RULE OF LAW PROJECT

a division of the

FREE MARKET FOUNDATION

Submission
to the
National Treasury
on the
"A Known and Trusted Ombud System for All"
Consultation Policy Document

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1. Executive Summary

On 3 October 2017, National Treasury published its new ombud consultation policy document as part of the new "Twin Peaks" system of financial sector regulation. The policy intends to address the "effective dispute resolution" aspect of the new system, particularly alternative dispute resolution in the form of ombuds.

In this submission, various faults in the policy are identified. The absence of an independently-conducted socio-economic impact assessment is problematised as this oversight permeates the whole policy. There is, further, an evident, but undue, distrust of the existing voluntary ombud system, which is similarly addressed in this submission.

The principal problem with the new financial ombud policy is that it is laden with faulty assumptions and that there is a lack of empirical evidence supporting these assumptions or the policy as a whole. To cure this deficiency, National Treasury should first commission an independent socio-economic impact assessment for this policy, in particular, and for the new Twin Peaks system in general.

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2. The Free Market Foundation and Rule of Law Project

The Free Market Foundation (FMF)[1] is an independent public benefit organisation founded in 1975 to promote and foster an open society, the Rule of Law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations, and sponsorships.

Most of the work of the FMF is devoted to promoting economic freedom as the empirically best policy for bringing about economic growth, wealth creation, employment, poverty reduction, and greater human welfare.

The FMF's Rule of Law Project is dedicated to promoting a climate of appreciation throughout South Africa, among the public and government, for the Rule of Law; continually improving the quality of South African law; identifying problematic provisions in existing and proposed laws, and, where feasible, advocating rectification.

3. Introduction[2]

The dictionary definition of an ombudsman is "an official investigator of complaints against government bodies or employees". The important factor to be drawn from this definition is that the function of an ombuds is to investigate complaints against government bodies or employees. A person carrying out a

[1] www.freemarketfoundation.com

[2] This section appears in substantially the same form in the FMF's submission on the "Proposal on the Future Constitution, Role and Function of Ombudsmen in the Financial Services Sector" by Eustace Davie.

function that entails intervening between the administrative arms of government and the general public, requires legal authority in order to do so. The role and authority of the government ombud must, therefore, necessarily be legislated. Some private organisations, consisting of businesses operating in certain industries have borrowed the word to describe individuals appointed by them to investigate and rule on complaints by customers against members of their own organisations. Although the role they perform may have a superficial resemblance to that of a government ombud, they are very different. Citizens with complaints against government bodies often have no recourse to the courts for resolution of their complaints. A government ombud, therefore, has been introduced by democratic governments to act as the champion of the helpless citizen who faces an intractable and unsympathetic bureaucracy.

Private organisations appoint and pay "ombudsmen" and, generally, give them autonomy and power to satisfy customers that they will be given a fair and independent hearing. The industry objective is to provide customers with a level of comfort regarding complaints: a feeling that they have a champion who is part of the industry, understands it, and will intercede on their behalf unless the matter is of such a nature that it can only be resolved by recourse to the courts.

The system described in the above paragraph functions perfectly well and saves many customers from having to use the courts to obtain satisfaction. It goes further, in that customers will not have to exhaust the avenues open to them within the individual company before turning to the ombuds for relief. Publicity-shy customers can also avoid the trauma of using the press to try and obtain relief regarding their complaints against suppliers.

On 3 October 2017, National Treasury published its new ombud consultation policy document[3] as part of the new "Twin Peaks" system of financial sector regulation. The policy intends to address the "effective dispute resolution" aspect of the new system, particularly alternative dispute resolution in the form of "ombuds".

In this submission, numerous faults in the policy are identified. The absence of an independently-conducted socio-economic impact assessment is clearly a significant source of the faults as this omission permeates the whole policy. There is, further, an evident, but undue, distrust of the existing voluntary ombud system, which is similarly addressed in this submission.

4. Equity and the law

On page 26, the policy provides that the governing rules of industry ombuds "must provide for cases to be heard on the basis of what is fair, irrespective of what the law or contract provides". The same is stated on pages 2 and 3, 11 and 42. It seems to be assumed that ombuds will operate on fairness outside of the law and contract. This contention is clearly wrong. It works on the basis that the ombud system can replace the law of contract and operate outside of the law. This is clearly *ultra vires* the enabling statute.

There is a significant legal error in this reasoning as "equity" cannot override clear law.

In the Appellate Division case of *Bank of Lisbon and South Africa Ltd v De Ornelas*,[4] the court held:

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3 National Treasury. "A Known and Trusted Ombud System for All – Consultation Policy Document". (2017). Henceforth "the policy".

4 *Bank of Lisbon and South Africa Ltd v De Ornelas* 1988 3 SA 580 (A).

> "Our law does not recognise courts of equity with jurisdiction to 'oversee' contractual transactions between parties who freely and voluntarily contract with each other on certain terms […] Roman-Dutch law is itself inherently an equitable legal system. In administering the law the Dutch Courts paid due regard to considerations of equity but only where equity was not inconsistent with the principles of law. Equity could not override a clear rule of law". (our emphasis)

Common law, statutory law, customary law, and constitutional law, are the sources of law in South Africa. Equity, if it is not codified in legislation, is not a separate part of our law, but it is an inherent part of our Roman-Dutch common law.

While an argument can be made that voluntary ombuds should be free to apply standards higher than our law to parties who voluntarily submit themselves to their jurisdiction, a statutory ombud will invariably be funded by the taxpayer and have compulsory jurisdiction. If they are allowed to operate outside of the bounds of South African law, then our constitutional order is undermined. As the Constitutional Court remarked in the seminal case of *Pharmaceutical Manufacturers Association of South Africa and Another: In re Ex Parte President of the Republic of South Africa and Others*:[5]

> "There are not two systems of law, each dealing with the same subject matter, each having similar requirements, each operating in its own field with its own highest court. There is only one system of law. It is shaped by the Constitution which is the supreme law, and all law, including the common law, derives its force from the Constitution and is subject to constitutional control". (our emphasis)

Finally, the Constitution of the Republic of South Africa[6] provides in the Founding Provisions that the democratic South African state[7] is founded upon various values, including the Constitution and the Rule of Law.[8] This means that the Constitution does more than merely provide for the structure of government and individual rights, but also charts a way of life. Walter F Murphy writes:[9]

> "The goal of a constitutional text must [...] be not simply to structure a government, but to construct a political system, one that can guide the formation of a larger constitution, a "way of life" that is conducive to constitutional democracy. If constitutional democracy is to flourish, its ideals must reach beyond formal governmental arrangements and help configure, though not necessarily in the same way or to the same extent, most aspects of its people's lives."

This invariably means that the whole of South African law, which derives its force from the Constitution, permeates all of South African society. In light of the involuntary nature of statutory ombuds, it stands to reason that both financial service providers and potential complainants must feel confident that the law will protect them, and that they will not be subjected to the whims and prejudices of ombud employees. This latter instance would amount to the 'rule of man' in South Africa, rather than the Rule of Law.

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5 *Pharmaceutical Manufacturers Association of South Africa and Another: In re Ex Parte President of the Republic of South Africa and Others* 2000 (2) SA 674 (CC).

6 Constitution of the Republic of South Africa, 1996. Henceforth "the Constitution".

7 The whole of the State, not only government, but including civil society.

8 Section 1(c),

9 Murphy, WF. "Civil Law, Common Law, and Constitutional Democracy." The 19th Tucker Lecture. (1991). 52 *Louisiana Law Review* 1.

By giving ombuds the ability to apply whatever the adjudicator considers "fair" or "equitable" will create unprecedented uncertainty in the financial services sector for which no financial services provider will be able to prepare. Equally, complainants might find themselves believing that they have been unfairly treated, as the adjudicator – not bound by precedent – may at a whim depart from the law and prior rulings and declare the conduct "fair". Such uncertainty undermines both the Rule of Law and economic growth.

5. Forum shopping

On page 4, the policy complains about apparent "forum shopping", saying that when consumers can pick and choose to find the dispute resolution provider who will give them the best result, "overall inefficiencies in the system" occur. This allegation is not supported by any evidence or rationale and is clearly a nonsensical supposition.

Competition between ombuds and alternative dispute resolution providers should be encouraged, not discouraged. Consumers should be going around trying to find the most favourable forum. In this way, the fora will try to outcompete one another to attract the business of both financial services providers as well as complainants. If they alienate either party, the fora will lose business.

It is important to keep the system private and voluntary. With government involvement, incentive structures change and alternative dispute resolution becomes a formalistic, bureaucratic exercise where the provider is not required to compete with anyone and have no substantive reason to improve the quality of their service.

6. Rationality of the policy

The Rule of Law is a principle of South African constitutional law found in section 1(c) of the Constitution. It provides that South Africa is a democratic state founded on the supremacy of the Constitution and the Rule of Law. The most important tenet of the Rule of Law is its prohibition on arbitrariness. Arbitrariness is not only a symptom of unfair and bad governance, but is also very harmful to the economy, as it leads to uncertainty so that people and businesses cannot plan their affairs ahead of time.

The opposite of arbitrariness is reasonableness. Reasonableness consists of two elements, namely, rationality and proportionality. Proportionality means that there must not be an imbalance between the adverse consequences of a policy and the beneficial consequences.[10] Rationality means that evidence must support the policy. Stated differently, there must be a rational connection between the purpose of the policy and the solutions proposed.[11] This requires, first and foremost, that some existing problem, or "mischief" must pre-exist the policy, which it is intended to cure. Without a discernible problem to solve, the policy is not evidence-based but whimsical, and thus irrational. It has also been said that a third element, effectiveness, is a part of reasonableness.

It stands to reason that the requirement of rationality, read together with section 195(1)(g) of the Constitution, which states the principles according to which the public administration must function,

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10 Hoexter, C. *Administrative Law in South Africa*. (2012). 344.

11 Hoexter 340.

provides that transparency "must be fostered by providing the public with timely, accessible and accurate information", is that policy or legislative interventions must be supported by demonstrable evidence.

To determine whether a policy will have the consequence intended by the enacting authority, a study must be done as a matter of course, and must be publicly available to satisfy the principle of transparency. If a study is not conducted, it means the intervention is not supported by evidence, and is therefore irrational and unconstitutional, and if a study is not released to the public, government is failing to comply with section 195(1)(g), and thus, the process is unconstitutional. These studies are known as socio-economic impact assessments (SEIAs).

Without published SEIAs, government is called upon to *judge for itself* whether its *own* policies are reasonable, and such a state of affairs would make the Rule of Law a redundant concept.

The policy on page 5 states that that the existing ombuds system is not failing, but that it "could be much better". This is stated without any attempt at providing supporting evidence and without any conducted SEIA. How can the system be better? Who is to say that the policy's interventions improve, rather than harm, the system which government admits is working?

For the people to have a say in the decisions that affect their lives, they must know how the decision was arrived at, and on what basis, and their participation must be meaningful (in other words, government must engage in good faith) and not merely a façade. Without a SEIA, the public cannot participate in the policy-making and law-making process as mandated by the Constitution.

In *Principles of Good Law*, the Good Law Project writes:[12]

> "Although widely divergent, all the international assessment models amount ultimately to institutionalised procedures for determining the need for a law and its expected benefits. They are also concerned with the cost to government of implementation, as well as the capacity of government to police and enforce the law and the cost to the public of compliance. Other aspects considered are the economic and other likely impacts, the prospect of unexpected or unintended consequences; and the behaviour modifications likely to be promoted by the law and distortions that might flow from them."

It goes on to describe what a SEIA would encompass:[13]

> "2. Socio Economic Impact Assessment (SEIA). Multi-faceted analysis *and quantification* of:
>
> 2.1 The purposes of laws – precisely what "mischief" they are addressing;
>
> 2.2 Desired consequences;
>
> 2.3 Estimated secondary and unintended effects, including impacts on the economy or society in general;
>
> 2.4 Feasibility and efficacy – prospects in practice of the law being observed, and if not, enforced by officialdom, police and the courts;

12 Good Law Project 34.

13 Good Law Project 35.

2.5 Costs and benefits – accurate and comprehensive estimates of costs of administration and implementation, enforcement and policing, compliance and avoidance/evasion/resistance;

2.6 Inter-departmental considerations – the extent to which other departments are implicated;

2.7 Administration and budget – advance provision for all budgetary, staffing, training and related needs; diversion or dilution of resources and capacity."

The Department of Planning, Monitoring and Evaluations' (DPME) SEIA System (SEIAS) guidelines describe the purpose of SEIA as follows:[14]

"3. The role of SEIAS

SEIAS aims:

- To minimise unintended consequences from policy initiatives, regulations and legislation, including unnecessary costs from implementation and compliance as well as from unanticipated outcomes.
- To anticipate implementation risks and encourage measures to mitigate them."

The DPME regards a SEIA as more than a mere cost-benefit analysis. SEIAs, instead, must contribute to improving policy, rather than measuring their net value. It must, furthermore, "help decision makers to understand and balance" the impact of policy on different groups within society.[15]

That regulations or legislation can lead to unintended consequences is acknowledged by government. It may happen as a result of inefficiency, excessive compliance costs, overestimation of the benefits associated with the regulation, or an underestimation of the risks involved with following through with the regulation.[16]

The SEIA System applies to legislation and regulations, as well as policy proposals.[17]

Neither the SEIA System requirements nor the Good Law Project's guidelines have been adhered to in the policy.

If the system is working and there is no discernible mischief to cure, the policy is potentially irrational. To cure this defect, an independent SEIA should be conducted to showcase empirically the problems with the existing system and the potential consequences of adopting the policy.

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14 Department of Planning, Monitoring and Evaluation. "Socio-Economic Impact Assessment System (SEIAS): Guidelines." (2015). 4.

15 DPME 7.

16 DPME 4.

17 DPME 8.

7. Independence of voluntary ombuds[18]

On page 5 the policy questions the independence of voluntary ombuds, but the policy at no point questions the independence of statutory ombuds. The implication that "government can do no wrong" is potentially indicative of a confirmation/selection bias in the policy, further emphasising the need for an independent SEIA. This view is echoed on page 12, with the policy describing "negative sentiment toward voluntary ombuds" as being a result of their mandates emanating from the industry (which is self-interested). This, again, assumes government is not self-interested and will act impartially.

Much is made of the supposed lack of independence of the industry ombuds who is appointed and paid by the industry. Yet judges and magistrates are appointed by the state and paid out of taxes, and, in a properly functioning democracy, have the independence they need to carry out their duties impartially. Naturally, they are compelled to base their decisions on their interpretation of the law and the statutes. To the extent that statutes conflict with the fundamental tenets of just law, judges and magistrates who differ in principle with the statutes they are expected to enforce, may find that their independence is impaired. Nevertheless, judges and magistrates build their reputations on the soundness of their decisions and not on who appoints and pays them.

Industry ombuds are chosen for their reputations for integrity and independence of thought. A person of questionable character and reputation would be of no value whatsoever to the firms paying their salaries and other expenses. The industry aim is to give the customers greater confidence in the industry and, consequently, there would be no purpose in appointing someone with a visible bias towards the firm - someone who fails to base decisions on the facts. Businesses are not in the habit of wasting their money on such futile exercises. Their purpose is to enhance their reputations for fair dealing and that is what they expect the ombuds to deliver - very often at the cost of their own discomfort. In fact, if they were not on occasion compelled to rectify the errors of staff members in their dealings with customers, they would conclude that the ombuds were not doing their job.

8. Apparent need for more complaints

On page 8 the policy bemoans that the number of complaints in South Africa is low "relative to the total size of the market". There is an assumption implicit in this that South Africa has a corrupt financial services sector and that there should be more complaints. It is outside of the policy's frame of reference that things might be going well in this sector and that consumers do not have much reason to complain.

The policy attempts to link it with the concern below relating to poor credit records, but this, in itself, as will be seen, is problematic. There is no rational basis for government to presume that something must be wrong in order to justify this intervention. An independent and level-headed SEIA is required to truly analyse whether consumers really do have problems which they are refusing for some or other reason to complain about to authorities.

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[18] This section appears in substantially the same form in the FMF's submission on the "Proposal on the Future Constitution, Role and Function of Ombudsmen in the Financial Services Sector" by Eustace Davie.

9. Who is to blame for poor credit records?

On page 9 the policy complains of 9.7 million South Africans with "impaired" credit records. The policy immediately blames "poor lending and collection practices". The policy thus assumes that lenders are at fault and consumers are not reporting it. Surely, consumers, at least in part, share in the blame for having a poor credit record? If consumers realise this, as they likely do, they would not make a complaint to the authorities.

10. Ombuds as a first resort

On page 10 the policy appears to take issue with alternative dispute resolution generally. It says that cases end up at statutory ombuds "as a last resort" rather than a first. It thus problematises the fact that consumers are trying alternative modes of problem solving rather than rushing to complain to the authorities.

The worrying implication here is that government does not want consumers and financial services providers to voluntarily first attempt an amicable resolution to their dispute. Instead, government desires consumers to be confrontational and escalate every problem to statutory ombuds as soon as the problem becomes evident. This conflicts with the spirit of alternative dispute resolution and *uBuntu* – that confrontation should be avoided in favour of voluntary problem-solving discourse.

It is submitted that alternative dispute resolution should be encouraged and that ombuds – especially statutory ombuds – should properly be considered a last resort within the ADR process, before approaching the courts.

11. Inflexibility of statutory ombuds

On page 15 the policy admits that statutory ombuds are more expensive and inflexible than voluntary ombuds, which begs the question of why government appears to show a preference for statutory ombuds instead of a system of voluntary ombuds.

12. Responsibility with the Minister

On page 22, the policy implies that putting final responsibility for the statutory ombud scheme with the politically-appointed Minister is better than putting it with the non-partisan Financial Services Board.

It states paradoxically that the current system "runs the risk of undue interference from the Board" in ombud affairs, as well as the risk of "under-accountability" because the Board may not feel confident about interfering in ombud affairs. The policy, however, does not appear to consider the fact that all of this can be equally true as it relates to the Minister. Without further ado, the policy assumes these are inherent defects in the Board having final responsibility for the statutory ombud scheme, and that merely transferring such responsibility to the Minister would solve the problem.

The problem inherent in this assumption is that the Constitution provides in chapter 10 that the civil service, of which the Board is a part, is impartial and non-partisan. Ministers, on the other hand, by their nature, are partisan. The policy thus does not only ignore this constitutional principle – it turns it on its head and argues that it is the Minister who will provide fair oversight, not the civil service.

13. Bias of the models table

On page 33, the policy includes a table with considerations for which ombud model to adopt.[19]

Model 1 is a hybrid system, model 2 is a centralised system, and model 3 is an industry-driven system.

Predictably, the table shows a clear preference for the centralised system. This is suspect, as, for instance, it counts oversight by the Minister as "good" (marked as green) without further ado, yet regards the alternatives (such as the Council setting standards) as less ideal (marked as yellow), also without further ado. The policy assigns these colour-codes arbitrarily in each category, creating the impression that the table is a sham.

14. Impartiality without political interference

The tone of the policy as a whole is that government must intervene in the functioning of the ombud system to, ostensibly, make it more effective. However, on page 39, the policy states that ombuds must be independent, thus "free from the influence of" the industry as well as government and regulators. How, then, does it make sense to scrap the existing system of voluntary ombuds for a centralised system that essentially falls on the responsibility of the Minister? The policy invites political influence.

Furthermore, the policy contradicts itself in the very next paragraph and provides that ombuds must merely "be free of influence by the industry". Ombuds must thus be appointed "by Parliament, the government, … regulators, … a body of public interest members, or a body combining industry and public interest members where the former can be outvoted". This is an explicit invitation for influence and interference from government and regulators, but for the exclusion of interference by industry. Embedded in this thinking, again, is the assumption that whereas the industry is tainted and cannot act impartially, government can.

The policy thus provides lip-service to the fact that government is not perfect, yet, remarkably, goes on to recommend that government should centralise the financial sector ombud system.

15. Conclusion

The principal concern with the new financial ombud policy is that it is laden with faulty assumptions and that there is a complete lack of empirical evidence supporting these assumptions or the policy as a whole. To cure this deficiency, National Treasury should commission an empirically-based independent socio-economic impact assessment for the policy in particular, as well as the new Twin Peaks system in general.

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[19] This should not be seen as a substitute for an independent and properly-conducted SEIA, as the considerations in the table are merely rhetorical with no evidence or data backing them up.