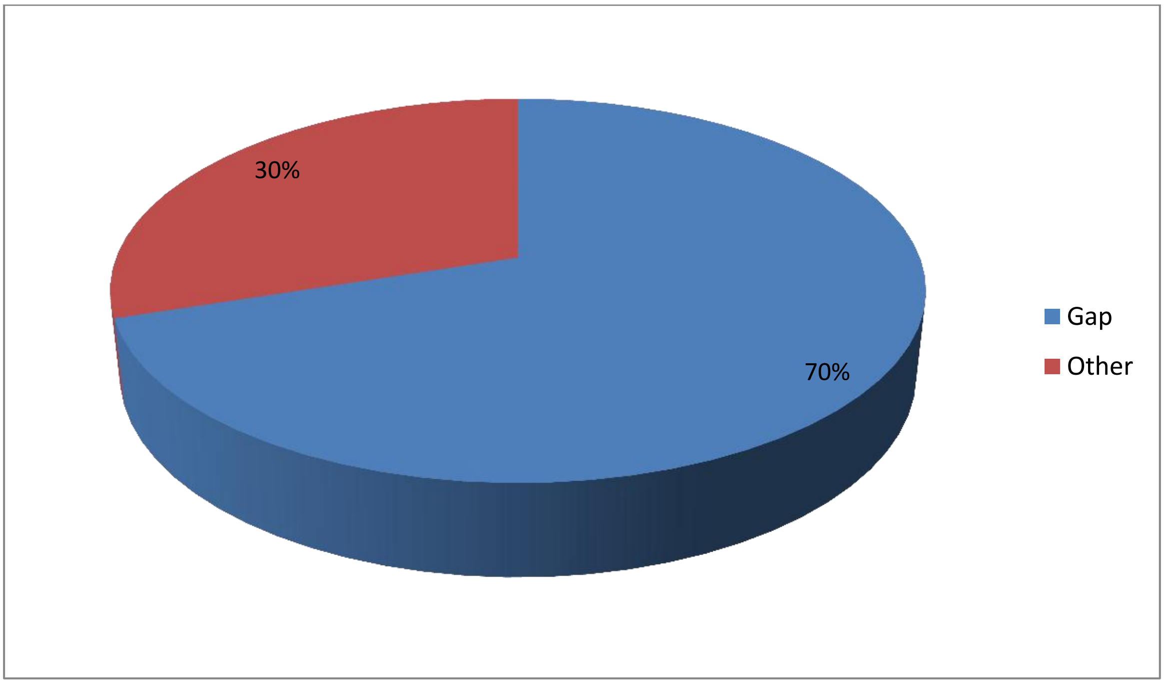

Figure 3: Gaps in monitoring and enforcement

4.1.4 Gaps in consumer education

About four respondents saw gaps in terms of the regulator’s ability to educate consumers. One respondent mentioned that the gap between the regulator and the

[9] Churning is the business of selling financial products to consumers and quickly replacing them for no apparent reason.

business of the regulated means that the regulator cannot move in quickly when consumers are being exploited. For him, the issue is about protecting consumers by educating them. He referred to the case of Saambou Bank, stating that regulators failed to educate consumers. Respondents fourteen and fifteen saw gaps in terms of consumer education. The point they made is, "the regulator is supposed to drive consumer education for regulation to be effective'. Respondent twenty also saw a gap in consumer education.

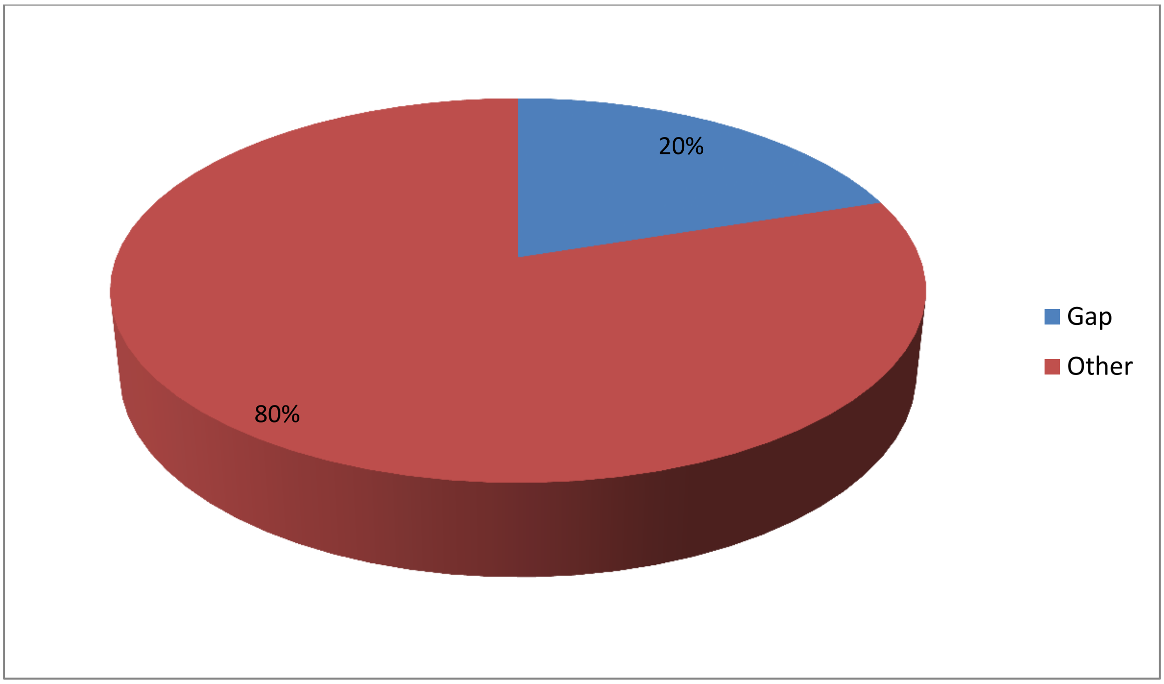

Figure 4: Gaps in consumer education

4.2 Lack of, or poor, co-ordination and collaboration mechanisms

About fourteen respondents alluded to the lack of, or poor, co-ordinating and collaborating mechanisms. In response to the question dealing with the design of the regulatory landscape, one respondent made it clear, "I believe in a single regulator." She made the point that the very regulator of non-banking financial services "is dressed up as a single entity, yet the reality is, it is different institutions." The point she was making was that there is no co-ordination within this entity due to its size. Other respondents were not at all concerned with the design. One respondent stated, "The absence of co-operation, co-ordination and understanding of each other's mandates (referring to other regulators') is the critical issue. Right now everyone is preoccupied with one's own mandate and the property syndications have exploited these gaps, in particular the fact that no one has tested their product".

Respondent number nine has no problem with the design. In his view, offices of the Pension Funds Adjudicator and the FAIS Ombud which are also part of the regulatory landscape, lack autonomy and that to him is a problem. Pressed for examples to bring about clarity, he mentioned the fact that everyone knows that the two offices are funded through the FSB's funding mechanism and that is a problem. In his view, these organisations are supposed to be funded via a different mechanism. For this respondent, the funding mechanism weakens these two offices. Respondent number ten stated that following the global financial crisis, even the UK is rethinking its stance of consolidating everything under one roof. In his view the UK could not avert the crisis, notwithstanding its supposed strength gained out of consolidating everything under one roof. In South Africa, the respondent stated, there is certainly scope for consolidation. On this score, the respondent referred to a treasury policy statement which has opened a discussion about establishing a twin peaks model of regulation.

Another respondent felt that , "the greatest weakness with regulators is that they do not talk to each other. Co-ordination would help with research capability. I am not in favour of a super regulator as this will bring about a bureaucracy that will have its own difficulties. For example, Fidentia and Sharemax, are good examples that the agencies do not talk." For respondent number twelve, regulation is the work of a 'collective'. For him, "even if the agencies were under one roof, there would have still been a Sharemax. Sharemax for me is what I call a perfect storm for regulators." According to this respondent, there are many other regulators who are seldom fingered in the Sharemax case. He mentioned the role of the audit regulatory board, pointing that it is unthinkable that auditors of the company did not see anything wrong in Sharemax. Another respondent mentioned the need to co-ordinate and collaborate and referred to the twin peaks model proposed in the treasury policy document. Respondents fourteen and fifteen added to the need for collaboration and co-ordination, "ruthless enforcement of the law". At the time of the interview with these two respondents there were still brokers who were selling Sharemax. According to them, this pointed to weakness in enforcement of the law.

Respondent sixteen stated that there were entities falling between the cracks; his idea was that there should be a single regulator for market conduct and for prudential investment, referring to the twin peaks model. Another problem for him is what he calls, “arbitrators who operate under different rules with different levels of effectiveness”. In his view, there should be a single complaints resolution forum.

Respondent seventeen, without specifically stating whether there was a problem with the design or not, stated, “There are all these agencies but one struggles to find a thread between them. What then happens is that regulators engage in turf wars. The idea behind establishing so many agencies does not appear to have been properly thought out. For example, there is indication that there is turf war between the Consumer Commissioner and the National Credit Regulator”. For respondent eighteen and nineteen, there is a problem with the fact that FSPs are not only burdened by legislation administered by the FSB. They have to satisfy other regulators which have different approaches to regulation. Respondent twenty saw no problem with the design of the regulatory system. In fact, for this respondent, “There is no regulatory explanation one can find for the failed entities”. The issue of collapsing FSP’s has nothing to do with effective regulation, “it is about sheer criminality”. When asked whether there are no regulatory matters one could identify for improving regulation, his view was, “This is financial crime”.

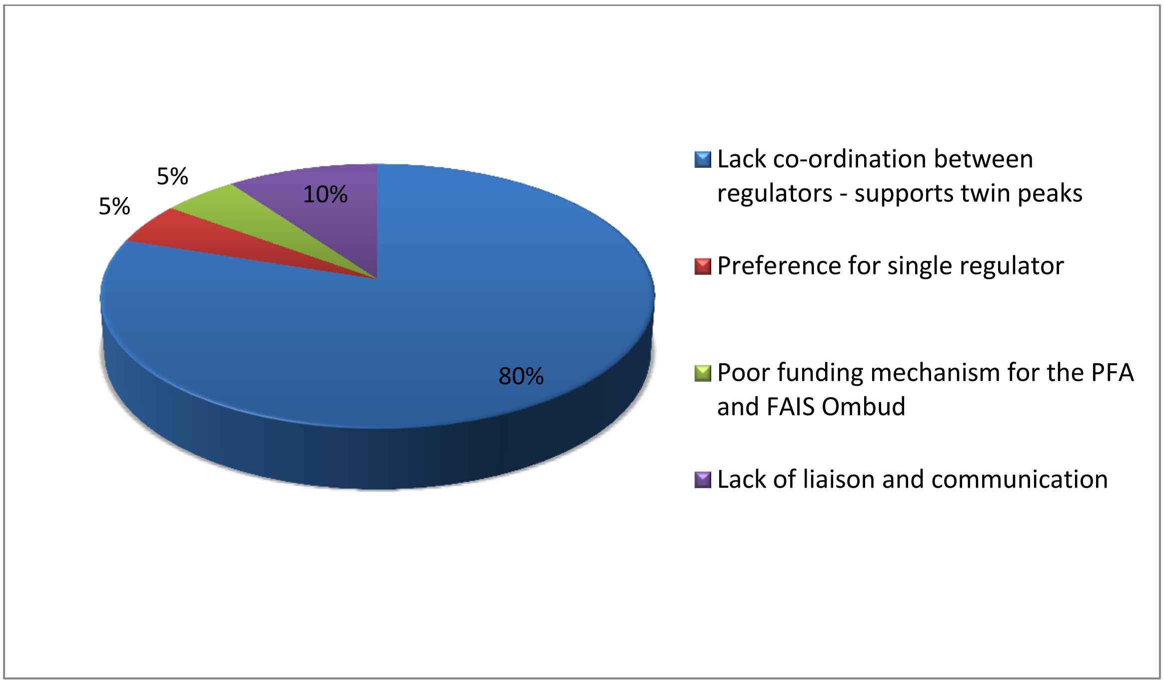

Figure 5: Collaboration and co-ordinating mechanisms

4.3 Inadequate, or lack of, capacity

The majority of respondents made an issue of lack of capacity even when responding to other questions. For example, issues of poor, or lack of, enforcement were often answered by respondents with reference to lack of capacity. Verification of details at license stage were associated with lack of capacity, amongst other things. Respondent number eleven stated that “gaps existed in terms of skill”. There are, according to this respondent, people who do not question things. “Regulators are supposed to challenge the normal appearance of things.” Gaps, for respondent number twelve, are caused by the ‘inability to understand what regulation is about’. He says regulators do not understand what regulation is about. He points to the issue of insufficient capacity. He also stated that in the Sharemax case, regulators believed they did not regulate it and calls this, “a narrow interpretation of legislation”. He referred to the case of Edwafin, stating that regulators came out publicly stating they do not regulate Edwafin who’s business was selling debentures through brokers. Debentures are defined as a financial product in the FAIS Act. Another respondent spoke about regulators being reactive and not proactive. Regulators, according to this respondent, do not talk and therefore do not understand where each other’s mandate starts and ends. There are also gaps in knowledge. She cites the example of FIC stating that they are unable to assist with simple issues like interpretation of their own legislation. Respondents eighteen and nineteen pointed to groups of people who are still unregulated, citing people who sell assistance business (a funeral benefit). In their view, the issue is not one of under regulation but over regulation as the regulator has made rules it cannot enforce. It is submitted that the inability to enforce rules the regulator has made as alluded to by respondents eighteen and nineteen is an issue of capacity. Respondent number one disagreed that there are regulators who are challenged by lack of skills. What he saw was lack of pro-activity. He gave the example of Fidentia, pointing that the issue is not ability but willingness to “do things before something goes wrong”. At this point, he re-emphasised that regulators should evaluate the business sense of an investment that is being sold to the public. The rest of the respondents stated that regulators in SA are challenged when it came to skill and the ability to appreciate the complex financial services world. Another respondent made the point that regulators are disconnected from reality. Another cited derivatives stating that regulators do not understand these products. Respondent number four stated that regulators are seen as a training ground by the rest of the industry because the industry can offer remuneration packages, including share options and other conditions that regulators are unable to offer. Respondent number five was simply of the view that regulators around the world are challenged by the same thing and SA was no exception. His point was that regulatory skill is so rare. It requires one to see what is hidden, and to hear and understand things that are not easily identifiable. He mentioned instances where the regulator (of the non-banking sector) lost cases simply because some of its personnel were unable to appreciate what others might consider basic matters pertaining to certain fields.

Respondent number seven pointed to the case of Leaderguard, an entity that sold forex denominated investments to the public. According to this respondent, it took a long time for the regulator to appreciate the product and what the institution was doing. For him, Leaderguard was nothing other than a pyramid scheme and the regulator did not see this. Respondent number ten stated that regulators are simply unable to appreciate the complex financial products. He referred to the new Consumer Protection Act and proffered that consumers are still being fleeced by financial institutions, notwithstanding the Act.

One stated that employees join regulators for three or four years to gain experience and then move on to make money. The lack of skill according to this respondent was exacerbated by the fact that there is not a single tertiary institution in SA that offers regulation specific training. Respondent number twelve mentioned that at least 60 % of entities that failed in SA could have been averted, if the regulator had acted in time. In his view regulatory intervention often comes late. He states that the reason is often due to lack of appreciation of the problem. He mentioned as an example, “the advice process in Sharemax was not queried by the regulator.” He points out that a mere reading of the Sharemax prospectus alone should have led the regulators to question the validity and the feasibility of discharging on the promises made to investors. He also pointed out that the prospectus was passed by the DTI, also a regulator. Respondent number thirteen felt that the numbers alone tell the story. He referred to the total staff complement at SARB estimating it roughly at 500 people and compared it to the number of big bank institutions

SARB is supervising, which he put at four or five. He then mentioned the FSB with about 400 staff and referred to the institutions it supervises. His view was that pension funds alone require the current staff complement before one can even think of other institutions that are supervised by the FSB; this includes insurers and other authorised financial services providers. According to this respondent, the regulatory authorities could either take a realistic view of the dire shortage of resources at the FSB now and rectify the problem or continue to prevaricate and live with the institutions supervising themselves.

According to respondent number twenty, the issue of deficiency in capacity was not so critical; however, ongoing development must be intensified.

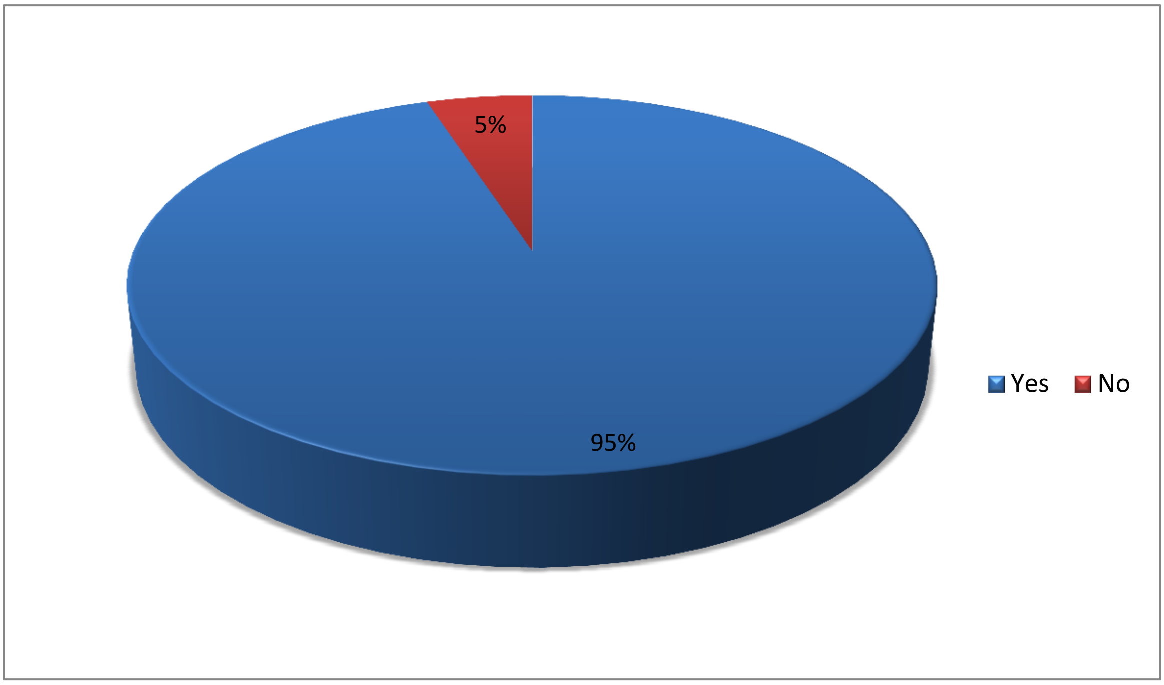

Figure 6: Challenges with capacity

4.4 Lack of, or poor communication, between regulators

About thirteen respondents stated there was lack of, or poor, communication between regulators. Respondent number one said that, based on what has happened with the various property syndications, there is no information sharing between regulators. However, for this respondent, the issue is not simply one of sharing but "engaging.

Engaging takes a little more effort in that one has to make the other person understand." According to him, this is not happening. The majority of respondents were in agreement that regulators do not share information. According to respondents four and five, regulators are pre-occupied with their own mandates. One of the respondents, a regulator, pointed to the case of Fidentia as an example of regulators not sharing information.

According to respondent number six, regulators do share information but more could be done. Respondent number seven stated that he does not believe regulators share information. He mentioned the Financial Intelligence Centre (FIC) stating that the entity is supposed to be an intelligence reservoir for regulators; however, he believes this is not the case, otherwise there would not have been a Blue Zone, Blue Pointer or even a Sharemax; all should have been thwarted from the start. Respondent number eight attributed the problem of regulators not sharing information to what he called, "silo mentality". It is this mentality that drives individuals to look after their own interests. Respondent nine stated he does not know whether regulators share information with one another and that all he knows is that the activities of the regulator are not known by the public. The only time people hear about the regulator is after an irregularity has been discovered, then the regulator will be heard, "playing a defensive role." For respondent number ten, regulators have performance contracts and incentives and are paid based on achievement of an organisation's goals. According to this respondent, herein lies the problem.

Respondent number eleven states that regulators do not share information. He mentioned the example of entities that report to Treasury and made the statement that these entities do not communicate with each other. Then he asked, "how much more complicated does it get, if one adds all the other regulators?" For respondent number thirteen, the issue is about key performance areas (KPAs), which, according to him / her define behaviour. For respondents fourteen and fifteen there was some information sharing but they felt more could be done. Respondent sixteen indicated that the impression created is that regulators are passing the buck and not taking responsibility. This was the case with the collapse of the property syndications where no regulator was prepared to accept responsibility. The impression created according to this respondent is that there is no information sharing.

Respondent seventeen was of the view that regulators do not share information. Eighteen and nineteen had no knowledge of whether regulators share information or not. According to these respondents, the enactment of the Consumer Protection Act and the overlap with the FAIS Act indicates that regulators do operate in isolation. Their view is this overlap is going to create a problem as the financial services industry is a specialist financial field. For respondent number twenty, regulators in SA were challenged by this issue; however, it was felt they have gone a long way to mitigate it.

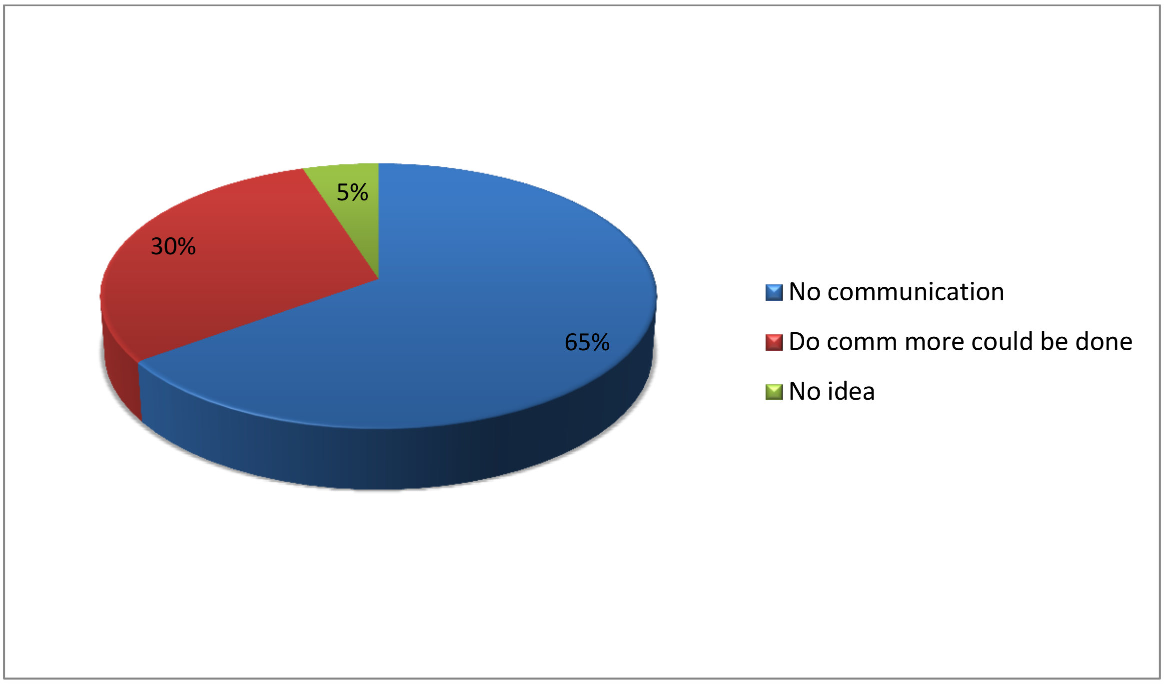

Figure 7: Challenges with communication

4.5 Regulatory capture

Three respondents had no evidence of regulatory capture. Respondent number one went so far as to dismiss the idea stating, "There is no such thing as capture. What exists is a power imbalance between larger financial institutions and smaller ones where the voice of the larger institutions, because they are able to lobby more strongly, individually and collectively, this ultimately prevails and shapes legislation". In this regard, he referred to changes in the regulations governing commission which he says is in the interests of the big firms. Respondent number four states regulators are required to consult and made the point that robust consultation and trade-ins to resolve impasses cannot be confused with capture. According to him, the industry respects regulators and both respect the relationship between them. He however conceded there may be “a chancer, who thinks he or she might get away with things, but that is not typical of regulators.” Two stated there is regulatory capture. In this respect respondent number two referred to the financial muscle of the industry which enables it to do things that the regulators cannot do due to resource constraints. In the past, this respondent states, the industry has blackmailed the regulator of the non-banking industry, threatening retrenchments if the regulator persists with a particular rule. For this respondent, the issue is not only prevalent in SA, but in most developing countries, like China, India and others that have social needs that cannot be ignored. Where the industry threatens to retrench two thousand workers over what they consider to be onerous regulatory requirements for example, no regulator will want to be blamed for that. Respondent number five stated, “while we can fool ourselves and think capture does not happen, it is possible that it happens at individual level“ For this respondent, regulation derives its character from the people behind it; capture can also happen during negotiations which is why regulators have to be vigilant.

Three respondents stated they have no information of capture. There is however, according to respondent number nine, undue pressure from the industry to have their own people in certain critical committees of the regulator. There is also according to this respondent, a resistance to the transformation imperative that has been shown by the industry. Respondent number seven agreed there is definitely capture and this is due to the financial muscle of the industry. Respondent number ten stated that the problem is one of resources. He states, “We have a powerful industry comprising banks and insurers with well-funded bodies looking after their (industry) interests unashamedly”. The regulator, according to the respondent, cannot match the resources to the extent that at times the regulator may have to seek assistance from industry bodies. He cites as example, instances where the regulator has had to make use of research carried out by industry for this respondent, capture is simply a consequence of resources.

Four more respondents felt there was capture. One completely rejected the idea claiming that if that was the case, the industry would have everything it wanted by way of regulation. Respondent number eleven stated that capture starts with professional relationships which then develop into cosy relationships followed by soft regulation where decision makers make their decisions on the basis of feelings, not on fact. He further referred to lobby groups that ensure regulators do not reach decisions contrary to the industry's interests. For this respondent, it is not easy to capture a large-scale regulator. However, there is danger of capture for smaller regulators. (In this context, the description of small or big refers to the scope of mandate of the regulator). Respondent number thirteen felt that where a firm, through its agents, behaves in a superior fashion when it interacts with the regulator, then there is capture. He mentioned that where the regulator cannot show intellectual independence, it will have no option but to rely on the regulated and for him that is capture. He recalls a time when deposit insurance was mooted. For him, it was not an anomaly that the regulated disagreed, but when the regulator itself disagreed choosing to be advocates for the industry, he felt they were captured. Respondent number fifteen stated, "there is partial capture because for regulators to appreciate what the regulated is doing in its business, they need to step closer to the regulated. With that there are relationships formed and within those relationships, life happens." Respondent number sixteen stated that capture is there but in a minimal way. (In the past it was obvious in that the industry used to prefer people who had served in FSP ranks to staff the regulator so that they can be sympathetic to their cause; however, this does not happen any longer. The same respondent referred to the practice of the industry luring the staff of the regulator with bigger remuneration packages in order to secure access to the regulator; over the years, the situation has improved, said this respondent. He gives the example of commission regulation, pointing out that it never had anything to do with protecting the consumer, but rather protection of the industry against its own practices of churning[10] business. Big firms that do not have cash flow problems were not affected by these changes but the same cannot be said of smaller firms. (For the bigger firms, they felt they were successful in squeezing the smaller firms in that any churning of business would simply bring no financial benefit for the intermediary.

Respondent number seventeen put it thus, "strictly speaking, the regulators are understaffed and lack resources to do their work properly. I do not see regulators in SA

[10] Churning in this sense refers to the business of replacement of a policy for no other reason other than commission interests of the intermediary.

prone to capture." Eighteen and nineteen said they do not see regulatory capture. They saw a regulator who was imposing all sorts of rules and giving its employees authority to conduct inspections into FSPs businesses. For these two respondents, such a picture shows anything but a captured regulator. Respondent twenty believes that South African regulators are simply prone, and possibly even pre-disposed to capture and this is solely because of the oligopolistic nature of the financial services industry.

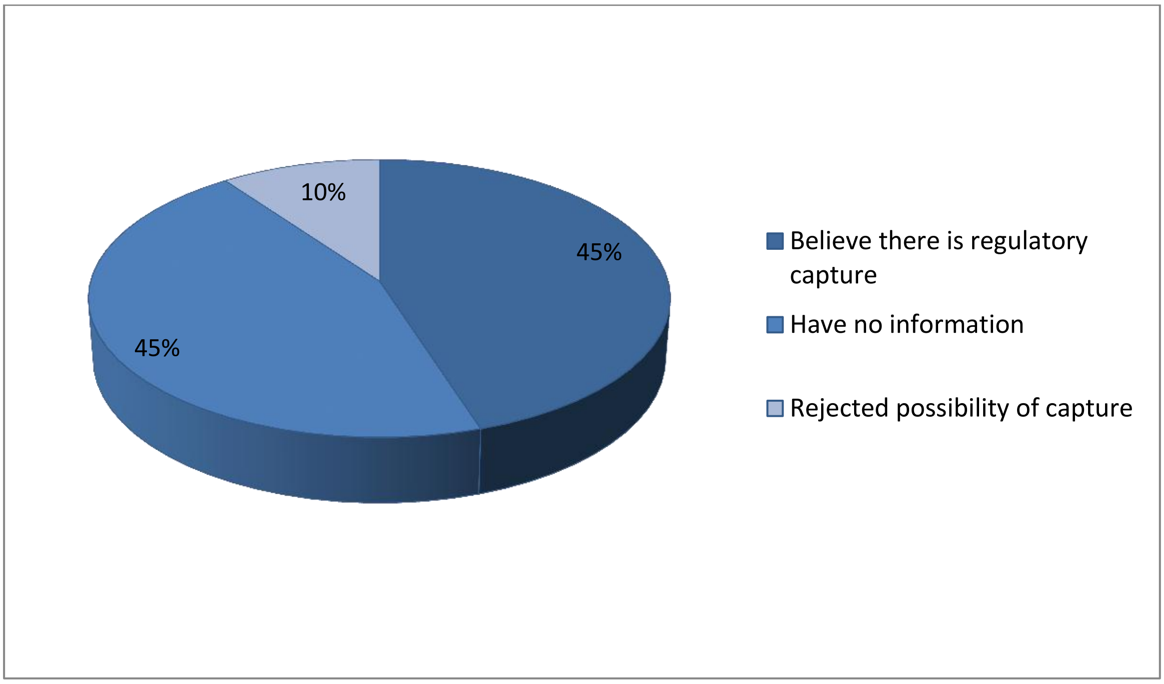

Figure 8: Regulatory capture

4.6 Conclusion of Analysis

In summary, sixteen respondents mentioned the issue of entities that are unregulated as a major problem and saw this as having an influence in the failure of financial services providers.

Ten respondents pointed to the gaps pertaining to licensing including the failure to regulate the product.

Fourteen respondents saw flaws in monitoring and enforcement.

The majority of respondents agreed with the proposition that South African regulators are no exception to the rest of the world in so far as challenges of capability are concerned.

A substantial number of respondents saw lack of co-ordination and collaboration as the problem as opposed to the design and the existence of multiple regulatory entities.

Thirteen respondents agreed with the proposition that South African regulators either did not communicate or communicated poorly with each other and cited examples to support their views.

It would appear that regulatory capture is not a factor that one could sufficiently argue influences failure of FSPs in South Africa. For example, whilst nine respondents agreed there may be capture, nine had no evidence of capture and two rejected that there is such thing as capture.

Four respondents mentioned lack of effective consumer education as a factor that could undermine regulatory effectiveness. For these respondents, for regulation to be effective, consumers must be empowered.

5 FINDINGS

The aim of the study was to test whether any of the factors perceived to be influencing the failure of financial services providers could be relevantly raised about South African regulation of financial services. The following propositions were tested:

5.1.1 Proposition 1

South African regulators are operating in a fragmented system challenged by the possibility of capture, lack of capability, and lack of information sharing.

5.1.2 Proposition 2

There will be different perceptions about the factors that influence the failure of FSPs across the different stakeholders.

5.1.3 Proposition 3

It is feasible to synthesise from the suggestions and the opinions a more effective regulatory framework to substantially minimise the failure of FSPs. Respondents were asked to simply identify the regulatory factors they perceived to be influencing the failure of FSPs in South Africa. One theme that came out of most respondents was that the system has **deficiencies (gaps).** These gaps manifested themselves in the following:-

a) Several entities were not regulated;
b) The licensing process was said to be considerably weak in that it allowed individuals who would otherwise not have succeeded to enter the financial services industry had there been stringent requirements;
c) The licensing process also did not test the business case made by potential applicants who wish to enter the financial services industry; and
d) Monitoring and enforcement.

There are suggestions to the effect that notwithstanding the fragmentation, vulnerability in the system is introduced by lack of information sharing, and lack of co-ordination and collaboration (Government Accountability Office, 2004).There was no conclusive evidence that South African regulators are prone to capture. The results of the study clearly show that while nine respondents believe there is capture, nine have no evidence of capture and two completely rejected the idea that there is capture.

South African regulators are challenged by skill. Nineteen respondents made the point unequivocally. The fundamental issue contributing to the lack of skill is the innovative nature of the industry, compelling regulators to always play a catch up game. It is no wonder that lack of monitoring and evaluation was singled out as the single biggest area where gaps are manifesting themselves (Benink and Schmidt, 2004; Crotty, 2008; Blinder, 2009).

6 RECOMMENDATIONS

In this chapter, a more effective regulatory framework is synthesised taking into account, the findings of the study, the literature review and documents relevant to this study in particular the discussion document recently released by the Department of National Treasury, (Department of National Treasury Republic of South Africa, 2011). The background to this document is, in 2007, National Treasury, (NT) launched a formal review of the financial regulatory system. The scope of the review was expanded in 2008 following the global financial crisis. The document provides a comprehensive review of the key challenges facing the financial services sector and is set to provide a road map to meet those challenges. It would appear that the study is still a work in progress. Apart from the fact that a number of respondents made reference to this document often citing the idea of a 'twin peaks' model of regulation, the document also contains information that seems to support some of the results of the study. Undoubtedly, the study contains richer detail.

In its overview, the report states that the financial services sector touches the lives of each and every South African. It enables economic growth, job creation, the building of vital infrastructure and sustainable development for South Africa and her people. It is therefore crucial that the sector is well regulated. Out of the principles espoused in the National Treasury document, four are relevant to this study:-

- Principle 1: Financial services providers must be appropriately licensed or regulated. Entry into the market must be subject to an appropriate licensing including being appropriately capitalised, taking into account financial stability, and safety and soundness concerns., sound corporate governance standards, encapsulating appropriate checks and balances.
- Principle 3: Supervision must be sufficiently intense, intrusive and effective. The ability to supervise requires appropriate resources, authority organisation and constructive working relationships with other agencies and must be complemented by the will to act. The will to act requires supervisors to have a clear and unambiguous mandate, operational independence, coupled with accountability, skilled staff and a relationship with industry that avoids regulatory capture.

- Principle 7: The legislative framework should allow for a lead regulator for every financial services institution that is regulated by a multiple set of financial regulators. All regulators involved must strive to co-ordinate their supervisory activities.
- Principle 13: Regulators should be appropriately funded to enable them to function effectively. A regulated sector should ideally fund the operational budgets of regulators in a way that eliminates risk of capture and conflicts of interest.

6.1 Licencing

It will be recalled that licensing was identified as one of the factors that influence regulatory failure in South African financial serviced industry. This resonates with first principle identified in the NT document. The intent to ensure that everyone who participates in the financial services as an FSP is welcome. The problem however, is, in the study, the results showed that it was not only a question of ensuring that everyone is licensed that was the shortcoming. Rather, it is how licenses are issued. Questions of verification of the details furnished by potential licensees were identified, coupled with the need to test the business case of the applicant. It is no use granting licence to people who peddle products that provide no value to investors[11]. It is important that the regulator verifies the details furnished by applicants and test the business case of the applicants.

6.2 Monitoring and evaluation

The NT document refers to supervision and advocates that it must be sufficiently intense, intrusive and effective. This no doubt must be welcomed as an important step. However, the results of the study showed that regulators adopt no more than a tick box approach when monitoring FSPs. There were questions raised about the ability to appreciate the business of the regulated and the catch- up game that regulators have to play due to the

[11] The Blue Zone case in this regard has reference. The group marketed an investment which had no chance of ever providing value to investors. See page

ingenious ways with which FSP's design their products and operations solely to evade the regulator's reach. It is noted that the NT document does not deal with how regulators must keep abreast with the developments in the financial services industry in order to supervise effectively. The romantic view that supervision must be intense, intrusive and effective, with respect offers little or no comfort unless the underlying issue of ensuring constant up-skilling of regulators is addressed.

6.3 Gaps in regulation, co- ordination & collaboration and information sharing

The NT document provides for a lead regulator for all instances where more than one institution is regulated by multiple regulators and advocates for the need for regulators to co-ordinate their activities. Indeed, the results of the study showed various instances where cracks in regulation were apparent either because one regulator believed another regulator had an oversight role over an FSP or due to lack of sharing of information, essentially pointing to the need for regulators to collaborate and co-ordinate their activities. The case of Sharemax immediately comes to mind. The group raised funds from members of the public for more than three years before the South African Reserve Bank (SARB) stepped in to stop them. They were said to the conducting the business of a bank without a license. The question is would such large numbers of consumers have lost their life savings had the regulators been sharing information and co-ordinating their activities. It is doubted. The problem however, is the NT document does not deal with the underlying causes for regulators to be concerned with their individual organisation's mandate. These problems are rooted from personal interest of achieving and the attendant compensation by way of incentive schemes. Unless the policy makers consider entrenching these key issues into individual performance contract of each individual regulator, little will change the status quo.

6.4 Challenges relating to capacity and capture

There was no clear evidence that South African regulators could be prone to capture. What came out of the study was lack of capacity which saw regulators behaving in a reactive way and at times uninterested even in instances where they were supplied information about irregularities. Capacitating regulators requires creative ways and these are not discussed in the NT document.

It would greatly assist the NT to delve deeper into the problems surrounding the financial services in order to gain more insight into the underlying causes of some of the symptoms they aim to address. The policy makers would be able to craft an effective regulatory framework which would substantially minimise the failure of FSPs, were they to take into account the findings of this study.

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APPENDIX A:

Table 2: Definition of terms

FSP	Financial Service Provider is described in the Financial Advisory and Intermediary Services Act 37 of 2002, (the FAIS Act) as a person other than a representative, who as a regular feature of their business furnishes advice, or renders intermediary service or both (The Republic of South Africa, 2002).
FAIS Act	Financial Advisory and Intermediary Services Act, Act 37 of 2002 – the FAIS Act which came into operation on 30 September 2004
FSB	Financial Services Board
SARB	South African Reserve Bank
DTI	Department of Trade and Industry
FIC	Financial Intelligence Centre
JSE	Johannesburg Securities Exchange

NCR	National Credit Regulator
CC	Consumer Commissioner
CC	Competition Commission
CMS	Council for Medical Schemes
BESA	Bond Exchange South Africa
Property Syndication	Public Property Syndication (property syndication) - the assembly of a group of investors invited to participate in entities whose sole assets comprises immovable property. The investors share profits and losses in these companies and enjoy the benefits of net rental growth through proportionate share of income (The Republic of South Africa, 2006)

Appendix B:

RESEARCH QUESTIONNARE

1. What factors in the financial regulatory system influence the failure of financial services providers?

2. Examples would be appreciated to support your answer in 1.

3. What in the design of the South African financial regulatory system could bring about ineffectiveness? In your answer, please comment about the existence of multiple agencies regulating the financial services industry and support your answer.

4. Examples would be appreciated in support of your answer in 3.

5. Do you see the financial regulatory system as one that could potentially have gaps? If so, what causes gaps?

6. Examples to support your answer in 5.

7. Regulatory capture is identified as something that affects regulators around the world. Are South African regulators prone to capture? If so, why. If your answer is no, why? Examples would be appreciated.

8. Inadequate regulatory capability (skills and ability to understand the complex financial services world) is seen as challenging many regulators around the world, would you say that South African financial regulators are challenged in this regard, if at all?

9. Why do you say they are challenged? Examples will be appreciated to support your answer.

10. Regulators are said to be weakened by the fact that they do not share information, to what extent do you think this applies to South African regulators? Why do you say this? Please provide examples to support your answer.

11. What other issues or events can you comment on which in your view could potentially undermine effective regulation within the financial services industry.

DEFINITIONS TO ASSIST RESPONDENTS WHERE NECESSARY

Regulatory capture refers to : a situation where regulators take on the objectives of management in the firms they regulate, thereby possibly losing sight of the ultimate objectives of regulation (Benink and Schmidt, 2004).

DECLARATION

I declare this research is my original work except for source material explicitly acknowledged, and that the same or related material has not been previously submitted for another course. I also acknowledge that I am aware of University policy and regulations.

2012-10-23

N N BAM | Date