



**UNIVERSITY OF  
KWAZULU-NATAL**  

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**INYUVESI  
YAKWAZULU-NATALI**

**A CRITICAL EXAMINATION OF THE REGULATION OF THE  
FINANCIAL SERVICES SECTOR IN SOUTH AFRICA**

A DISSERTATION CONDUCTED

**BY**

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## Declaration

I, Faisal Zorgani, hereby declare that:

- 1- This project is my own work, and that all my sources of information have been acknowledged. To my knowledge, the dissertation has not previously been submitted for any academic examination towards any degree in any other University.
  
- 2- This project is an original piece of work which is made available for photocopying and for inter-library loan.

Signed: \_\_\_\_\_

Faisal Zorgani

17 December 2014

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## **Dedication**

I would lovingly like to dedicate this dissertation to the following valuable persons:

- The most honest and faithful human being, who was sent as a mercy to the worlds, as a beacon of science, our Prophet and Master Mohamed (P.B.U.H).
- The great Imam of this time, Dr. Mohamed Alaaeldin Madi Abouelazaiem.
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## **Abstract**

The financial system of a country has a crucial role to play in economic growth. The system, efficiently directs savings of lenders to ultimate borrowers. It also provides an efficient payment system through the banking institutions. Every country seeks to have effective laws regulating its financial system to ensure the efficiency and effectiveness of such system. However, the global financial crisis in 2008 revealed that the soft regulation approach adopted by most countries was not effective and that tougher regulation was needed. This led many countries to reform their system of financial regulation and to adopt a macro-prudential regulation approach. The macro-prudential approach deals with the financial stability and soundness of the financial system as a whole and not the individual financial institutions in isolation. South Africa is no exception. Although South Africa, compared with many other developed countries, was protected from the repercussions of the crisis, it introduced a number of financial regulatory reforms. Following the trend in the United Kingdom, South Africa has indicated an intention to adopt a twin-peaks model of financial regulation to make the financial sector of the country safer and to serve the country better. This dissertation seeks to consider the impact of the twin-peaks model of financial regulation on the financial sector in South Africa. It is intended that the model will provide protection for consumers of financial services on issues which are not covered by the Consumer Protection Act, 2008. The model will dispense with the need for a multiplicity of regulators. This will ensure that there is proper control over market conduct, and will prevent unscrupulous persons from jumping from one regulator to another to avoid detection. It is suggested that it would be better for South Africa, to introduce a regulatory system that suits its own problems and environment instead of adopting systems adopted by other countries. However, it is acknowledged that this may take a couple of years to be conceived, prepared and implemented, which could result in consumers and investors being prejudiced by unscrupulous advisors. It is concluded therefore that the twin-peaks model may have some flaws and may be cumbersome for South Africa, but it is an immediate solution, and it can be optimised to accommodate South Africa's specific needs as time goes by. It is also suggested that the model should embrace the National Credit Regulator in order to provide an efficient control of the credit industry, and to ensure that an Africa Bank type saga does not re-occur.

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# Chapter 1

## Introduction

### 1.1 Background

In every country there is a need for effective regulation to ensure the effectiveness and efficiency of the financial system in that country.<sup>1</sup> The global financial crisis in 2008 has led many countries to reconsider their financial regulation and whether that regulation will be able to weather any contingency in the future.<sup>2</sup>

In South Africa, the government had launched a change in the regulation of the financial sector even before the crisis occurred. Through the enactment of the National Credit Act (NCA),<sup>3</sup> the South African government managed, to some extent, to avoid the worst of the crisis.<sup>4</sup> However, a number of proposals have been submitted by the South African Treasury since the crisis. These proposals intend to strengthen the financial sector so that it will be able to avoid any potential risk, and to reduce the number of problems which may be encountered by consumers. These proposals have culminated in issuing “the twin-peaks model of financial regulation”.<sup>5</sup>

The twin-peaks model can simply be described as a method that places the responsibility for prudential regulation of financial institutions onto one regulator, which is the first peak, and the supervision of market conduct and consumer protection onto another regulator, which is the second peak. By adopting the new regime of twin-peaks, South Africa is seeking to increase the regulation of the financial sector and to make existing regulation more stringent.

### 1.2 The purpose of the study

The life of every single person in the world is connected to the financial services sector.<sup>6</sup> The sector enables job creation, economic growth, the creating of effectual infrastructure and

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<sup>1</sup> H Falkena, R Bamber, D Llewellyn and T Store *Financial Regulation in South Africa* South African financial sector forum report (2001) 2.

<sup>2</sup> C Brummer *Soft law and the global financial system* (2012) 233, 234.

<sup>3</sup> National Credit Act 34 of 2005.

<sup>4</sup> T Woker „Why the need for consumer protection legislation? A look at some of the reasons behind the promulgation of the National Credit Act and the Consumer Protection Act“ (2010) 31(2) *Obiter* 217.

<sup>5</sup> South Africa National Treasury *Policy Document: A safer financial sector to serve South Africa better* (2011).

<sup>6</sup> *Ibid* 1.

sustainable development for every country and its people. It is, therefore, very important that the sector is well-regulated and stable.<sup>7</sup>

Before the financial crisis of 2008 occurred, many jurisdictions tended to approach the financial sector rather “gently”. In other words, a “soft” regulatory stance was adopted, rather than a stringent approach.<sup>8</sup> Many large banks in the United States of America (USA) for example, were regarded as “too big to fail”.<sup>9</sup>

In South Africa, the government was criticised for introducing the NCA which was regarded as a case of “over regulation”.<sup>10</sup> However, the global financial crisis of 2008 proved that the NCA was an appropriate step.<sup>11</sup> Moreover, many countries, as a response to the crisis, were encouraged to carry out similar reforms to their regulatory systems.<sup>12</sup>

The purpose of this research is to examine this increased regulation over financial markets since the time of the financial crisis in 2008, with specific reference to the South African response.

### **1.3 Literature Review**

In the aftermath of the financial crisis, the financial sectors in many countries have witnessed changes to their regulation.<sup>13</sup> These changes intended to consolidate the global financial system, and to fill gaps that existed in global financial regulation and supervision which contributed to the occurrence of the crisis.<sup>14</sup>

The 2008 crisis, which had a disastrous effect in many countries, proved that the South African financial sector is well regulated compared to many other developed countries.<sup>15</sup> However, South Africa has followed in other countries’ footsteps with the introduction of further financial regulation. In South Africa, this regulation has followed a twin-peaks model.

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<sup>7</sup> Ibid.

<sup>8</sup> United States of America, Financial Crisis Inquiry Commission: *final report of the national commission on the causes of the financial and economic crisis in the United States*, January (2011) xvi.

<sup>9</sup> C Brummer (note 2 above) 224.

<sup>10</sup> Woker (note 4 above).

<sup>11</sup> Financial Services Board „Regulatory Overhaul: Throw the Bath Water out but Keep the Baby“ (2009) Fourth Quarter *FSB Bulletin* 3.

<sup>12</sup> C Brummer (note 2 above) 233.

<sup>13</sup> Ibid.

<sup>14</sup> Ibid 334.

<sup>15</sup> T Woker „Property Syndications v Property scam: who decides? A critical examination of the regulation of property syndications in South Africa“ (2013) 34(2) *Obiter* 248.

According to the National Treasury of South Africa, the new regime will maintain the safety and soundness of financial institutions, and will enhance stability in the financial sector, as the whole financial system will be overseen holistically by the South African Reserve Bank (SARB), instead of institutions in isolation.<sup>16</sup> However, the introduction of the twin-peaks model of financial regulation has not been without its critics. The White Paper issued by the British Government on regulatory reform in the aftermath of the crisis, claimed that the twin-peaks model will onerously burden the financial system.<sup>17</sup>

Moreover, it is alleged that financial sector regulation in South Africa does not need the twin-peaks model. Rather, there is a need for practical coordination between the current regulators.<sup>18</sup> Furthermore, it is claimed that adopting a new structure for financial regulation may only have a political objective in that politicians need to show to public opinion that they are doing something in response to the crisis.<sup>19</sup> In addition, the regime, as Woker contends, will not be applied to non-regulated entities when the entity in question falls outside those entities which are governed by the various Acts which are administered by the Financial Services Board (FSB).<sup>20</sup> Public property syndications, for example, are not regulated by any act which administered by the FSB.<sup>21</sup> This means that these syndications will not be subject to the supervision of the FSB under the new regime which may lead to consumers being trapped into becoming involved in fraudulent schemes.

In view of this criticism of the twin-peaks model, it is important to analyse the effects the introduction of this model may have in the South African context. This research serves to outline the position of South African legislation with regard to the new approach of increasing the regulation in the financial sector, particularly in respect of the twin-peaks approach. Furthermore, the research identifies certain pertinent questions that may be raised regarding this topic. Because the twin-peaks model has yet to be introduced, it is not possible to provide answers regarding what impact this new regulation will have on the South Africa financial markets. However certain commentators have raised some questions which are identified in this research.

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<sup>16</sup> South Africa National Treasury Document (note 5 above) 24.

<sup>17</sup> M W Taylor „The road from “twin peaks”– and the way back“ (2009) 16(1) *Connecticut Insurance Law Journal* 80.

<sup>18</sup> M Mhango „Approach with care when considering twin peaks“ *Business Report* 6 March 2014 at 16.

<sup>19</sup> M Taylor "Regulatory reform after the financial crisis–Twin Peaks Revisited available at <http://www.iopsweb.org/principlesandguidelines/47663630.pdf>, accessed on 3 September 2014.

<sup>20</sup> Woker (note 15 above) 249, 250.

<sup>21</sup> *Ibid.*

## **1.4 Questions to be identified by the research**

The purpose of this research is to address the following questions:

- (1) How was the South African financial market regulated prior to the introduction of the NCA?
  - (1.1) Why was the NCA introduced?
  - (1.2) How did the NCA protect South Africa from the worst excesses of the financial crisis which occurred in 2008?
- (2) How has South Africa modified its regulation of the financial sector since the crisis of 2008?
  - (2.1) Why has South Africa decided that further regulation is necessary?
  - (2.2) What regulation has been introduced in the financial sector of SA since the crisis?
- (3) What is the purpose of the twin-peaks model?
- (4) How will the twin-peak model affect the financial sector in SA in the future?

## **1.5 Methodology**

The research takes the form of desktop research. Literature in the form of textbooks and journal articles has been consulted. Newspaper articles, proposals and recommendations of relevant financial bodies are referred to in order to establish the current position of the financial sector. Online discussions are also used to examine the increased regulation of the sector after the financial crisis and how such regulation will affect the financial system of South Africa. A number of South African Acts, such as the Financial Services Laws General Amendment Act 45 of 2013, the Financial Markets Act 19 of 2012, Financial Service Board (FSB) Act 97 of 1990 and the NCA 34 of 2005 are also discussed.

## **1.6 Structure of the dissertation**

In order to examine the recent developments and initiatives for regulating the financial sector in South Africa, it is important to provide an overview of the financial system. This is discussed in chapter two. The chapter deals with the main elements of the financial system

and how such system is structured. The chapter also addresses the leading regulators within the South African financial system, namely, the South African Reserve Bank, the Financial Services Board, the Johannesburg Stock Exchange (JSE), the Central Securities Depository (CSD) and the National Credit Regulator (NCR). The most important laws regulating the South African financial system are also dealt with. Relevant legislation includes the South African Reserve Bank Act, the Banks Act, the Financial Advisory and Intermediary Services (FAIS) Act, the Financial Markets Act and the NCA as far as it is responsible for establishing the NCR.

Ensuring that consumers have access to credit is very important from both a consumer perspective and an economic perspective. Reckless lending and over indebtedness has severe implications for both consumers and the economy. This was a major cause of the financial crisis and one of the reasons why the NCA was introduced. A discussion of these issues form an important part of this discussion, so chapter three discusses the introduction of the NCA, its history as well as the common law which regulates the relationship between credit grantors and credit receivers.

Chapter four describes the financial crisis and what lies at the root of the crisis. It also touches on various factors that protected the South African financial system form the repercussions of the crisis. The chapter outlines the aftermath of the crisis from a global and local perspective. It discusses recent developments in the regulation of the financial system of South Africa. It also deals with the new model of regulation which the South African government intends to adopt, namely, the twin-peaks model. The chapter concludes with a humble evaluation of the model.

Finally, the conclusions of the research are presented in chapter 5. This chapter also provides some recommendations which may be appropriate to fill gaps that may be still exist in the current regulation of the financial system.

## Chapter 2

### Historical overview of the regulation of the financial system in South Africa

#### 2.1 Overview of the financial system

The financial system is defined by Van Wyk as follows:<sup>22</sup>

“a set of arrangements/conventions embracing the lending and borrowing of funds by non-financial economic units and the intermediation of this function by financial intermediaries in order to facilitate the transfer of funds, to create additional money when required, and to create markets in debt and share instruments (and their derivatives) so that the price and allocation of funds are determined efficiently”.

The financial system has five main elements without which it cannot exist. These elements are as follows:

- Lenders and borrowers.
- Financial intermediaries.
- Financial instruments.
- Money creation.
- Financial market.

##### 2.1.1 Lenders and borrowers

The element of lenders and borrowers mainly embraces the four main spheres of the economy, namely, household sphere, business sphere, government sphere and foreign sphere. Each of these spheres can be a lender or/and a borrower.<sup>23</sup>

##### 2.1.2 Financial intermediaries

These are the entities that mediate the process of lending and borrowing.<sup>24</sup> Financial intermediaries exist as there is always a conflict between the demands of lenders and borrowers.<sup>25</sup> These entities provide more satisfying terms for the parties to the transaction than would be the case if these parties dealt directly with each other.<sup>26</sup> For example, a flourishing company has an interest in lending money for a period of six months, while a

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<sup>22</sup> K Van Wyk, Z Botha & I Goodspeed *Understanding South African Financial Markets* 4ed (2012) 3.

<sup>23</sup> Ibid 6.

<sup>24</sup> Ibid 3.

<sup>25</sup> Ibid 6.

<sup>26</sup> Lifelong Learning Programme (Leonardo da Vinci programme project) *Financial Markets* (2010) 9.

poor company needs to borrow for a period of not less than one year. The financial intermediaries therefore conciliate between these demands by various methods, such as investing the credit or deposit of the wealthy company in short-term funds.<sup>27</sup> Examples of financial intermediaries are banks, retirement funds, finance companies and insurance companies.<sup>28</sup>

### **2.1.3 Financial instruments**

These are the instruments which are created to meet the demands of financial participants.<sup>29</sup> The financial instruments are either marketable or non-marketable.<sup>30</sup> Non-marketable instruments are those instruments where their markets are only the primary market, namely, the market of issuance, for example, insurance policies.<sup>31</sup> However, the marketable instruments are those instruments which are issued in the primary markets and then traded in the secondary markets.<sup>32</sup> Bonds are the best example of a marketable instrument.<sup>33</sup> A bond is a loan instrument which is usually issued by corporations or governmental bodies in order to raise their capital. In this case, the issuer (known as the “borrower”) of the bond undertakes to pay the buyer of such bond (known as the “bondholder”) a certain amount of interest over a certain period of time. This interest is paid in addition to the repayment of the principal sum at agreed date, which is known as the “maturity date”.<sup>34</sup>

### **2.1.4 Money creation**

One of the most important elements of the financial system is the creation of money. This is a task which is performed by banks.<sup>35</sup> Although banks are prohibited from issuing their own currency, they can create money through increasing their deposits, which are obtained from the central bank in return for securities.<sup>36</sup> Money is anything which is utilised as a measure of payment and it comprises notes and coins from the central bank as well as bank deposits.<sup>37</sup>

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<sup>27</sup> Van Wyk (note 22 above) 6.

<sup>28</sup> Lifelong Learning Programme (note 26 above) 9, 10.

<sup>29</sup> Van Wyk (note 22 above) 10.

<sup>30</sup> Ibid.

<sup>31</sup> Ibid.

<sup>32</sup> Ibid.

<sup>33</sup> Ibid 10-13.

<sup>34</sup> A Thau *The bond book: Everything investors need to know about treasuries, municipals, GNMA's, corporates, zeros, bond funds, money market funds, and more* 3ed (2010) 3.

<sup>35</sup> Van Wyk (note 22 above) 22, 23.

<sup>36</sup> R A Arnold *Macroeconomics* 8ed (2007) 251.

<sup>37</sup> L Thomas *Money, Banking and Financial Markets* (2005) 19.

While the central bank's notes and coins form 2% of the money within the economy, bank deposits form 98%.<sup>38</sup>

If there is a shortage of money and there is a need for funds, such as in the case where borrowers default on the repayment of their loans, banks can create money.<sup>39</sup> The creation of money is achieved by creating new bank loans, and these loans lead to creating new deposits in the banks. For example, company X applies for loan of R200 million from bank in return for issuing R200 million in bonds to the bank in order to buy machines from company Z. The bank in this case will transfer the money from company X account to company Z's account. Because of this system it is alleged that the financial system can never suffer from a shortage of funding.<sup>40</sup>

### **2.1.5 Financial markets**

Financial markets are regarded as the lungs of any economy. There are a number of markets. These markets are categorized differently by various authors.<sup>41</sup> However, in this thesis the financial markets are referred to according to the most common categorisation, which is provided below.

#### *2.1.5.1 Primary markets versus secondary markets*

The primary market is the place where securities are issued, while the secondary market is the place where these securities are exchanged and traded between investors.<sup>42</sup> The best example of the secondary market is the stock exchanges.<sup>43</sup> The public is less familiar with the primary market as the issuance of securities usually takes place between investment banks.<sup>44</sup>

#### *2.1.5.2 Equity markets versus debt markets*

The Equity Market is also called a stock market.<sup>45</sup> It is the market in which shares are issued and traded, and dividends are paid on these shares as opposed to interest that is paid on

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<sup>38</sup> Van Wyk (note 22 above) 28.

<sup>39</sup> Ibid.

<sup>40</sup> Ibid 23.

<sup>41</sup> According to Thomas (note 37 above) 47-51, financial markets are divided into ten markets, while according to Van Wyk (note 22 above) 13-21, they are divided into nine markets. According to Bailey (note 45 below 3-5) financial markets are divided into seven categories.

<sup>42</sup> F J Fabozzi *Handbook of Finance, Financial Markets and Instruments* (2008) 44.

<sup>43</sup> Van Wyk (note 22 above) 4.

<sup>44</sup> Thomas (note 37 above) 47.

<sup>45</sup> R E Bailey *The economics of financial markets* (2005) 3.

debt.<sup>46</sup> The Debt Market is the market in which debt instruments are issued, traded and exchanged for funds.<sup>47</sup> It embraces the money market (also called the short-term debt market) and the marketable part of the Bond Market (called the long-term debt market).<sup>48</sup> It is noteworthy that the Equity Market and the long-term debt market are referred to as the “Capital Market”.<sup>49</sup>

#### *2.1.5.3 Cash markets versus derivatives markets*

Financial markets can be categorised in terms of the time of payment and whether such payment is performed in advance or at a later date.<sup>50</sup> While in a cash market a transaction is finalised up front, in a derivatives market a transaction is agreed on in advance but the payment and delivery of the instrument is performed in a stipulated future date.<sup>51</sup> Derivatives are contracts, and they are called derivatives because their value is derived from their underlying securities or assets.<sup>52</sup> Examples of derivative instruments are forwards, futures, options and swaps.<sup>53</sup>

#### *2.1.5.4 Foreign exchange markets*

The foreign exchange market is also called the “FOREX” or “FX” market.<sup>54</sup> This is the market where currencies are traded and exchanged,<sup>55</sup> for example, where the USA dollar is traded for the South African rand.

#### *2.1.5.5 Commodities markets*

The commodities market is the market in which real assets that have intrinsic value are traded; examples of these commodities are precious metals (such as gold and silver) and energy (such as oil and gas).<sup>56</sup>

The financial system has a number of functions which are very important for economic growth.<sup>57</sup> It directs, through its intermediaries, savings of ultimate lenders into ultimate

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<sup>46</sup> Van Wyk (note 22 above) 14, 17.

<sup>47</sup> Ibid.

<sup>48</sup> Ibid 14, 15.

<sup>49</sup> Ibid 17.

<sup>50</sup> Thomas (note 37 above) 49.

<sup>51</sup> Ibid.

<sup>52</sup> M Burton, R Nesiba and B Brown *an Introduction to Financial Markets and Institutions* 2ed (2010) 48.

<sup>53</sup> Bailey (note 45 above) 4, 5.

<sup>54</sup> Ibid 17.

<sup>55</sup> M Levinson *Guide to Financial Markets* 5ed (2010) 14.

<sup>56</sup> The South African Institute of Financial Markets *Introduction to Financial Markets* (2013) May 149.

borrowers, and allocates the funds efficiently.<sup>58</sup> It also works on providing an efficient payment system through the banking institutions.<sup>59</sup> This will be discussed further below. Another significant function of the financial system is the creation of money when required, as discussed above.

Finally, as risk is entrenched in the financial system, the system “through its intermediaries” endeavours to reduce and manage such risk.<sup>60</sup> Examples of financial system risks are systemic risk, legal risk, such as the improper application of law, credit risk, which is the risk of payment defaults, and liquidity risk, which is the risk of having insufficient funds to meet obligation.<sup>61</sup>

This brief overview of the basics of the financial system paves the way for the discussion which follows of how the financial sector is regulated, in order to facilitate the answering of the research questions which have been set out in chapter 1.

## **2.2 Leading regulators of the financial sector in South Africa**

Every country has regulations that control and organise its financial services sector. These regulations are supervised and implemented by regulators, without which the financial system cannot operate effectively.<sup>62</sup> In pursuit of their purposes to introduce an efficient, effective and stable financial system, these regulators monitor all the players of the financial system.<sup>63</sup> The task of monitoring these players is performed in order to ensure that the players comply with the laws that govern them. Figure 1 (set out below) illustrates how the regulators fit into the financial system.

South Africa has a number of different regulators each of which focuses on a certain aspect of the financial services sector.<sup>64</sup> The banking system is regulated by the South African Reserve Bank, and the non-banking system is regulated by the Financial Services Board. In addition, the South African credit industry is supervised and regulated by the NCR. There are also two

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<sup>57</sup> Lifelong Learning Programme (note 26 above) 6.

<sup>58</sup> Ibid 6,7.

<sup>59</sup> Van Wyk (note 22 above) 28, 29.

<sup>60</sup> Ibid 29.

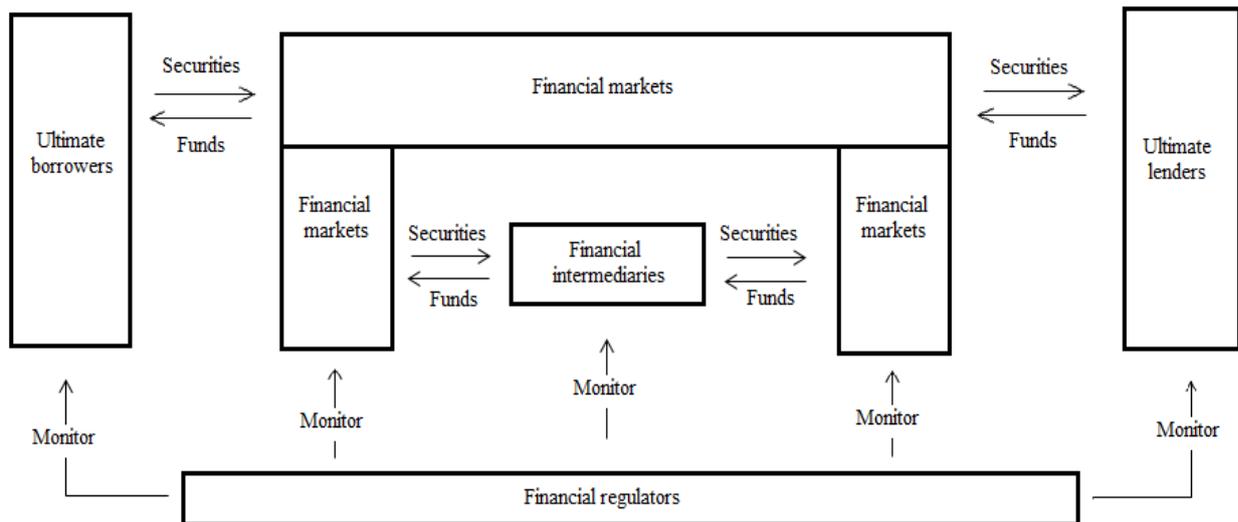
<sup>61</sup> Bank for International Settlements *Principles for financial market infrastructures* (2012) April available at <http://www.bis.org/cpmi/publ/d101a.pdf>, 18-20, accessed on 1 September 2014.

<sup>62</sup> L Swart & V A Lawack-Davids „Understanding the South African financial markets: an overview of the regulators” (2010) 31(3) 622.

<sup>63</sup> Van Wyk (note 22 above) 4.

<sup>64</sup> L Swart „The legal framework pertaining to selected segments of the financial market” (LLM thesis Nelson Mandela Metropolitan University 2011) 11, 12.

self-regulatory organisations, namely, the Johannesburg Stock Exchange (JSE) and the Central Securities Depository (CSD). Each of these regulators is discussed further below, after which the laws they enforce are dealt with.



**Figure 1:** The role of the regulators in the financial system (adopted from Van Wyk).<sup>65</sup>

### 2.2.1 The South African Reserve Bank

The SARB is the central bank of South Africa.<sup>66</sup> Although it was established in 1921 through the Currency and Banking Act,<sup>67</sup> proposals for establishing a central bank of South Africa had been made since 1879. The Currency and Banking Act underwent several amendments which eventually resulted in the SARB Act.<sup>68</sup> Prior to the establishment of the SARB, there were a number of commercial banks in South Africa issuing banknotes to the public. The first

<sup>65</sup> Van Wyk (note 22 above) 7.

<sup>66</sup> Section 223 of the South African Constitution of 1996.

<sup>67</sup> Act 31 of 1920.

<sup>68</sup> The South African Reserve Bank Act 90 of 1989 (hereinafter the SRB Act). The Currency and Banking Act was amended several times and re-introduced in the form of the South African Reserve Bank Act of 1944 which was replaced by the current South African Reserve Bank Act of 1989.

bank in South Africa was the Lombaard Bank in Cape Town which came into operation in 1793.<sup>69</sup>

The goal of the SARB is entrenched both in the Constitution<sup>70</sup> and the SARB Act.<sup>71</sup> According to section 224 of the Constitution and section 3 of the SARB Act, “[t]he primary objective of the Bank shall be to protect the value of the currency of the Republic in the interest of balanced and sustainable economic growth in the Republic”.

The SARB has various roles in the financial system and in the economy as a whole. It is beyond the scope of this dissertation to discuss this in any detail and therefore only those roles which are aimed at achieving stability in the financial system are referred to. Firstly, as the SARB is the leading banking institution in South Africa, it is responsible for the regulation and supervision of other banks in South Africa.<sup>72</sup> The term “regulation” in this regard refers to the rules that govern the conduct of banking institutions, while “supervision” refers to the overseeing and application of these rules.<sup>73</sup> The Bank achieves this responsibility through its Bank Supervision Department which issues licences to the commercial banks in addition to monitoring their activities in terms of either the Banks Act<sup>74</sup> or the Mutual Banks Act.<sup>75</sup>

Secondly, the SARB may “perform such functions, implement such rules and procedures and, in general, take such steps as may be necessary to establish, conduct, monitor, regulate and supervise payment, clearing or settlement systems”.<sup>76</sup> These functions are performed through the National Payment System Department of the SARB in terms of the National Payment System Act.<sup>77</sup>

It should be mentioned that in 1998, an advanced real-time gross settlement (RTGS) system (called the South African Multiple Option Settlement (SAMOS) system) was adopted by the SARB. The system facilitates the settlement of interbank transactions on a real-time basis.<sup>78</sup>

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<sup>69</sup> Information regarding the Reserve Bank can be found at <https://www.resbank.co.za/AboutUs/History/Pages/History-Home.aspx>, accessed on 1 September 2014.

<sup>70</sup> The Constitution of the Republic of South Africa, 1996.

<sup>71</sup> Act 90 of 1989.

<sup>72</sup> Swart (note 62 above) 625.

<sup>73</sup> Van Wyk (note 22 above) 46.

<sup>74</sup> Act 94 of 1990.

<sup>75</sup> Act 124 of 1993.

<sup>76</sup> Section 10(c) (i) of the SARB Act.

<sup>77</sup> Act 78 of 1998.

<sup>78</sup> Van Wyk (note 22 above) 48, 49.

In addition, a real-time global settlement system was introduced in the Bank in 2004. This system, which includes the South African rand, is the Continuous Linked Settlement Network (CLS). It strives to mitigate the risk that may arise from the delay of foreign exchange settlements as a result of the differences in time zones.<sup>79</sup>

### **2.2.2 The Financial Services Board**

The FSB was established through the FSB Act<sup>80</sup> in 1990. It supervises and monitors the financial services of the non-banking sector in the interest of the public and it operates independently of the government.<sup>81</sup> As opposed to the SARB which is responsible for the soundness of the banking sector, the FSB is responsible for ensuring that non-banking institutions comply with relevant legislation as well as the requirements of capital adequacy.<sup>82</sup> It enhances the soundness of these institutions and protects investors and the financial system as a whole from any potential risk.<sup>83</sup> The functions of the FSB, as stated in the FSB Act,<sup>84</sup> are as follows:

- to supervise compliance with laws regulating financial institution and the provision of financial services;
- to advise the Minister on matters concerning financial institutions and financial services, either of its own accord or at the request of the Minister; and
- to promote programmes and initiatives by financial institutions and bodies representing the financial services industry to inform and educate users and potential users of financial products and services.

The FSB performs these functions through a number of relevant Acts passed for this purpose. These Acts are:<sup>85</sup>

- the Collective Investment Schemes Control Act;<sup>86</sup>
- the Credit Rating Services Act;<sup>87</sup> the Financial Service Board Act;<sup>88</sup>

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<sup>79</sup> Ibid 49.

<sup>80</sup> The Financial Services Board Act 97 of 1990.

<sup>81</sup> Manual on access to information held by the financial services board „Compiled in terms of section 14 of the Promotion of Access to Information Act, 2 of 2000“ 1

<sup>82</sup> The Financial Services Board *Strategic Plan* (2010/2011) 4.

<sup>83</sup> Ibid.

<sup>84</sup> Section 3.

<sup>85</sup> Information regarding the Acts administered by the Financial Services Board can be found at <https://www.fsb.co.za/legislation/Html%20Pages/legislation.html>, accessed on 1 September 2014.

<sup>86</sup> Act 45 of 2002.

<sup>87</sup> Act 24 of 2012.

- the Financial Advisory and Intermediary Services Act;<sup>89</sup>
- the Financial Institutions (Protection of Funds) Act;<sup>90</sup>
- the Financial Markets Act;<sup>91</sup>
- the Financial Services Ombud Schemes Act;<sup>92</sup>
- the Financial Supervision of the Road Accident Fund Act;<sup>93</sup>
- the Friendly Societies Act;<sup>94</sup>
- the Inspection of Financial Institutions Act;<sup>95</sup>
- the Long-term Insurance Act;<sup>96</sup>
- the Pension Fund Act;<sup>97</sup> and
- the Short-term Insurance Act.<sup>98</sup>

All these Acts are supervised and implemented by the various departments of the FSB. These departments include the following: Retirement Funds Department, Insurance Department, Department of Market Abuse, the Collective Investment Schemes Department, the Financial FAIS Division, the Legal and Policy Department, Capital Market Department (CMD), Inspectorate Department, Consumer Education Department and the Actuarial Department.<sup>99</sup> For the purpose of this dissertation, the FAIS Division and the CMD are the most important.

The FAIS Division of the FSB is responsible for regulating and supervising financial services providers<sup>100</sup> in terms of the FAIS Act.<sup>101</sup> This division focuses on market conduct rules for financial service providers in order to ensure that consumers are properly protected.<sup>102</sup> It consists of four departments, namely, the Registration Department, the Supervision

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<sup>88</sup> Act 97 of 1990.

<sup>89</sup> Act 37 of 2002.

<sup>90</sup> Act 28 of 2001.

<sup>91</sup> Act 19 of 2012.

<sup>92</sup> Act 37 of 2004.

<sup>93</sup> Act 8 of 1993.

<sup>94</sup> Act 25 of 1956.

<sup>95</sup> Act 80 of 1998.

<sup>96</sup> Act 52 of 1998.

<sup>97</sup> Act 24 of 1956.

<sup>98</sup> Act 53 of 1998.

<sup>99</sup> Information regarding the Financial Services Board Departments can be found at <https://www.fsb.co.za/>, accessed on 1 September 2014.

<sup>100</sup> According to s 1 of the FAIS Act, financial services provider means any person, other than a representative, who as a regular feature of the business of such person-

- (a) furnishes advice; or
- (b) furnishes advice and renders any intermediary service; or
- (c) renders an intermediary service.

<sup>101</sup> Act 37 of 2002.

<sup>102</sup> Van Wyk (note 22 above) 125.

Department, the Compliance Department and the Enforcement Department.<sup>103</sup> These departments are responsible for ensuring that financial service providers act properly and in the best interests of their clients.<sup>104</sup>

The CMD is responsible for regulating and supervising the licenced exchange in South Africa, the central securities depository and the clearing houses in terms of the Financial Markets Act.<sup>105</sup> The CMD endeavours to ensure efficient, fair and sound capital markets and associated services for the trade of securities, including suitable mechanisms for the protection of investors.<sup>106</sup>

In order to ensure compliance with the international regulatory standards in respect of financial markets' regulation and supervision, the CMD participates in the International Organization of Securities Commissions (IOSCO).<sup>107</sup> The IOSCO has established a number of objectives and principles of securities regulation.<sup>108</sup> After the financial crisis these principles were expanded and South Africa strives to comply with them through the CMD.<sup>109</sup> It should be mentioned that, although the JSE, STRATE and SAFCOM are supervised by the CMD, all these entities are self-regulatory organisations, and their members and participants are approved by the respective market infrastructure and not the FSB.<sup>110</sup>

### **2.2.3 Johannesburg Stock Exchange Ltd**

The discovery of gold in South Africa, particularly in Witwatersrand in 1886, resulted in a number of finance and mining companies being created.<sup>111</sup> These companies, in order to expand their activities, were in need of a central facility providing access to capital.<sup>112</sup> This

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<sup>103</sup> Financial Services Board „Financial Advisory and Intermediary Services Departments“ available at <https://www.fsb.co.za/Departments/fais/Pages/aboutUs.aspx>, accessed on 2 September 2014.

<sup>104</sup> Ibid.

<sup>105</sup> Act 19 of 2012. There is only one exchange in South Africa, namely, the JSE, one self-regulatory depository, namely, the Shares Transactions Totally Electronic (STRATE) and one clearing house, namely, the SAFCOM Ltd. For further discussion see below.

<sup>106</sup> Information regarding the Capital Markets Department of Financial Services Board can be found at <https://www.fsb.co.za/departments/capitalMarkets/Pages/Home.aspx>, accessed on 2 September 2014.

<sup>107</sup> The International Organization of Securities Commissions (hereinafter the IOSCO), is an international body that brings together the world's securities regulators, and it is recognized as the global standard setter for the securities sector available at <http://www.iosco.org/about/>, accessed on 2 September 2014.

<sup>108</sup> Van Wyk (note 22 above) 128.

<sup>109</sup> Ibid.

<sup>110</sup> Information regarding the Capital Markets Department of Financial Services Board (note 106 above).

<sup>111</sup> Swart (note 62 above) 633.

<sup>112</sup> South African History Online „The Johannesburg Stock Exchange is established“ available at <http://www.sahistory.org.za/dated-event/johannesburg-stock-exchange-established>, accessed on 17 October 2014.

facility was provided by the establishment of the JSE in 1887.<sup>113</sup> The JSE is the place where sellers and buyers of securities are brought together.<sup>114</sup> In 1963, the JSE became a member of the World Federation of Exchanges,<sup>115</sup> and today it is rated the nineteenth largest stock exchange in the world and it is the largest stock exchange in Africa.<sup>116</sup>

In the 1980s, the Bond Market Association was established and it was licenced in 1996 as the Bond Exchange of South Africa (BESA) in terms of the Securities Services Act.<sup>117</sup> The BESA is tasked with regulating interest-rate derivative and debt securities markets and it was originally supervised by the FSB in terms of the SSA. However, in 2009, the BESA was merged with the JSE in an effort to raise liquidity and efficiency and to establish one exchange on which all markets can be included.<sup>118</sup> Today, the JSE embraces five markets, namely, Bonds and Equities as well as Commodity, Financial and Interest Rate Derivatives.<sup>119</sup>

As mentioned above, the JSE is a self-regulatory organisation and it is responsible for laying down its own rules and directives in terms of the Financial Markets Act.<sup>120</sup> However, the FSB plays an oversight role according to the FSB Act.<sup>121</sup>

In the exchange environment there is what is referred to as an “authorised broker”. According to the Financial Market Act, the authorised person “means a person authorised by a licensed exchange to perform one or more securities services in terms of the exchange rules, and includes an external authorised user, where appropriate”.<sup>122</sup>

It is noteworthy that the JSE played a significant role in establishing the only CSD in South Africa, namely, Shares Transactions Totally Electronic (STRATE) in 1999.<sup>123</sup> All securities listed in the JSE were dematerialised and transferred to the STRATE records in 2002.<sup>124</sup>

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<sup>113</sup> Swart (note 62 above) 633.

<sup>114</sup> Section 1 of the Financial Market Act.

<sup>115</sup> Swart (note 64 above) 25.

<sup>116</sup> Information regarding the Johannesburg Stock Exchange can be found at <https://www.jse.co.za/about/history-company-overview>, accessed on 3 September 2014.

<sup>117</sup> Act 36 of 2004 “repealed”.

<sup>118</sup> Van Wyk (note 22 above) 326.

<sup>119</sup> Information regarding the Johannesburg Stock Exchange (note 114 above).

<sup>120</sup> Section 10 of the Financial Markets Act.

<sup>121</sup> Section 3 of the FSB Act.

<sup>122</sup> Section 1 of the Financial Market Act.

<sup>123</sup> Swart (note 64 above) 25.

<sup>124</sup> Ibid.

## 2.2.4 Central Securities Depository

The JSE, as mentioned above, is the place where sellers and buyers of securities are brought together. However, when a deal is struck between a seller and buyer, there is a need for a mechanism that enables the securities to be transferred from the seller's name to the buyer's name in return for cash. This mechanism is provided by the CSD.<sup>125</sup> As mentioned above, there is only one CSD in South Africa, namely STRATE. The functions of STRATE are conducted through the assistance of what is referred to as "participants".<sup>126</sup> A participant is "a person authorised by a licensed central securities depository to perform custody and administration services or settlement services or both in terms of the central securities depository rules, and includes an external participant, where appropriate".<sup>127</sup>

The CSD is responsible for holding the records of ownership of securities in electronic form, which ensures the secure saving and transfer of ownership of such securities.<sup>128</sup> Once a buyer and seller of securities have reached agreement using the JSE trading system through a broker, the JSE sends the details of the transaction to STRATE which forwards them to its participant.<sup>129</sup> The participant then (under STRATE monitoring) verifies the securities availability in the seller's possession, and the cash availability in the buyer's possession. Once this information has been verified, STRATE ensures the transfer of securities from the seller's account to the buyer's account in due time, and ensures that the cash is transferred to the seller's account.<sup>130</sup>

Historically, securities were settled on a paper basis. These were called certificated securities and they were transferred manually by changing securities certificates. However, since 1999, when STRATE was established, paper-based securities have been converted into electronic records. This is referred to as dematerialisation.<sup>131</sup> Today, although there are still investors holding certificated securities, more than 98% of paper securities have been dematerialised. Dematerialised securities are called uncertificated securities.<sup>132</sup>

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<sup>125</sup> Information regarding the CSD industry can be found at <http://www.strate.co.za/about-strate/basics-csd-industry>, accessed on 4 September 2014.

<sup>126</sup> Swart (note 62 above) 621.

<sup>127</sup> Section 1 of the Financial Markets Act.

<sup>128</sup> Information regarding the CSD industry (Note 123 above).

<sup>129</sup> Ibid.

<sup>130</sup> Ibid.

<sup>131</sup> Ibid.

<sup>132</sup> Ibid.

The electronic records system is safer than the old system as it ensures that the securities are protected from any risk such as loss or theft or damage by for example, fire or water. In addition, under the new system, ownership of securities is easily proved and easily transferred. This is contrary to what occurred previously. According the FSB Act, the CSD (STRATE) is supervised by the FSB in terms of the Financial Markets Act.<sup>133</sup> However, In terms of the latter Act, STRATE must issue its own rules and directives.<sup>134</sup>

### **2.2.5 The National Credit Regulator**

Credit markets play a considerable role in the financial system and economy of every country.<sup>135</sup> The South African credit industry is regulated and supervised by the NCR which was established by the NCA.<sup>136</sup> According to this Act, the NCR is an independent body and it is subject only to the Constitution and the law.<sup>137</sup> The NCR is tasked with various functions as set out in the NCA. The leading functions are the registration of the key players in the industry (namely, credit providers, credit bureaux and debt counsellors), the development of the credit market and the enforcement the NCA.<sup>138</sup>

### **2.3 The leading laws of the financial sector in South Africa**

The above discussion sets out the main regulators which are responsible for ensuring a safe and secure financial market in South Africa. The main laws which these regulators are responsible for enforcing are the subject of the following section.

As mentioned above, most countries have regulations governing their financial sectors and South Africa is no exception. The most important laws regulating the financial sector in South Africa are: the South African Reserve Bank Act, the Banks Act, the FAIS Act, the Financial Markets Act and the NCA. Each of these laws will be discussed in brief.

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<sup>133</sup> Section 3 of the FSB Act.

<sup>134</sup> Section 30 of the Financial Markets Act.

<sup>135</sup> South African Dept of Trade and Industry „Making Credit Markets Work“ A *Policy Framework for Consumer Credit* 6.

<sup>136</sup> Sections 12 to 18 of the NCA.

<sup>137</sup> Section 12 (1) (c) of the NCA.

<sup>138</sup> Chapter 2, Part A of the NCA.

### **2.3.1 The South African Reserve Bank Act**

The SARB Act<sup>139</sup> was established “[t]o consolidate the laws relating to the South African Reserve Bank and the monetary system of the Republic”.<sup>140</sup> It sets out the primary objective, powers and duties of the Bank.<sup>141</sup> The Act also lays down the framework of the minimum reserve requirement.<sup>142</sup> According to the Act, every bank must hold an account with the SARB and banks are required to deposit in cash a prescribed percentage of their adjusted total liabilities on their accounts at the SARB.<sup>143</sup> The requirement of such deposit is known as the cash reserve requirement, it is currently set at 2.5 per cent and is subject to change by the Governor of the Bank from time to time.<sup>144</sup>

### **2.3.2 The Banks Act**

The Banks Act<sup>145</sup> is considered as the most important act in the banking industry of South Africa.<sup>146</sup> It regulates and supervises companies that take deposits from the public.<sup>147</sup> To be registered as a bank, the Act requires that a firm meet minimum capital requirements.<sup>148</sup> The Act contributed to the growth of the banking industry as 41 bank licences were issued by the end of 2001.<sup>149</sup> However, this number has decreased to be fixed at 16 registered banks at the end of 2013.<sup>150</sup>

### **2.3.3 The Financial Advisory and Intermediary Services Act**

The FAIS Act<sup>151</sup> regulates the conduct of all financial services providers and their representatives.<sup>152</sup> It performs this task through a code of conduct drafted by the Registrar of Financial Services Providers.<sup>153</sup> According to the code, “[A] provider must at all times render financial services honestly, fairly, with due skill, care and diligence, and in the interests of

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<sup>139</sup> Act 90 of 1989.

<sup>140</sup> Extract from the preamble of the SARB Act.

<sup>141</sup> Sections 3 and 10 of the SARB Act.

<sup>142</sup> Section 10A of the SARB Act.

<sup>143</sup> Ibid.

<sup>144</sup> The South African Reserve Bank’s system of accommodation, available at <https://www.resbank.co.za/AboutUs/PublicAwareness/Documents/FactSheet9.pdf>, accessed on 4 October 2014.

<sup>145</sup> Act 94 of 1990.

<sup>146</sup> Van Wyk (note 22 above) 71.

<sup>147</sup> The preamble of the Banks Act.

<sup>148</sup> Section 80 of the Banks Act.

<sup>149</sup> The Banking Association South Africa, available at <http://www.banking.org.za/index.php/our-industry/2012-south-african-banking-sector-overview/>, accessed on 4 October 2014.

<sup>150</sup> SARB, Bank Supervision Department Annual Report 2013.

<sup>151</sup> Act 37 of 2002.

<sup>152</sup> Woker (note 15 above) 242. The meaning of the financial services provider mentioned in (note 98 above).

<sup>153</sup> Sections 15 of the FAIS Act.

clients and the integrity of the financial services industry”.<sup>154</sup> As mentioned above, the responsibility for applying this Act is vested with the FAIS Division of the FSB.<sup>155</sup>

### 2.3.4 The Financial Markets Act

The purpose of enactment the Financial Markets Act<sup>156</sup> is described in the preamble of the Act as follows:

“[T]o provide for the regulation of financial markets; to license and regulate exchanges, central securities depositories, clearing houses and trade repositories; to regulate and control securities trading, clearing and settlement, and the custody and administration of securities; to prohibit insider trading, and other market abuses.....to replace the Securities Services Act 2004”.<sup>157</sup>

Through consolidating the financial markets laws, the Act strives to avoid any financial crisis such that occurred in 2008.<sup>158</sup> The Act is also intended to bring South African regulation in line with the international standards set by international bodies such as the Financial Stability Board, the G20, the International Organisation of Securities Commissions and Basel Committee on Banking for Supervision.<sup>159</sup> Even though, South Africa, according to World Economic Forum’s Global Competitiveness Survey for 2013-2014, has the best regulation in the world in respect of securities exchanges.<sup>160</sup>

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<sup>154</sup> Section 2 of the General Code of Conduct for Authorised Financial Services Providers and their Representatives promulgated under section 15 of the FAIS Act 37 of 2002 „Board Notice 80 of 2003“.

<sup>155</sup> See 2.2.2.

<sup>156</sup> Act 19 of 2012.

<sup>157</sup> Extract from the preamble of the Financial Markets Act.

<sup>158</sup> Financial Markets Act to come into effect in June *South African Government News Agency*, available at <http://www.sanews.gov.za/south-africa/financial-markets-act-come-effect-june>, accessed on 6 October 2014.

<sup>159</sup> South African National Treasury, Media Statement „Promulgation Of The Financial Markets Act No. 19 Of 2012“ 28 May 2013.

<sup>160</sup> The JSE website „history & company overview“ available at <https://www.jse.co.za/about/history-company-overview>, accessed on 7 October 2014.

## Chapter 3

### Access to credit

#### 3.1 Introduction

As stated in the introductory chapter, access to credit is very important for both consumers and for the development of the economy. For many consumers, the only way to meet their monthly demands is to have access to credit.<sup>161</sup> In addition, access to credit enables people to create small businesses which then lead to jobs creation.<sup>162</sup> Therefore, access to credit is a crucial matter for any country to stimulate its economy and to enable its consumers to satisfy their needs.<sup>163</sup> In the USA, for example, the economy experienced a recession after the terrorist attack on 11 September 2001.<sup>164</sup> The USA government responded by facilitating access to credit in order to combat the recession.<sup>165</sup> The flow of credit into the marketplace resulted in the economy becoming very prosperous.<sup>166</sup> However, this later resulted in an economic collapse because credit was made available to consumers who eventually could not repay the credit that they had received.<sup>167</sup> From the American experience it can be seen that access to credit must be balanced with prudent lending. Reckless lending may lead to economic disaster such as that which occurred in the USA after the expansion of the credit to the poor consumers (this will be discussed further in chapter 4). In South Africa, there has been the recent experience of the collapse of African Bank.<sup>168</sup> African Bank is a bank which specialises in unsecured loans to poor consumers.<sup>169</sup> Unfortunately poor consumers were granted too many loans and eventually reached the position where they could not repay these loans.<sup>170</sup> In 2013 African Bank was investigated by the National Credit Regulator for reckless

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<sup>161</sup> M Kelly-Louw „The Statutory in duplum Rule as an Indirect Debt Relief Mechanism“ (2011) 23(3) *SA Merc LJ* 352.

<sup>162</sup> U.S. Small Business Administration, “President Obama Announces New Efforts to Improve Access to Credit for Small Businesses,” October 21, 2009, at [http://www.whitehouse.gov/assets/documents/small\\_business\\_final.pdf](http://www.whitehouse.gov/assets/documents/small_business_final.pdf), accessed on 11 October 2014.

<sup>163</sup> South African Dept of Trade and Industry document (not 134 above).

<sup>164</sup> Financial Crisis Inquiry Commission (note 8 above) 59.

<sup>165</sup> Van Wyk (note 22 above) 32.

<sup>166</sup> Brummer (note 2 above) 211.

<sup>167</sup> Van Wyk (note 22 above) 33.

<sup>168</sup> Fall of the Titans: The Story of African Bank & Lehman Brothers *CNBC Africa* <http://www.cnbc.com/africa/177157.aspx>, accessed on 15 December 2014.

<sup>169</sup> SA banks ease pace of unsecured lending *Eyewitness News* <http://ewn.co.za/2013/05/27/SA-banks-ease-pace-of-unsecured-lending>, accessed on 15 December 2014.

<sup>170</sup> African Bank 'kept lending to indebted customers' *fin24* <http://www.fin24.com/Companies/Financial-Services/African-Bank-kept-lending-to-indebted-customers-20140821>, accessed on 15 December 2014.

lending.<sup>171</sup> The matter was settled with African Bank paying an administrative penalty of R20 million.<sup>172</sup> Both these examples demonstrate that access to credit needs to be well regulated.

South African legal history has witnessed several laws which regulate the credit industry, the latest of which is the NCA. The NCA was enacted as a result of the deficiencies of the previous laws, namely, the common law, the Usury Act,<sup>173</sup> the Credit Agreements Act<sup>174</sup> and the Consumer Affairs (Unfair Business Practices).<sup>175</sup> Each of these laws will be briefly discussed in turn.

### 3.2 The common law

The common law is the law which applies if there is no legislation which is applicable to a particular situation. The common law of contract is the most important aspect of the common law which is relevant to this discussion. Generally it is a contract which establishes the relationship between credit grantors and credit receivers or consumers. A full discussion of the common law of contract is beyond the scope of this dissertation. Suffice to state that the history of granting and receiving credit in South Africa has demonstrated that the general principles of the common law of contract do not provide consumers with sufficient protection.<sup>176</sup> In view of the overriding principle of freedom of contract and other overarching common law rules, namely, *pactum sunt servanda* (which means that an agreement entered into freely and seriously must be honoured and enforced),<sup>177</sup> and *caveat subscriptor* (which means let the signatory be aware),<sup>178</sup> it is difficult for consumers who sign documents containing contractual terms, to avoid liability on the basis that they did not agree to certain terms or that certain representations (or misrepresentations) were made to them during the contracting process.<sup>179</sup>

Most South African consumers are not educated to the point where they are able to understand the sophisticated contracts which govern financial arrangements such as the loans

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<sup>171</sup> African Bank to pay R20m after reaching NCR agreement Mail & Guardian (online newspaper) available at <http://mg.co.za/article/2013-10-04-credit-regulator-agreement-african-bank-to-pay-over-r20m>, accessed on 15 December 2014.

<sup>172</sup> Ibid.

<sup>173</sup> The Usury Act 73 of 1968.

<sup>174</sup> The Credit Agreements Act 75 of 1980.

<sup>175</sup> The Consumer Affairs (Unfair Business Practices) 71 of 1988.

<sup>176</sup> R H Christie *The law of contract* 5ed 2006 12.

<sup>177</sup> D Hutchison, CJ Pretorius and J Du Plessis *The law of contract in South Africa* 2ed (2012) 500.

<sup>178</sup> Ibid 492.

<sup>179</sup> Woker (note 4 above) 227, 228.

of money or the purchasing of goods on credit; this means that there is usually no equal bargaining power between the parties to financial contracts.<sup>180</sup> Only after contracts are concluded do parties realize that they contain what is commonly referred to as „unfair contract terms“.<sup>181</sup> However, the consumer will only be able to escape the contract if a reasonable person would have been misled by the other party“s conduct.<sup>182</sup> The courts have said that they will not uphold a contract which is contrary to public policy but in *Sasfin v Beukes*<sup>183</sup> the court pointed out that the courts power to strike down a contract on the basis that it is manifestly unjust must be exercised sparingly and only in cases where the contract is patently unjust.<sup>184</sup>

Moreover, In terms of the caveat subscriptor rule, a consumer who signs a contract containing contractual terms may be bound by these terms even if he did not understand them.<sup>185</sup> This rule may become even more stringent when consumers are presented with standard-form contracts which are most often signed without consumers reading the document. In *George v Fairmead (Pty) Ltd*<sup>186</sup> and *Afrox Healthcare Bpk v Strydom*,<sup>187</sup> the court held that the consumer by signing the contract was bound by the exemption clause as if he had read it.<sup>188</sup> These issues have been dealt with in the Constitutional Court in a number of decisions, the most important of which was *Barkhuizen v Napier*.<sup>189</sup>

Again it is not possible in this mini dissertation to deal with this decision in detail, suffice to point out that the Constitutional Court has pointed out that the principle of pactum sunt servanda is a very important principle in the law of contract.<sup>190</sup>

This short and albeit insufficient summary of the common law of contract is intended to highlight some of the problems which unsophisticated consumers faced when entering into contracts with highly developed and sophisticated credit grantors. Another major problem

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<sup>180</sup> D McQuoid-Mason *Consumer Law in South Africa* (1997) 25.

<sup>181</sup> Ibid.

<sup>182</sup> *Brink v Humphries & Jewell (Pty) Ltd* 2005 (2) SA 419 (SCA).

<sup>183</sup> *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A).

<sup>184</sup> Ibid at 9.

<sup>185</sup> See *Bhikhagee v Southern Aviation (Pty) Ltd* 1949 (4) 105 (E). In this case B, who had signed a contract containing an exemption clause, was held bound by the clause, although his inability to read English (the language in which the contract had been written).

<sup>186</sup> *George v Fairmead (Pty) Ltd* 1958 (2) SA 465 (A).

<sup>187</sup> *Afrox Healthcare Bpk v Strydom* 2002 (6) SA 21 (SCA).

<sup>188</sup> See *George v Fairmead (Pty) Ltd* 1958 (2) SA 465 (A) at 472, 473; *Afrox Healthcare Bpk v Strydom* 2002 (6) SA 21 (SCA) at 29.

<sup>189</sup> *Barkhuizen v Napier* 2007 (5) SA 323 (CC).

<sup>190</sup> Ibid at 363, 364.

that led to the enactment of the NCA is the failure of the common law to provide for the need to furnish consumers with precise information regarding the cost of credit.<sup>191</sup> In some instances consumers found themselves in a position where they had to pay an interest rate exceeding ten times the principle amount of the loan,<sup>192</sup> a transaction which they would probably not have concluded had they known the full details regarding their loans.

These problems have been dealt with by the NCA in sections 89 and 90. In terms of these sections, unfair, unreasonable and unjust agreements and provisions are prohibited. Moreover, the NCA confirms consumers' right to disclosure and information relating to the involved agreement including their right to information in plain and understandable language.<sup>193</sup>

It must be accepted that credit providers are not charitable organisations, and the providing of credit is a business transaction. Therefore, consumers who are granted credit must be charged interest. According to Otto and Grove,<sup>194</sup> there was a period of time when there was no regulation over the maximum rates of interest or other finance charges which could be charged other than the common-law *in duplum* rule. According to this rule, interest on credit only stops accruing once it equals the amount of unpaid principle debt.<sup>195</sup> There are however, different ways in which this rule can be interpreted (for example it only applies to the actual loan itself and not to additional fees and collection charges) and so consumers often found that their original debts had increased to enormous amounts when they fell into arrears.<sup>196</sup> Moreover, when a creditor institutes proceedings to enforce their debt against the defaulting debtor, the interest continues to accumulate during the litigation even if it equals the outstanding principal debt.<sup>197</sup> Once judgment is handed down, the interest starts accruing on the amount of the judgement debt (which consists of the principal debt and the interest accrued on such debt, including the interest that has accrued during the litigation) until it

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<sup>191</sup> Woker (note 4 above) 225.

<sup>192</sup> J Campbell „The Cost of Credit in the Micro-Finance Industry in South Africa“ (LLM thesis Rhodes University 2006) 67.

<sup>193</sup> Sections 63 & 64 of the NCA.

<sup>194</sup> South African Law Commission Working Paper 46 (Project 67): *the Usury Act and Related Matters: New Credit Legislation for South Africa* (proposed to the South African Law Commission by JM Otto & NJ Grové) (1991) 4.

<sup>195</sup> Kelly-Louw (note 161 above) 354.

<sup>196</sup> Ibid 361, 362.

<sup>197</sup> See comments by Zulman J in *Standard Bank of SA Ltd v Oneanate Investments (Pty) Ltd (in liquidation)* 1998 (1) SA 811 (SCA) p834.

reaches the unpaid amount of the judgment debt.<sup>198</sup> When the Usury Act was enacted in 1968, it was intended to regulate loans and it stipulated maximum interest rates.<sup>199</sup>

### 3.3 The Usury Act

It must be accepted that borrowers are often in a much weaker bargaining position than lenders which means they are often in a vulnerable position and can be abused by credit providers. Therefore, most countries have enacted legislation to protect consumers from such abuse.

South Africa is no exception. In 1968 the Usury Act was enacted to regulate three types of transactions, namely, moneylending transactions, credit transactions and leasing transactions.<sup>200</sup> The Act also provides for borrowers' right to recover any overpayments<sup>201</sup> as well as the responsibility of lenders to supply relevant information to recipients.<sup>202</sup> Importantly, the Act imposed limited amount of interest which could be charged by lenders.<sup>203</sup> This limit was not fixed in the Act but it was subject to the promulgation of the Minister of Finance from time to time.<sup>204</sup>

The history of credit in South Africa has demonstrated that there are many people in South Africa who have not been able to access to credit.<sup>205</sup> Borrowers were divided into two categories; one with high income, easy-obtained credit and limited-interest charge in terms of the Usury Act (mainly white people), and the other with low income, limited access to credit and, if they could get credit, they were usually subject to very high interest rates (the majority of this category is black people).<sup>206</sup> The latter category was denied access to the formal lending entities because poor (usually black people) were unable to furnish security for their obligations.<sup>207</sup> This means that those people have been precluded from buying their own homes or cars, they are unable to operate small businesses or obtain loans for education

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<sup>198</sup> Ibid.

<sup>199</sup> Campbell (note 180 above) 52.

<sup>200</sup> These types of transactions were defined in section 1 of the Act.

<sup>201</sup> Section 7 of the Act.

<sup>202</sup> Section 10 of the Act.

<sup>203</sup> Section 2 of the Act.

<sup>204</sup> In December 1992 (when the first exemption was promulgated) the interest rate was fixed at 30% per annum for loans not exceeding R 6000, and 27% for loans exceeding R6000 per annum (Usury Act, 1968, R3273 Government Gazette 14438, 4 December 1992).

<sup>205</sup> T Woker „Paper presented at International Consumer Law Conference Pretoria, September 2014“ 3, 4.

<sup>206</sup> South African Dept of Trade and Industry document (note 135 above) 12.

<sup>207</sup> Comments set out by Yacoob J in *AAA Investments (Pty) Ltd v The Micro-finance Regulatory Council and the Minister of Trade and Industry* 2006 (11) BCLR 1255 (CC) para 8.

purposes.<sup>208</sup> Moreover, there are many people in South Africa who do not have money to even feed their families.<sup>209</sup> Therefore, in order to encourage lenders to make credit available to those consumers, who were generally regarded as high risk borrowers, the Usury Act was amended to include section 15A.<sup>210</sup> This section expressly empowered the Minister to determine that certain institutions could be exempted from the provisions of the Act. The section was introduced in order to encourage these institutions to provide credit to poor borrowers who did not have appropriate security for their loans.<sup>211</sup> Subsequently, two Exemption Notices were published.

The first Exemption Notice was introduced in 1992.<sup>212</sup> The notice exempted all loans not exceeding R6000 which were supplied to natural person borrowers from the provision of the Usury Act. The Notice provided, among others, that the loan had to be paid back over a period not exceeding 36 months from the date of payment of the loan. Accordingly, micro-lenders were no longer obliged to comply with interest rates determined by the Act, the matter which opened the door to the creation of numerous micro-lending entities.<sup>213</sup>

The Exemption ultimately led to abuses by lenders, which are best described in the *Lurama* case by Mynhardt J as follows:<sup>214</sup>

“Consumers were exploited. The high, sometimes exorbitant, rates at which interest on short-term loans were charged, created so-called debt traps. Consumers had to enter into fresh loan agreements in order to repay existing loans. This resulted in them becoming more and more indebted to their creditors.”

As a result of the abovementioned abuses, the Minister decided to promulgate the second Exemption Notice. This notice was introduced in 1999.<sup>215</sup> It raised the amount of loans at which lenders can be exempted from the provisions of the Act from R6 000 to R10 000, provided that the loan was repayable over a period not exceeding 36 months. However, the Notice stipulated stringent conditions which micro-lenders had to comply with before they could be exempted from the requirements of the Usury Act. Some of these included that

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<sup>208</sup> South African Dept of Trade and Industry document (not 134 above).

<sup>209</sup> Woker (note 193 above) 5.

<sup>210</sup> Section 15A was inserted into the Act in 1988 through section 8 of Act 100 of 1988 „the Usury Amendment Act“.

<sup>211</sup> Campbell (note 180 above) 62, 63.

<sup>212</sup> Government Gazette 14498 GN 3451, 31 December 1992.

<sup>213</sup> Woker (not 4 above) 226.

<sup>214</sup> *Lurama Vyftien (Pty) Ltd and 49 Others v The Minister of Trade and Industry* (case no 22125 of 1999) (unreported TPD).

<sup>215</sup> Government Gazette 20145 GN 713, 1 June 1999.

they had to be registered with the Micro-finance Regulatory Council<sup>216</sup> and they had to comply with a number of rules.<sup>217</sup> The Notice faced some challenges which emerged in *AAA Investments v MFRC*.<sup>218</sup> However, the court upheld the legislation. Despite the introduction of the stringent requirements, problems in the credit market continued.<sup>219</sup> Eventually the government decided that it was necessary to completely overhaul all the legislation which governed lending to consumers and the Usury Act was ultimately repealed by the NCA.<sup>220</sup>

While the Usury Act related to loans and interest rates, sale of goods on credit was regulated by the Credit Agreements Act which was also repealed by the NCA.

### 3.4 The Credit Agreements Act

As mentioned above, the Usury Act was tasked with regulating loan transactions, and interest limit that could be charged by lenders in terms of such transaction. However, the Credit Agreements Act was responsible for regulating transactions of sales, leases and rendering services which were based on credit, and which were pertaining to movable goods.<sup>221</sup>

The Credit Agreements Act existed at the time of the Usury Act and they complemented each other.<sup>222</sup> However, there was confusion in the application of the Acts and what Act had to be applied in each case; this confusion was due to the fact that both Acts regulated credit agreements but in different ways.<sup>223</sup> The Credit Agreement Act was administered by the Department of Finance, while the Usury Act was administered by the Department of Trade and Industry.<sup>224</sup> Therefore, there was a need for a comprehensive Act that combined both Acts, to be administered by one regulator. This was achieved by the enactment of the NCA, which repealed the Credit Agreements Act.

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<sup>216</sup> The Micro-finance Regulatory Council (MFRC) was established by the minister's notice in 1999, as a regulatory institution in respect of the 1999 Exemption Notice.

<sup>217</sup> Annexure A to the Schedule to GN 713 of 1 June 1999.

<sup>218</sup> *AAA Investments (Pty) Ltd v The Micro-finance Regulatory Council and the Minister of Trade and Industry* 2006 (11) BCLR 1255 (CC).

<sup>219</sup> Woker (note 205 above) 14, 15.

<sup>220</sup> Ibid 15.

<sup>221</sup> The preamble of the Credit Agreements Act.

<sup>222</sup> J Otto „The history of consumer credit legislation in South Africa“ (2010) 16(1) *Fundamina: A Journal of Legal History: Libellus ad Thomasium: Essays in Roman Law, Roman-Dutch Law and Legal History in Honour of Philip J Thomas* 266.

<sup>223</sup> Otto (note 182 above) 14-16.

<sup>224</sup> Ibid 16.

### 3.5 The Consumer Affairs (Unfair Business Practices) Act

Consumer protection measures are not a new innovation in South African law. These measures had been addressed by different provisions scattered in different laws, but there was no comprehensive body of law which dealt exclusively with consumer issues.

Although the Consumer Affairs (Unfair Business Practices) Act, which was introduced in 1988, attempted to protect consumers' interests, it was, as Woker pointed out, unable to achieve its intended purpose.<sup>225</sup> The purpose of the Act was "[t]o provide for the prohibition or control of certain business practices".<sup>226</sup> The Act did not identify specific practices to be prohibited, it rather authorised the Consumer Affairs Committee to investigate business practices and to report to the minister about unfair practices.<sup>227</sup>

The Committee was powerless as it was not authorised to order a supplier to refund prejudiced consumers, and it was only able to report to the Minister about unfair practices with recommendations, and the Minister thereafter decided to either ignore or accept these recommendations.<sup>228</sup> Unfortunately, even if the Minister accepted the recommendations and ordered that certain practices be prohibited, these orders were usually not applied. According to the Act, the contravention of the Minister's orders constituted a criminal offence, and accordingly they had to be enforced by the South African Police Services and the prosecuting authorities.<sup>229</sup> Unfortunately, both these entities, according to *S v Pepsi-Cola (Pty) Ltd*,<sup>230</sup> were overloaded with criminal matters, and consumer problems were not given special attention, a matter which made the Minister's orders meaningless. The Consumer Affairs Act was repealed when the Consumer Protection Act<sup>231</sup> was introduced in 2011.

### 3.6 The National Credit Act

As can be seen from the above discussion, there were major difficulties with the granting of credit in South Africa. By the end of the last century the number of over-indebted consumers had increased excessively and the debt situation in South Africa had become out of control.<sup>232</sup> Furthermore, the credit market had developed and changed over the decades and the previous

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<sup>225</sup> Woker (note 4 above) 220, 221.

<sup>226</sup> Extract from the preamble of the Consumer Affairs (Unfair Business Practices) Act.

<sup>227</sup> Section 3 of the Consumer Affairs (Unfair Business Practices) Act.

<sup>228</sup> Woker (note 4 above) 220.

<sup>229</sup> Ibid.

<sup>230</sup> 1985 3 SA 141 (C).

<sup>231</sup> 68 of 2008.

<sup>232</sup> Kelly-Louw (note 161 above) 353.

laws regulating the credit industry were outdated.<sup>233</sup> In order to address these problems in the credit industry, the government repealed the existing credit legislation and introduced the NCA. The Act aims at promoting “a fair and non-discriminatory marketplace for access to consumer credit”.<sup>234</sup> It seeks to improve the credit market by ensuring that credit providers comply with certain requirements set out in the Act. The Act also introduces certain fundamental rights for consumers in the credit market. These rights include:

- Right to apply for credit.
- Protection against discrimination in respect of the application or granting of credit.
- Right to be furnished with reasons for credit being refused or ceased.
- Right to information pertaining to the relevant agreement, in official language, and in plain and understandable language.
- Right to choose whether to receive relevant documents electronically or in paper form.<sup>235</sup>

The Act also, in pursuit of its objectives, established new institutions, namely:

- The NCR.<sup>236</sup>
- The National Consumer Tribunal (NCT).<sup>237</sup>

According to Wilson, one of the reasons why consumers become over-indebted is reckless lending by credit providers.<sup>238</sup> In an effort to prevent this kind of lending, the NCA requires credit providers to conduct a reasonable assessment in regard to the consumer’s repayment history, current obligations and the consumer’s general understanding of the effects of the credit before providing a credit.<sup>239</sup>

If a credit provider fails to conduct such an assessment, or conducted an assessment and then entered into the credit agreement with the consumer, despite the consumer’s ignorance about the effects of the credit, or in circumstances where entering into that agreement would make the consumer over-indebted, the court may declare that the granting of the credit was

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<sup>233</sup> South African Dept of Trade and Industry document (not 134 above) 13.

<sup>234</sup> Extract from the preamble of the NCA.

<sup>235</sup> Chapter 4, Part A of the NCA.

<sup>236</sup> Chapter 2, Part A of the NCA.

<sup>237</sup> Chapter 2, Part B of the NCA.

<sup>238</sup> T Wilson „Responsible Lending or Restrictive Lending Practices?: Balancing Concerns Regarding Over Indebtedness with Addressing Financial Exclusion“ *The Future of Consumer Credit Regulation: Creative Approaches to Emerging Problems* (2008) 9.

<sup>239</sup> Section 81 of the NCA.

reckless. The court may also make an order setting aside all or part of the consumer's rights and obligations under that agreement, or suspend the force and effect of that credit agreement until a date determined by the court.<sup>240</sup> The consumer is considered to be over-indebted if, having regard to available information at the time, a determination is made that the particular consumer is or will be unable to satisfy in a timely manner the entire obligation under all the credit agreements to which a consumer is a party.<sup>241</sup>

Over-indebted consumers, who do not have any relief, face many negative consequences which can also impact on the economy; such negative consequences include putting burdens on the health system, burdens on legal aid and this can impact on productivity because of anxiety on the part of over-stressed debtors.<sup>242</sup> Over-indebtedness may also lead to poverty and debtors may become violent, suicidal or homicidal due to stress and depression.<sup>243</sup> As Evans submits, if burdened debtors are ignored, debtors may become debt slaves, who will never be able to escape from debt.<sup>244</sup> Debtor may then have to depend on social handouts, which ultimately places a burden on the country's social and economic system. Therefore, the NCA under section 86 offers a debt relief procedure for overburdened consumers.

In terms of this section when a consumer who is in a financial difficulty approaches a debt counsellor for assistance, the debt counsellor, having conducted an assessment, may reject the consumer's application, recommend that the consumer and the respective credit providers agree on a debt re-arrangement plan, or issue a proposal recommending that the court make an order that one or more of the credit agreements be declared reckless credit, and/or that one or more of the consumer's obligations be re-arranged.

It was hoped that the introduction of the legislation would go a long way to deal with the problems which existed in the credit market. However, recent developments, especially the financial crisis of 2008 and the collapse of African Bank in South Africa have indicated that there may well be a need to introduce further and tighter regulation in the financial sector.

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<sup>240</sup> Sections 80 & 83 of the NCA.

<sup>241</sup> Section 79 of the NCA.

<sup>242</sup> Wilson (note 225 above).

<sup>243</sup> Ibid.

<sup>244</sup> R G Evans „A brief explanation of consumer bankruptcy and aspects of the bankruptcy estate in the United States of America“ (2010) 43(3) *Comparative and International Law Journal of Southern Africa* 337.

## Chapter 4

### The financial crisis of 2008 and its consequences

#### 4.1 Introduction

In 2008 the world witnessed the greatest financial crisis since the Great Depression in 1930.<sup>245</sup> While the crisis initially developed in the USA, the global nature of financial dealings resulted in the crisis casting its shadow on most countries of the world.<sup>246</sup> This financial meltdown led many countries to reconsider their financial regulations to ensure that future crises could be avoided.<sup>247</sup> The crisis was addressed by a number of scholars, academic researchers, and committees, who identified the reasons for the crisis and the impact it had on global financial regulation. Some of these reasons as well as the international response to the crisis are discussed below.

#### 4.2 The causes of the crisis

The international financial crisis of 2008 is well known. It occurred as a result of various problems at different stages.<sup>248</sup> The epicentre of the crisis occurred within the financial system of the USA and it then expanded to many other countries.<sup>249</sup> The origin of the crisis was the exorbitant creation of money that occurred because so many poor consumers (called sub-prime borrowers) had access credit which in time they could not repay.<sup>250</sup>

In 2003, the Federal Reserve Bank (FRB) of the USA (the central bank) decreased the level of the repo rate, as the country was encountering an economic recession.<sup>251</sup> The repo rate is the rate at which private banks borrow money from the central bank. The central bank uses the repo rate as a method of controlling the growth of credit lending from private banks. When the repo rate is increased the private banks borrow money from the central bank at a more expensive rate, and these banks lend money to consumers at higher rates, which

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<sup>245</sup> Three Top Economists Agree 2009 Worst Financial Crisis Since Great Depression; Risks Increase if Right Steps are Not Taken *Reuters* <http://www.reuters.com/article/2009/02/27/idUS193520+27-Feb-2009+BW20090227>, accessed on 19 November 20114.

<sup>246</sup> Brummer (note 2 above) 15, 16, 211.

<sup>247</sup> *Ibid* 233, 234.

<sup>248</sup> Van Wyk (note 22 above) 32.

<sup>249</sup> Brummer (note 2 above) 211.

<sup>250</sup> Van Wyk (note 22 above) 32.

<sup>251</sup> Financial Crisis Inquiry Commission (note 8 above) 59, 60.

subsequently leads to a contraction in the demand for credit by consumers (and vice versa).<sup>252</sup> The objective of the FRB in decreasing the repo rate was to encourage consumers to borrow money from banks, and so to raise consumption and investment spending.<sup>253</sup> Banks simultaneously, in an effort to combat the recession, encouraged the poorer sector of the community (sub-prime borrowers) to borrow money for the purpose of buying their own houses, something which the American government was in favour of.<sup>254</sup> As a result, not only did numerous sub-prime borrowers approach the banks for loans to buy houses, but also owners, who were motivated to develop their houses.<sup>255</sup> At the time, the impression was created that housing markets were booming, leading to increasing flows of foreign capital into the USA Capital Markets and the prosperity of such markets.<sup>256</sup>

With the increased demand for houses, the demand for household equipment also increased, and banks' lending was excessively raised.<sup>257</sup> The banks were encouraged to expand their lending because of the advantage of securitisation, which protects lenders from any risk of borrowers defaulting on repayment.<sup>258</sup> Securitisation is a financial practice according to which several types of assets such as mortgages, loans and credit card debts are pooled, levelled (by rating agencies) and sold as securities.<sup>259</sup> The rating levels (also called tranches) are categorised AAA, AA, A, BBB, BB...etc. (from the most creditworthy to the least credit worthy).<sup>260</sup> Securities backed by mortgages are called mortgage-backed securities, while those securities which are backed by other types of rights of payment are called asset-backed securities.<sup>261</sup>

When the banks' lending started to rise excessively, the FRB raised the repo rate sharply in order to settle the lending demand.<sup>262</sup> However, most of the borrowers, who could afford the repayment of their mortgages when the interest rates were low, now defaulted on their

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<sup>252</sup> Information regarding the repo rate can be found at [http://www.glasscock.co.za/news/entry/the\\_repo\\_rate\\_and\\_its\\_effect\\_on\\_individuals/](http://www.glasscock.co.za/news/entry/the_repo_rate_and_its_effect_on_individuals/), accessed on 13 October 2014.

<sup>253</sup> S B Das *Road to Recovery: Singapore's Journey Through the Global Crisis* (2010) 17, 18.

<sup>254</sup> Van Wyk (note 22 above) 32.

<sup>255</sup> Ibid.

<sup>256</sup> Das (note 6 above) 22.

<sup>257</sup> Van Wyk (note 22 above) 32.

<sup>258</sup> K Bonnick *Why Too Big to Fail?* (2010) 61.

<sup>259</sup> A Jobst „Back to Basics-What Is Securitization?“ (2008) 45(3) *Finance & Development* 48, 49.

<sup>260</sup> Financial Crisis Inquiry Commission (note 8 above) figure 8.1 at 128.

<sup>261</sup> K Kettering „Securitization and its Discontents: The Dynamics of Financial Product Development“ (2008) 29 *Cardozo Law Review* 1557.

<sup>262</sup> P Mattick *Business as usual: The economic crisis and the failure of capitalism* (2011) 13.

repayments.<sup>263</sup> This was the first stage of the problem, and it was attributed to the FRB as it had kept the interest rate too low for too long a period of time.<sup>264</sup>

The second stage of the problem was attributed to the banks.<sup>265</sup> During the lending process, the banks were not prudent in their assessment of the borrowers' creditworthiness; as a result, there was a great deal of reckless lending.<sup>266</sup> When the banks started selling the mortgage-backed securities, many of these securities were rated at lower than triple A. This meant that they were very difficult to be sold as the holder of these securities would have been placed in waterfall payments if the borrowers had fallen into default.<sup>267</sup> In other words, the holders of the higher tranche (in the case of borrowers' default) would receive interest and principal payments, while the lower-tranche holders would receive only interest payments; when the higher tranche holders have received all interest and principal payments in full, the next tranche holders start receiving interest and principal payments.<sup>268</sup>

In order to resolve this problem, mortgage-backed securities were converted into structures called collateralized debt obligations (CDOs), which are type of derivatives.<sup>269</sup> The mechanism of the CDOs is that entities called special purpose entities are created, and lower tranches of mortgage-backed securities are placed in these entities.<sup>270</sup> The entities thereafter repackage these securities into new ones (CDOs).<sup>271</sup> Approximately 80% of these CDOs were rated triple A, and they were sold as such, although they originally consisted of the lower-rated tranches of mortgages-backed securities.<sup>272</sup> These CDOs were sold to undercapitalised banks and other financial institutions who took advantage of deregulation of derivatives to conceal their risk.<sup>273</sup> This was the next stage of the problem as the rating agencies failed to

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<sup>263</sup> J Friedman *What Caused the Financial Crisis* (2011) 5.

<sup>264</sup> Van Wyk (note 22 above) 33.

<sup>265</sup> Ibid.

<sup>266</sup> Ibid.

<sup>267</sup> Financial Crisis Inquiry Commission (note 8 above) 127.

<sup>268</sup> R Kolb *Lessons from the Financial Crisis: Causes, Consequences, and Our Economic Future* (2010) 213.

<sup>269</sup> Lehman Brothers „The Lehman Brothers guide to exotic credit derivatives“ (2003) 12; Financial Crisis Inquiry Commission (note 8 above) 127.

<sup>270</sup> The entities are separate from investment banks, who issue the mortgage-backed securities. They are also called special purpose vehicles. See B E Gup *The Financial and Economic Crises: An International Perspective* (2010) 9.

<sup>271</sup> Financial Crisis Inquiry Commission (note 8 above) 127; A Jobst (note 11 above); Lehman Brothers (note 20 above) 13.

<sup>272</sup> Financial Crisis Inquiry Commission (note 8 above) 127.

<sup>273</sup> Brummer (note 2 above) 210.

assess the securities properly and there was an absence of rules that regulated derivative transactions.<sup>274</sup>

The CDOs were sold locally and internationally through foreign investors who were seeking high profits in the USA markets.<sup>275</sup> The most notable investors were the Norwegian municipalities of Rana, Hemnes, Hattjelldal and Narvik, who invested about \$120 million of their taxpayers' money in the CDOs.<sup>276</sup> The foreign investors entered into these investments on the basis that the CDOs were triple-A-rated securities, while in fact they were not.<sup>277</sup> As most countries hold their foreign reserves in USA Dollar assets, the unsound securities constituted part of the foreign reserves of investing countries, and resulted in the globalising of the crisis.<sup>278</sup> This implies that bank regulators were not efficient enough, as they failed to recognise the reality of the CDO quality. The crisis also proved that the international financial codes and standards were ineffective and unable to prevent the expansion of the crisis throughout the world.<sup>279</sup>

The crisis culminated in the collapse of a number of financial institutions in the USA, including banks, such as Lehman Brothers.<sup>280</sup> As a result of the uncertainty, financial institutions stopped lending to each other and interbank funding suffered a shortage of liquidity.<sup>281</sup> Governments therefore were obliged to rescue systemically important financial institutions (SIFIs), which are not allowed to fail and the collapse of which would have led to the destruction of the entire financial system.<sup>282</sup>

### **4.3 How the South African financial system weathered the crisis**

As mentioned above, the South African financial system, compared with many developed countries, managed to resist the repercussions of the financial crisis of 2008. This resistance was due to several factors, such as the efficiency of the monetary policy adopted by the SARB and the economy's limited exposure to foreign assets.<sup>283</sup> According to Van Wyk, the implementation of prudential regulation pertaining to foreign investments also enabled South

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<sup>274</sup> Van Wyk (note 22 above) 33; Brummer (note 2 above) 210.

<sup>275</sup> Ibid 211.

<sup>276</sup> N Ferguson *The Ascent of Money, a Financial History of the World* (2008) 269.

<sup>277</sup> Financial Crisis Inquiry Commission (note 8 above) 127.

<sup>278</sup> Van Wyk (note 22 above) 33, 34.

<sup>279</sup> Brummer (note 2 above) 210.

<sup>280</sup> South Africa National Treasury Document (note 5 above) 10.

<sup>281</sup> Ibid.

<sup>282</sup> Ibid 20; Brummer (note 2 above) 213.

<sup>283</sup> South Africa National Treasury Document (note 5 above) 13-15.

Africa to weather the crisis. This regulation replaced exchange control regulation in respect of institutional investors in 2008.<sup>284</sup> Van Wyk states that the regulation is intended to strike a balance between encouraging foreign investments and protecting the economy from the external shocks.

Another significant measure which protected South Africa from the crisis was the adoption of strong legislation regulating the credit industry, namely the NCA.<sup>285</sup> The Act seeks to ensure an efficient and effective credit market.<sup>286</sup> It requires credit providers to assess consumers' affordability before providing any credit in order to ensure that the consumers will be able to repay the credit.<sup>287</sup> As a consequence, the Act managed to protect consumers from reckless lending, a practice which contributed to the financial crisis in the USA in 2008.<sup>288</sup> Furthermore, through debt counselling measures contained in the NCA, several thousands of households managed to restructure their debts and were subsequently protected from losing their houses.<sup>289</sup> However, the implementation of the Act still needs to be optimised, especially in terms of the behaviour of debt counsellors.<sup>290</sup> Furthermore, the African Bank collapse which occurred in August of 2014 cast doubts on the role of the NCR and whether such Regulator operates effectively in the credit industry.<sup>291</sup> The African Bank is now under the curatorship of the SARB and details of the collapse are not clear as an investigation is still under way.<sup>292</sup> However it seems that the problems stem from reckless lending on the part of African Bank.<sup>293</sup> The fact that such lending could continue to take place after the introduction of the NCA is a cause for concern and is an indication either that the Act does not provide sufficient measures to combat such reckless lending and that there is therefore a need to introduce further and more stringent legislation or that the NCR is not performing its functions properly. Either way the problems at African Bank highlight the fact that there is a need for the government to revisit the issue of regulation in the financial sector.

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<sup>284</sup> Van Wyk (note 22 above) 122, 123.

<sup>285</sup> South Africa National Treasury Document (note 5 above) 13, 14.

<sup>286</sup> Section 3 of the NCA.

<sup>287</sup> Section 81 of the NCA.

<sup>288</sup> South Africa National Treasury Document (note 5 above) 51.

<sup>289</sup> G Davel „Consumers the victims while credit regulator left headless“ *Business Day* 18 July 2011 at 9.

<sup>290</sup> Ibid.

<sup>291</sup> African Bank: The rot stops here *Mail & Guardian* (online newspaper) available at <http://mg.co.za/article/2014-09-04-african-bank-the-rot-stops-here>, accessed on 19 November 2014.

<sup>292</sup> Ibid.

<sup>293</sup> African Bank 'kept lending to indebted customers' (note 168 above).

#### 4.4 The Aftermath of the crisis

The financial crisis in 2008 revealed that the soft regulatory approach towards financial regulation was not able to protect the financial system of a country and that more regulation, rather than less regulation, is needed. The financial crisis drew many countries' eyes to the urgent need for refining the international and local regulatory system.<sup>294</sup> In the wake of the crisis, reforms on the international regulatory framework were introduced. One of these reforms was conducted by the Basel Committee on Banking Supervision (BCBS), which is commonly referred to as Basel III.<sup>295</sup> According to Basel III, banks are required to hold a minimum capital ratio to operate against any potential loss; they are also required to keep a capital conservation buffer which will be increased during economic growth and utilised during crises.<sup>296</sup> In addition, the International Organization of Securities Commissions (IOSCO) published several reports dealing with derivative trading and how such trading can be optimised.<sup>297</sup> The reports also focus on the securities regulators and the role which such regulators can play to mitigate system risks through proper supervision and market transparency.

Furthermore, the international trend to financial regulation has been directed to a new approach, namely the macro-prudential regulation approach.<sup>298</sup> This regulation refers to regulation that deals with the systemic risks of the whole financial system, as opposed to micro-prudential regulation which focuses on the regulation of soundness and financial stability of the individual financial institutions.<sup>299</sup> The crisis demonstrated that micro-prudential regulation was not sufficient to protect the financial system from the contagion of unhealthy financial institutions.<sup>300</sup> Macro-prudential regulation therefore strives to control the risks arising from the interconnection between financial institutions and to ensure the financial stability, safety and soundness of the financial system as a whole.<sup>301</sup>

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<sup>294</sup> Brummer (note 2 above) 233, 234.

<sup>295</sup> South Africa National Treasury Document (note 5 above) 17.

<sup>296</sup> Ibid 17, 18.

<sup>297</sup> Van Wyk (note 22 above) 118-120.

<sup>298</sup> South Africa National Treasury Document (note 5 above) 9.

<sup>299</sup> Van Wyk (note 22 above) 117, 118.

<sup>300</sup> South Africa National Treasury Document (note 5 above) 12.

<sup>301</sup> Ibid.

#### 4.4.1 South African response to the crisis

Although South Africa was initially shielded from the financial crisis of 2008, it was important for the government to follow the international trend in strengthening financial regulation and to protect the country from any potential crises.<sup>302</sup> The recent problems experienced by African Bank have highlighted that the belief that there is a need for more stringent regulation is not ill conceived.

Through the introduction of the Financial Markets Act<sup>303</sup> and other legislation, South Africa has committed itself to comply with the international standards such as Basel III and IOSCO standards.<sup>304</sup> In addition, South Africa will adopt the approach of macro-prudential regulation of financial system.<sup>305</sup> As mentioned above, this approach deals with the regulation and financial stability of the entire system instead of individual institutions separately. It ensures safety, soundness and solvency of the financial institutions during economic meltdowns.<sup>306</sup> In pursuit of adopting the macro-prudential approach, a Financial Stability Oversight Committee (FSOC) will be established; this entity will be co-chaired by the Minister of Finance and the SARB Governor, and it will be responsible for supervising financial stability on a systemic basis.<sup>307</sup> It will also strive to mitigate any risk arising from any potential crisis and to provide a proper resolution for such crises.<sup>308</sup>

The government will also adopt the twin-peaks model of financial regulation, the model which has been adopted by the UK.<sup>309</sup> The model will be implemented over two stages. In the first stage, which will be implemented by the Financial Sector Regulation Bill, two authorities will be established. The first authority, namely the Prudential Authority, will be responsible for the supervision of the prudential regulation of banks, insurers and financial conglomerates. The Prudential Authority will be established within the SARB, which denotes the first peak of the model.<sup>310</sup> The other authority, namely the Market Conduct Regulator, will be overseeing the market conduct of financial institutions (including banking charges). The Regulator will be created within the FSB, which denotes the second peak of the

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<sup>302</sup> Van Wyk (note 22 above) 123.

<sup>303</sup> Act 19 of 2012.

<sup>304</sup> South African Government News Agency (note 157 above).

<sup>305</sup> Van Wyk (note 22 above) 123.

<sup>306</sup> South Africa National Treasury Document (note 5 above) 23.

<sup>307</sup> Ibid 32.

<sup>308</sup> Van Wyk (note 22 above) 123.

<sup>309</sup> South Africa National Treasury Document (note 5 above) 28.

<sup>310</sup> South African National Treasury, Media Statement „Implementing the twin peaks model of financial regulation“ 11 December 2013.

model.<sup>311</sup> The Market Conduct Authority will be responsible for the protection of consumers of financial services, and for enhancing the confidence of consumers in the financial system of South Africa.<sup>312</sup> The Regulator will operate along with the NCR, which is responsible for both banking and non-banking credit.<sup>313</sup>

Consumer protection is a rational factor for ensuring economic growth. As was demonstrated in the financial crisis, defective financial products can result in financial instability and a lack of confidence in the financial system, which ultimately affects economic growth.<sup>314</sup> It is submitted that consumers of financial products need higher standards of protection than those provided in the CPA.<sup>315</sup> The reason is that the nature of the financial products is largely different from that of non-financial products. For instance, the consumer's right to a cooling-off period in terms of the CPA can be applied for household items, but it cannot be accepted in securities trading, as time is a fundamental element in such trading, and applying this right to securities transactions could result in a systemic risk.<sup>316</sup> Furthermore, the quality of some financial products, such as life insurance, can only be valued after a considerable period of time after purchase.<sup>317</sup> In addition, consumers are vulnerable to unfair treatment because of the disproportion between consumers and financial services providers in terms of information and expertise.<sup>318</sup>

The FSB therefore introduced the "Treating Customers Fairly" (TCF) proposal,<sup>319</sup> which adopts a system of stronger control of the market conduct of financial institutions. The proposal indicates various aims that should be achieved by financial institutions, such as making consumers more confident when dealing with financial firms, and furnishing consumers with appropriate information and advice.<sup>320</sup> The proposal also provides that consumers should be offered suitable financial products and services that can satisfy their needs; they should also be allowed to lodge claims and complaints after concluding a transaction. In addition to the establishment of the FSOC, in the first stage of the implementation of the model a Council of Financial Regulators (CFR) will be established.

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<sup>311</sup> South Africa National Treasury Document (note 5 above) 32, 33.

<sup>312</sup> South African National Treasury „Roadmap for Implementing Twin Peaks Reforms“ 1 February 2013, 6.

<sup>313</sup> South Africa National Treasury Document (note 5 above) 43.

<sup>314</sup> Ibid 40.

<sup>315</sup> Act 68 of 2008.

<sup>316</sup> South Africa National Treasury Document (note 5 above) 41, 42.

<sup>317</sup> Ibid.

<sup>318</sup> South African Financial Services Board „Treating Customers Fairly Roadmap“ 31 March 2011, 6

<sup>319</sup> South African Financial Services Board „Treating Customers Fairly Roadmap“ 31 March 2011.

<sup>320</sup> Ibid 7.

The CFR will be established with a view to coordinating all financial regulators and sharing information between these regulators on issues influencing the financial system.<sup>321</sup> In order to ensure compliance with the regulation of the new regime, a Financial Services Tribunal will be created, which is intended to enhance the effective enforcement of the administrative actions of the related regulators.<sup>322</sup>

The Financial Sector Regulation Bill, through which the first stage of the model will be implemented, will introduce minor changes to the existing financial legislation in order to empower the new regulators.<sup>323</sup> However, a number of statutes have already been introduced in response to the changes in the financial sector of South Africa.<sup>324</sup> These acts include the Banks Amendment Act,<sup>325</sup> the Financial Services Laws General Amendment Act,<sup>326</sup> the Financial Markets Act<sup>327</sup> and the Credit Ratings Services Act.<sup>328</sup> In addition, in the second stage of the implementation of the model, the existing sectoral legislation will be amended or repealed in order to give full effect to the twin-peaks regime.<sup>329</sup> The Financial Sector Regulation Bill is expected to be tabled in Parliament before the end of this year.<sup>330</sup>

According to the Bill, the financial services institutions will be divided into mono-regulated and dual-regulated institutions.<sup>331</sup> Mono-regulated institutions are those that conduct activities which only relate to market conduct regulation, and which will be regulated by the Market Conduct Authority; pension funds, financial advisors and investment schemes are typical examples of these institutions.<sup>332</sup> Dual-regulated institutions, such as banks and insurers, are those that conduct activities which relate to both prudential and market conduct regulation; these institutions will be regulated by both Prudential and Market Conduct Authority.<sup>333</sup>

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<sup>321</sup> Media Statement (note 295 above); see also Sabinet Legal at <http://www.sabinetlaw.co.za/finances/articles/financial-sector-regulation-bill-track>, accessed on 17 November 2014.

<sup>322</sup> Media Statement (note 295 above).

<sup>323</sup> Ibid.

<sup>324</sup> South Africa National Treasury Document (note 5 above) 8.

<sup>325</sup> 22 of 2013.

<sup>326</sup> 45 of 2013.

<sup>327</sup> 19 of 2012.

<sup>328</sup> 24 of 2012.

<sup>329</sup> Media Statement (note 295 above).

<sup>330</sup> Sabinet Legal at <http://www.sabinetlaw.co.za/finances/articles/financial-sector-regulation-bill-track>, accessed on 17 November 2014.

<sup>331</sup> Media Statement (note 295 above).

<sup>332</sup> Ibid; Schedule 2, Part 1 of the Financial Sector Regulation Bill.

<sup>333</sup> Ibid; Schedule 2, Part 2 of the Financial Sector Regulation Bill.

It is contended that the new model will protect the financial sector of South Africa and will make it safer.<sup>334</sup> According to Dixon, the model will ideally suit South Africa due to the prominence of large financial conglomerates, with some groups housing both banking and insurance operations.<sup>335</sup> However, Mhango criticised the model in that it is a copy-paste model which was inspired from the UK, and it does not consider the South African features.<sup>336</sup> He also submits that the model is not suitable for South Africa as the conditions on which the model is based in the UK are not present in South Africa. Mhango contends that South Africa should introduce its own regulatory system that suits its particular characteristics and demands.

Although, it is accepted that it may be the best approach for South Africa to invent a regulatory system that suits its own problems and environment instead of adopting other countries' systems, this may take years to be conceived, prepared and implemented. This may result in consumers and investors losing their money because of schemes dreamed up by unscrupulous persons. It is suggested therefore that whilst the twin-peaks model may have some flaws and may be cumbersome for South Africa, it is an immediate solution, and it can be refined to accommodate South African features as time goes by. The model will solve the problem of the multiplicity of regulators. There will be more control of market conduct and, it is hoped that, this will prevent unscrupulous persons from jumping from one regulator to another to avoid detection.

As mentioned above, access to credit is very important for both consumers and for the development of the economy. However, the flow of credit in an unreasonable manner could lead to economic disaster, as demonstrated by the 2008 crisis and the collapse of African Bank. Therefore, access to credit must be balanced with prudent lending and must be regulated and overseen carefully, a duty for which the NCR is responsible.<sup>337</sup> However, the recent African Bank saga demonstrated that the NCR may not be performing as was envisaged in the credit industry. Its failure to deal with problems such as reckless lending could lead to financial instability. Furthermore, it has not yet been clarified how the new model will be financed and who will bear the cost of its operation. In general, the costs of regulatory authorities are, covered either by the government or the regulatory participants.

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<sup>334</sup> South Africa National Treasury Document (note 5 above) 8.

<sup>335</sup> FSB Deputy Executive Officer- Insurance Division, available at <http://www.moneyweb.co.za/moneyweb-financial/2014s-twin-peaks>, accessed on 20 November 2014.

<sup>336</sup> Mhango (note 18 above).

<sup>337</sup> Sections 12 to 18 of the NCA.

When the costs are covered by the government, these costs are paid by taxpayers, while the costs paid by the institutions, for which the regulatory authorities are responsible, are in fact passed on customers of these institutions.<sup>338</sup> While the first method of covering the costs seems unfair, as may have taxpayers who do not benefit from the concerned authorities, the second method is certainly fair, as the costs are passed only on customers who are the beneficiaries of the involved authorities.

Another issue that can be raised is that effective regulation cannot secure its objective without efficient supervision and enforcement. The establishment of the Financial Services Tribunal provided by the Financial Sector Regulation Bill therefore, is a laudable step in promoting the enforcement of actions of the regulatory authorities. However, it has not been explained whether consumers of financial services will be required to bear any costs in order to approach the Tribunal to resolve any related dispute. The powers of the Tribunal are also not clearly defined and whether such Tribunal will be able to award damages for prejudiced consumers. Hopefully it will not follow in footsteps of the National Consumer Tribunal, which does not have the power to order redress for aggrieved consumers.<sup>339</sup>

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<sup>338</sup> Falkena et al (note 1 above) 9.

<sup>339</sup> Woker (note 4 above) 221.

## **Chapter 5**

### **Conclusion**

The financial system plays an important role in economic growth of countries. It is, therefore, very important that the system is well-regulated and stable. The financial crisis of 2008 drew countries' attention to the need for serious revision to their financial regulation. It was realised that with the innovative instruments in the financial dealings, the soft regulation approach followed by most countries was no longer suitable. Most countries therefore adopted tougher regulation to introduce a stronger financial system and South Africa was no exception. In addition to reforms introduced by international bodies, South Africa adopted a twin-peaks model of the financial regulation.

The new model is basically based on two authorities, namely the Prudential Authority and the Market Conduct Authority. The first is responsible for prudential regulation which play pre-emptive role in mitigating any risk threatening the financial stability of the financial system. This Authority lies within the SARB. In order for the Prudential Authority to perform its duty effectively, the risk should be identified and dealt with in a timeous manner through a successful information system. The handling of existing and potential risk must occur at the first stages of the risk. Postponing dealing with the risk, hoping that the risk will disappear as time goes by, may make the problem even worse. The crisis of 2008 is a typical example of the negative consequences of delayed action.

The second authority is responsible for market conduct regulation and the protection of consumers of financial services. This authority will operate within the FSB closely with the NCR. The recent collapse African Bank revealed that the NCR needs to be optimised in order to ensure an effective credit industry. It is suggested therefore that the NCR should be brought into the twin-peaks model of regulation, in order to ensure that the Regulator does its job effectively.

The introduction of the Financial Services Tribunal is welcomed, as effective regulation cannot secure its objective without an efficient enforcement mechanism. The Tribunal should be granted broad powers in order to conduct its task properly. It should be entitled to award damages to prejudiced consumers and investors to ensure that they will not be hindered by the long and costly process of civil courts, and so to promote confidence in the financial sector. The model should provide proper protection for consumers of financial services on

issues were not covered by the Consumer Protection Act. The model will ensure that South Africa does not have a multiplicity of regulators. Hopefully there will be proper control over market conduct, and unscrupulous persons will be prevented from jumping from one regulator to another to avoid detection. It would be better for South Africa however, to invent a regulatory system that suits its own problems and environment instead of adopting other countries' systems; but this may take a couple of years to be conceived, prepared and implemented, which will result in consumers and investors losing their money to unscrupulous persons. The twin-peaks model may be flawed and cumbersome for South Africa, but it is an immediate solution, and it can be optimised to accommodate South African features as time goes by. It is hoped that the model will achieve its intended purposes and will put South Africa in the forefront of consumer protection, as the NCA was intended to do.

It can be concluded that consumer education is a crucial aspect in ensuring that any regulation succeeds, and effective regulation cannot achieve its objective without increasing consumer awareness. Regulators must also conduct strict supervision as unscrupulous persons always invent sophisticated instruments and methods to deceive investors and consumers, and to escape provisions of law. The following Arabic proverb that says: "The thief is always cleverer than the guard!" should be borne in mind. However this should not prevent the guards from continuing in their attempts to thwart the thieves.

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