Western Cape Government
Economic Development and Tourism

AIFMRM
AFRICAN INSTITUTE OF FINANCIAL MARKETS AND RISK MANAGEMENT

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Financial Services Sector Assessment Report 2014

Growth, Regulation, Compliance, Skills and Recruitment in South Africa

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Financial Services Sector Assessment Report

Research commissioned by the Department of Economic Development and Tourism.

Research conducted by the Department of Economic Development and Tourism and the Faculty of Commerce, University of Cape Town.

Report prepared by the Faculty of Commerce, University of Cape Town, Executive Summary prepared by Department of Economic Development and Tourism.

March 2014

FOREWORD

We are pleased to present this Financial Services Assessment Report developed by the Western Cape Government's Department of Economic Development and Tourism, and the University of Cape Town's African Institute of Financial Markets and Risk Management (AIFMRM). The assessment is the product of interviews with C-level executives, regulators, five key industry associations and surveys with Human Resources and Recruitment Managers across financial services industries in South Africa.

The objective of the report is to aggregate the perceptions and strategies of market participants with respect to the following:

- Risks to profitability and revenue growth;
- Current market opportunities in South Africa and beyond our borders;
- The impact of current and proposed changes to the regulatory environment, and the potential risks to business operations;
- Human capability needs of firms.

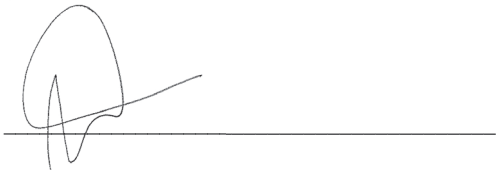
The foremost findings of the report are:

- Unsurprisingly, macroeconomic conditions, trends and indices across the sector were the most frequently cited influence on revenue and profit growth. Growth in consumer indebtedness, GDP trends, education and the impact of social instability were of particular concern.
- Companies appeared to be increasingly optimistic about emerging markets. Most companies included the rest of Africa in their growth strategies; this was most pronounced in Retail Banking.
- Participants in the assessment differed in their opinion of the appropriate level of South African financial regulation and the impact regulation has on both efficiency and profitability. Concern focused on the cost of implementing changes and complying with new legislation. However, respondents commented favorably on the nature of their relationship with the regulators and accept the need for improved regulations. This strong relationship, allied with a shared understanding of currently implemented risk models, left South Africa relatively unaffected by the 2007/2008 financial crisis.
- Firms and regulators were unanimous in their concern regarding the dearth of suitable skills in the increasingly complex and interrelated operating environment of Financial Services.
- South Africa has demonstrated world-leading capability in this sector, but should be using this strength for rapid growth and to have a greater impact on the country's economic development and employment growth.

These findings have added impetus to initiatives from the University of Cape Town such as AIFMRM. Such initiatives form part of a wider Western Cape Government and UCT strategy to support the sector's growth. AIFMRM provides flexibility in the development of course structure and content, and the delivery of financial services skills training. This will result in a secure supply of skills and a consequential improvement in the industry's competitiveness. AIFMRM will provide the institutional capacity to develop local and African financial services. It will produce market intelligence reports as well as provide new perspectives on our financial systems, highlighting the region's financial services and capabilities.

The report is being issued on the occasion of the inaugural African Financial Services Forum. The forum may prove to be an important step in spurring the industry towards higher growth and providing insight on a strategy for growth in South Africa, the rest of Africa and other emerging markets in the context of global and regulatory changes.

I would like to acknowledge the support of Professor Don Ross, the Dean of the Faculty of Commerce at the University of Cape Town; Minister Alan Winde, the Western Cape Minister of Finance, Economic Development and Tourism and Mr Solly Fourie, Head of Department of Economic Development and Tourism. Without their support, this assessment would not have been possible. Lastly, a particular word of thanks must go to Professor David Taylor, the Director of AIFMRM, and his team for their dedication, insight and leadership in the production of the report.



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1.1. Background to the assessment

The Western Cape Government – Department of Economic Development and Tourism, in collaboration with the Faculty of Commerce at the University of Cape Town (UCT) established that an assessment of the Financial Services sector in South Africa was required in order to inform their future strategy in this area.

South Africa has a highly sophisticated Financial Services sector that contributes significantly to both the economy in the Western Cape and South Africa as a whole. In fact, the World Economic Forum Global Competitiveness Report 2012–2013 ranks South Africa 3rd out of 142 countries for financial market development and 2nd for the accountability of its private institutions. Consequently, the sector has the potential for substantial development opportunities in both local (South Africa and the rest of Africa) and global markets.

A key focus area of the Department of Economic Development and Tourism is in capturing opportunities in global and middle office Financial Services Business Process Outsourcing. Growth in this area is critically dependant on the availability of skilled labour at a competitive price. In addition, there are significant concerns over the offshoring of business processes by local Financial Services companies, driven by costs and the availability of certain key skills. The Department of Economic Development and Tourism aims to effect systemic change by alleviating skills deficits in the Financial Services sector, thereby stimulating economic growth in both the Western Cape and the rest of South Africa.

The Faculty of Commerce at UCT has a responsibility to address skills deficits and examine the status of recruitment, the working environment, training and development, and tertiary education in South Africa. The Financial Services Sector is a particular focus, as this sector employs the majority of the Faculty's graduates.

A thorough assessment of the Financial Services sector is a prerequisite to achieving these aims.

1.2. Objective of the study

The key objective of the study is for the Faculty of Commerce at the University of Cape Town to initiate the development of new postgraduate programmes in response to the articulated needs of the Financial Services sector. The development of new programmes should ideally facilitate and support the following desired outcomes:

- Reduce the cost of skills development by Financial Services companies.
- Increase the availability of graduates with qualifications specifically aligned to the requirements of the Financial Services sector.
- Increase the availability of specialised Financial Services skills in the sector.
- Reduce offshoring of business functions by Financial Services companies due to the lack of available skills.
- Alleviate as far as reasonably possible issues of work preparedness and practical experience in graduates.

1.3. Scope of the assessment

The scope of this assessment is the Financial Services sector in South Africa. Research included companies in the Insurance, Banking and Asset Management sub-sectors.

The following areas were included within the sub-sectors:

- Retail Banking
- Investment Banking
- Long-term Insurance
- Short-term Insurance
- Healthcare
- Asset Management

The study subsequently incorporated the ancillary areas:

- Service Providers to the Financial Services sector
- Industry Bodies
- Regulatory Authorities

The assessment excluded the areas listed below:

- Finance and Accounting Services
- Reinsurance companies
- Financial Intermediaries, including:

1.4. Methodology

The basis of the research included interviews with Executives at Financial Services companies, Service Providers to the Financial Services sector, Industry Bodies and Regulatory Authorities. The discussions focussed on the following key topics:

- Regulation and Compliance
- Growth
  - Growth areas
  - Expansion into the rest of Africa and other Emerging Markets
  - Costs
  - Outsourcing
  - Risks to growth
- Education
  - Training and development
  - Tertiary education
- Skills deficits
- Recruitment

Recruitment and Talent Managers in Human Resources divisions of Financial Services companies completed surveys, with an emphasis on the following areas:

- Skills deficits and role shortages
- Recruitment
- Outsourcing due to a lack of available skills
- Graduate productivity
- Workplace skills needs
- Training and development
- Tertiary education
- Alignment of existing university programmes with industry needs
- Sought after university degrees and specialisations
- Development of new university programmes

The development of the following four sections used existing literature and information from official websites.

- Overview of the Financial Services sector
- Overview of each sub-sector
- Descriptions of the South African Regulators and sub-sector regulation
- Descriptions of each Industry Body

1.5. Key findings

The following key findings are discussed in detail in the main body of this report.

1.5.1. Regulation and Compliance

While acknowledging that regulatory changes enhance the stability and safety of the financial system, companies across the sector are struggling with the volume and rapid pace of regulatory changes. The chief concerns are increased costs due to compliance with changing regulation, uncertainty around the requirements for implementing new regulation and apprehensiveness that the overall impact of regulatory changes will hinder the ability of companies to conduct business.

1.5.2. Growth

While growth is largely steady, major growth possibilities in the local market are nominal, as certain areas of the market are close to saturation point, especially in the middle-income segment in both Retail Banking and Long-term Insurance. Many companies do not anticipate that increased market penetration in the low-income segment will generate significant profits. Companies compete for existing business through product innovation and enhancing their client value propositions.

Real opportunities exist for South Africa to become an offshoring location for financial services multi-nationals. Although South Africa is not as cheap as other locations, the available pool of experienced financial services expertise makes it attractive as a destination for offshoring more sophisticated functions.

1.5.3. Expansion into the rest of Africa and other Emerging Markets

The majority of the growth strategies of Financial Services companies concentrate on expansion into the rest of Africa and, in some cases, other Emerging Markets. Generally, South African companies favour collaborative arrangements where they develop partnerships with existing companies in-country, as this reduces barriers to establishing operations and the associated risks. Commonly cited challenges to setting up business in the rest of Africa include:

- Different regulatory environments per country
- Different requirements from local authorities
- Potential political instability
- Length of time taken to realise profits
- Business models and products needing to be tailored to each unique environment

Despite the obstacles mentioned, most companies are optimistic that there are genuine opportunities for growth in the rest of Africa.

1.5.4. Costs

Staff and Information Technology are the largest overheads of Financial Services companies. Traditionally, the majority of organisations build and maintain systems internally and the debate around the high costs versus the competitive advantage of in-house systems development is ongoing. The increase in financial regulation has also had the effect of driving up costs, as specialist staff and systems enhancements are required to meet regulatory reporting requirements.

Efficiency and profitability are key drivers for companies, with a specific focus on systems and product innovation, streamlining of business processes and the retention of existing business.

1.5.5. Outsourcing

The majority of companies across the Financial Services sector stated that they outsource functions only where the skills are not available in the marketplace. (Please refer to 2.3, Outsourcing due to lack of available skills, for further details.)

1.5.6. Risks to growth

Although the perceived risks to growth were sometimes sub-sector specific, companies across the Financial Services sector mentioned the following threats to growth:

- Lack of business and consumer confidence since the Financial Crisis
- Increased regulation and reporting requirements
- Consumer over-indebtedness
- Credit exposure and the risk of increasing interest rates
- Increased competition from the Government and non-Financial Services companies providing Financial Services products

1.5.7. Skills deficits, recruitment, the working environment, training and development, and tertiary education

Please refer to section 2 below for the Consolidated section on skills deficits, recruitment, the working environment, training and development, and tertiary education.

2. Consolidated section on skills deficits, recruitment, the working environment, training and development, and tertiary education

This section of the report consolidates the comments of interview participants and survey respondents on issues related to skills deficits, role shortages, recruitment (including outsourcing due to a lack of available skills), the working environment, training and development, and tertiary education across the Financial Services sector.

2.1. Skills deficits

2.1.1. Holistic skills

A key trend that emerged during the Financial Services sector assessment ("the Assessment") is that companies increasingly require individuals with a holistic range of skills. It is imperative that employees have the capacity to thrive in a process-driven environment built on collaboration. A good education and technical skills form an essential foundation, but employees in middle and senior management positions and specialist roles require a wide-ranging set of competencies acquired chiefly through experience.

Key differentiating capacities include strategic and governance thinking skills, creativity and an innovative mind-set. Furthermore, the ability to interact effectively with stakeholders, to co-operate effectively in a team and to influence others without using authority is imperative. Individuals also need to be adept at making sound judgements that take into account individual needs and behavioural factors, while balancing the requirements of business and the demands of the greater environment.

2.1.2. Financial Services experience and sub-sector knowledge

Financial Services experience is a foundational requirement across the sector, with specific product knowledge within the relevant sub-sector – Retail Banking, Investment Banking, Long-term Insurance, Short-term Insurance and Asset Management. This includes a holistic understanding of processes, procedures and the interconnectedness of the different business areas in the relevant type of company. These underlying skills form an essential basis for the majority of roles within Financial Services companies.

An increasingly saturated Financial Services market means that companies have to find new ways to differentiate themselves to remain profitable. Streamlining of processes, product innovation, systems automation, increased customer expectations and changing regulatory requirements have resulted in the development of progressively more integrated business functions. In such a situation, it is no longer possible for employees to operate productively in relative isolation with no clear comprehension of the larger business environment.

In addition to holistic skills and Financial Services experience, our assessment consistently highlighted the following skills and roles as critical across the Financial Services sector.

2.1.3. Information Technology skills

There is a massive deficiency of Information Technology skills in the South African economy as a whole. The following roles are vital for Financial Services companies:

- Analyst Developers
- COBOL Developers
- Information Architects
- JAVA Developers
- .NET Developers
- IT Project Managers
- SAP Developers
- Software Developers
- Systems Architects
- Systems Analysts
- Systems Developers

Hybrid roles, particularly Business Architects and Business Analysts, which translate business needs into optimal Information Technology solutions, have become crucial for businesses to function effectively. There is also a growth in the need for Digital Managers.

The demand for Project Management expertise is intensifying not only in a traditional Project Management role, but also as a foundation skill in many specialist roles.

A significant number of companies mentioned that Information Technology staff have a narrow knowledge of programming languages and systems. Financial Services systems are increasing in sophistication as products and regulatory reporting requirements become more complicated. Companies highlighted an underlying knowledge of how investments are structured, regulation, business processes and products as key areas where Information Technology staff need to gain expertise. Background knowledge is crucial in order to develop complex systems that effectively meet the shifting needs of the business.

2.1.4. Specialist Quantitative, Mathematical and Investment skills

The demand for specialist Mathematical, Quantitative and Investment expertise far exceeds the supply. These skills are indispensable specifically in Investment Banking and Asset Management, but are also required in other sub-sectors. Organisations across the Financial Services sector compete fiercely to attract candidates. Critical roles include:

- Credit Risk Specialists
- Equity Analysts
- Fund Managers
- Investment Analysts
- Investment Bankers
- Investment Business Development Managers
- Investment Managers
- Market Risk Specialists
- Mergers and Acquisitions Specialists
- Portfolio Managers
- Quantitative Analysts

- Research Analysts
- Risk Analysts

2.1.5. Statisticians and data analysis skills

A major future development area for the Financial Services sector is Data Analytics. Companies have vast quantities of consumer data at their disposal – the ability to identify trends and develop innovative solutions from the analysis of big data will become a vital competitive advantage.

Currently this is a massively underexplored area, chiefly due to the dearth of Statisticians in South Africa, as statistically inclined individuals tend to become Actuaries.

2.1.6. Actuarial skills

Actuaries are in high demand; the supply of Actuaries has increased, but still does not meet the growing need. Specific mention was made of the following:

- Qualified and Student Actuaries
- Reinsurance Actuaries
- Short-term Insurance Actuaries
- Specialist Actuaries required for the implementation of financial regulation

There is a dire need for registered Short-term Insurance Actuaries. The sub-sector previously did not require Statutory Actuaries specifically qualified in Short-term Insurance; this has changed due to the imminent implementation of Solvency II regulation.

2.1.7. Underwriting skills

There is an on-going shortage of Underwriters across the Insurance sub-sector. Underwriting skills improve over time and there is a substantial scarcity of Senior Underwriters with 10 to 15 years of experience.

2.1.8. Sales and Distribution skills

Large numbers of Intermediaries are required on an on-going basis in the Insurance sub-sector, and to a lesser extent in the Banking sub-sector. There is generally a high turnover of staff in Sales and Distribution; Financial Advisers earn commission and it is challenging to be consistently successful in the sales environment, particularly in a sluggish economy. Role shortages include:

- Financial Advisors including Agents, Brokers and Independent Financial Advisors
- Heads of Distribution Channels
- Sales Managers
- Broker Consultants

2.1.9. Regulation and Compliance skills

Escalating levels of financial regulation have resulted in a severe scarcity of specialist expertise in Regulation and Compliance. Although each organisation typically requires four or five staff in these positions, the function is crucial.

Companies across the Financial Services sector find it extremely difficult to find suitably qualified candidates, as staff in these roles require a specific combination of skills and experience. The required expertise includes the ability to assess legislation and make appropriate recommendations while taking into account all aspects – regulation, compliance requirements, business operations and strategic goals. It is also essential that staff have strong stakeholder management and analytical thinking skills, as well as a solid understanding of the Financial Services environment and a holistic view of the business.

A certain foundational level regulatory knowledge is required to a greater or lesser extent across all business areas and is not just restricted to specialist Regulation and Compliance roles.

2.1.10. General skills shortages

Survey respondents and interview participants listed further skills and role shortages as follows:

- Accounting Experts at all levels
- Branch Managers
- Business Bankers
- Chartered Accountants
- Claims Assessors
- Claims Specialists
- Customer Relationship Managers
- Engineers
- Human Resources Specialists
- Legal Experts
- Middle and Senior Management
- Recruitment Managers
- Risk Surveyors
- Risk Assessors
- Statisticians
- Strategists
- Taxation Specialists

2.1.11. School education as a cause of skills deficits

It is the view of Financial Services companies and Industry Bodies that the poor standard of school education is a key underlying cause of skills shortages and development problems in South Africa and that it is ultimately the responsibility of the government to address this issue.

In particular, the quality of Mathematics taught at schools is substandard. Mathematics is a requirement to enter a large number of university programmes and a high percentage of school leavers do not have the requisite Mathematics marks to gain entrance to sought-after degrees. In addition, Mathematical skills are a basic requirement of the majority of roles in Financial Services companies – low Matric marks in this area exclude many school leavers from opportunities in the Financial Services sector.

2.2. Recruitment

Financial Services companies consistently cited the following key employment issues.

2.2.1. Employment equity

In general, organisations find it challenging to find suitably qualified and experienced candidates to fill employment equity positions; companies highlighted the following issues.

- There are almost no black Actuaries.
- Certain business areas are male-dominated and gender equality is difficult to implement, for example, in Information Technology.
- Companies find it challenging to retain black professionals – black employees tend to move companies frequently due to the high demand for qualified Employment Equity candidates.

- Junior Management transformation has generally been successful, and companies are struggling to find a way of implementing transformation in Senior Management.
- There is a general lack of available black candidates in certain business areas, specifically Risk Management, Investment Management, Governance, and Regulation and Compliance.

2.2.2. Information Technology roles

Information Technology staff are particularly difficult to attract and retain. Financial Services companies have core systems that use specific programming languages; this limits the range of experience that their staff in Information Technology areas can achieve. Information Technology is a rapidly changing environment and skills quickly become outdated – staff leave companies in order to gain wider technical experience and exposure to evolving developments in the larger field.

Information Technology skills are in such short supply in South Africa that individuals have a varied scope of employment choices and Financial Services is not the most attractive option available. Competition for Information Technology skills across all sectors of the broader economy often results in overpayment for these skills in relation to the level of expertise. This has led to outsourcing in the area of Information Technology (Please refer to 2.3. Outsourcing due to lack of available skills, for further details.)

2.2.3. Regulation and Compliance roles

Regulatory and Compliance roles are exceptionally challenging to fill; there is a general lack of applicants for these positions due to the complex set of skills requirements. The dearth of staff with specialist expertise in financial regulation has resulted in highly inflated salaries.

Companies find it problematic to benchmark the appropriate salaries for Regulation and Compliance roles; the scarcity and high level of accountability attached to this critical business function has escalated remuneration close to executive levels.

2.2.4. Recruitment difficulties

Survey respondents and interview participants listed further recruitment difficulties as follows:

Lengthy and rigorous recruitment processes result in the loss of candidates. Applicants either accept another offer of employment in the interim, fail to meet the mandatory screening requirements or perform poorly during pre-employment psychometric testing. In addition, many applicants lack suitable interview skills.

Companies do not perceive Matric results as a reliable indicator of ability when employing school leavers and conduct psychometric assessments as a further measure of the potential of a candidate (Please refer to 2.1.11. School education as a cause of skills deficits, for further details.)

Companies outside of Gauteng find it difficult to attract top candidates as there are greater career opportunities and more lucrative remuneration packages on offer at Financial Services companies located in Gauteng.

The Investment Banking and Asset Management sub-sectors are more attractive to specialist Risk Management and Investment Management candidates as these companies are willing to pay substantially higher remuneration packages for such key roles.

Most companies stated that it takes a long time to source suitable staff for roles where skills are scarce, sometimes up to one year. There is also a general shortage of skilled and experienced candidates across the Financial Services sector. Companies are competing for experienced staff from a pool of resources where demand generally exceeds supply. The result is an inescapable increase in the cost of skills.

The table below details survey responses to a specified set of recruitment difficulties.

Table 1: Recruitment difficulties

Recruitment difficulty	Sometimes	Often	Very frequently	N/A
Lack of applicants with the required skills	16.67%	38.89%	44.44%	-
Lack of applicants with the required tertiary qualifications	52.63%	31.58%	15.79%	-
Have had to employ staff that don't meet all the job requirements	57.89%	15.79%	10.53%	15.79%
General lack of applicants	61.11%	22.22%	5.56%	11.11%
Lack of Employment Equity applicants	11.11%	55.56%	27.78%	5.55%
Long periods of time taken to fill vacancies (6 months to 1 year)	66.67%	22.22%	11.11%	-
Increased outsourcing due to difficulties in finding skilled and experienced applicants	44.44%	27.78%	5.56%	22.22%
Unable to offer competitive salary packages	38.89%	16.67%	11.11%	33.33%
Difficulty attracting applicants due to competition from other areas of the Financial Services sector	38.89%	38.89%	5.55%	16.67%

2.3. Outsourcing due to a lack of available skills

52.63% of survey respondents stated that their organisation had outsourced some business functions, while 47.37% stated that they had not.

2.3.1. Type of outsourcing

The table below details survey responses to specified types of outsourcing that companies may engage in.

Table 2: Types of outsourcing

Type of outsourcing	Percentage
Outsourcing to providers in South Africa	88.89%
Outsourcing to providers in a foreign location	11.11%
Offshoring (moving a business function to a foreign location)	-

2.3.2. Reasons for outsourcing

The table below details survey responses to specified possible reasons for outsourcing business functions.

Table 3: Reasons for outsourcing

Reasons for outsourcing	Percentage
Lack of available skills	63.64%
Skills are too expensive to employ permanently	9.09%
Outsourcing is more cost effective	27.27%
Outsourced functions are not core business	36.36%
Outsourced functions are only required periodically	27.27%

The majority of companies across the Financial Services sector actively avoid outsourcing as a business practice. Companies feel a strong sense responsibility towards contributing to economic development and job creation in South Africa and often choose not to outsource despite the potential cost saving. Consequently, even when functions are outsourced, companies attempt wherever possible to ensure that the Service Provider is a South African company or a multinational that has operations within South Africa. Some companies observed that outsourcing often has hidden costs that only become apparent after a time, resulting in less cost saving than initially anticipated.

It is commonplace for companies to outsource some aspects of recruitment functions, typically advertising vacancies and the initial screening of applicants – this applies to most large companies in South Africa, not only in the Financial Services sector. Overwhelmingly, outsourcing in the Financial Services sector is in the area of Information Technology due to the chronic shortage of Information Technology expertise in South Africa.

Most companies are reluctant to fully outsource Information Technology functions due to concerns about not being able to access, or be in full control of, company data. Companies often only outsource a portion of systems development or the implementation aspect of a new system and ensure that existing Information Technology staff receive training in the process. This enables companies to upgrade skills and systems while retaining the core Information Technology function in the longer term.

Call Centre outsourcing only occurred in the Short-term Insurance sub-sector. Other sub-sectors specifically mention Call Centre's as a business function that they are not prepared to consider outsourcing. Companies that have attempted to outsource Call Centres to foreign locations have experienced strong resistance from customers when having to deal with non-South African Call Centre Agents.

2.4. The working environment

2.4.1. Graduate productivity

The table below details survey responses to a specified set of possible reasons for the commonly stated complaint that graduates take 6 months or longer to become usefully productive in the working environment.

Table 4: Reasons for lack of graduate productivity

Reasons for lack of initial graduate productivity	Percentage
Lack of work experience	37.50%
Lack of organisational knowledge	93.75%
Lack of technical skills	18.75%
Lack of general workplace and soft skills	50%
Lack of product knowledge	62.50%

2.4.2. Workplace skills needs

Over and above an expected lack of experience in new graduates and the normal adjustment period to any new job, companies consistently mentioned workplace skills as a problematic area when employing graduates. Companies stated that graduates need to be cognisant of the fact that a university degree is an entry into an organisation – the real value of an employee lies in overall work performance.

The general lack of workplace skills substantially extends the length of time it takes for new graduates to adapt to the working environment and become usefully productive. Companies mentioned that this period varies from 6 months to as much as 18 months in extreme cases.

While experience is the only way to acquire certain knowledge and skills, companies feel that universities could contribute positively to assisting with the transition of graduates into the workplace. They suggested that certain elements of workplace skills training be included in the curriculum of all final year undergraduate and postgraduate programmes. A number of companies expressed willingness to collaborate with universities on workplace skills development.

Both interview participants and survey respondents mentioned that the following attributes are lacking in most graduates:

- Ability to adapt to the organisational culture and formal structures within the business
- Ability to handle criticism
- Ability to meet deadlines
- Ability to work in a team
- Ability to work under pressure
- Analytical skills
- Business acumen
- Business etiquette
- Business language and communication skills, especially business writing skills
- Commitment
- Computer literacy and knowledge of commonly used software – Word, Excel, PowerPoint etc. (this is not as prevalent as it was in the past)
- Confidence and assertiveness
- Emotional intelligence
- General life skills – managing finances, budgeting etc.
- Numerical and foundational Mathematical skills
- Personal career management and self-development
- Planning, prioritisation and organisational skills
- Practical application of theoretical knowledge
- Presentation and facilitation skills
- Problem solving skills
- Relationship building and networking skills
- Realistic expectations of career advancement
- Respect
- Self-management
- Sharing ideas in a structured manner
- Taking initiative, being proactive and asking questions when uncertain
- Time management
- Verbal communication skills
- Work ethic

2.5. Training and development

2.5.1.Development Programmes

All companies run a compulsory Induction Programme for all new employees to impart an understanding of the organisational culture, the structure of the business, Human Resources processes, staff benefits, etc. In addition, a certain amount of on-the job training is commonly required for new staff (with or without prior working experience) to learn organisation and role specific processes and procedures; supervision normally reduces over a period, usually around 3 months. New graduates take much longer than experienced staff to become productive (Please refer to 2.4. The working environment, for further details.)

The majority of companies interviewed run a Graduate Development Programme and offer one or more other internal development programmes in the areas listed below:

- Actuarial Development Programme
- Branch Manager Development Programme

- Branch Staff Development Programme
- Bursary Programme
- Chartered Accountant Development Programme
- Internship Programme
- Leadership Development Programme
- Learnership Programme
- Management Development Programme
- Mentorship Programme
- Training Outside Public Practice (TOPP) Programme

2.5.2. Training

Companies generally host development programmes internally and use external training providers as specific needs arise. The financial outlay on skills development is substantial and internally run programmes are particularly costly - this contributes to the preference for external training wherever possible. Organisations run programmes internally when the volume of staff requiring training justifies the expense, when there is an on-going training need or for a specific competency requirement that is unique to the company.

Insurance companies run extensive Financial Advisor training programmes. Intermediaries have a high attrition rate and as a result, companies constantly employ new Financial Advisors. In addition to the initial Financial Advisor training, further training requirements periodically arise due to new products being launched, changes to existing products, regulatory and compliance requirements, changes to systems and adjustments to sales related procedures.

Overall, companies perceive the investment in staff training and development as key to organisational growth strategies and the expansion of the available pool of experienced Financial Services employees; this ultimately benefits the entire sector.

2.6. Tertiary education

2.6.1. Alignment of existing university programmes with industry needs

Almost half of the survey respondents and interview participants mentioned that there could be an improvement in the alignment of university programmes with the needs of the Financial Services sector.

South African undergraduate degrees are generally criticised as overly directed towards specific professions. Postgraduate studies create further restrictions as they generally allow only a specialist continuation of a subject area studied at undergraduate level. The consequence is graduates with specific degrees tend to think uniformly and are unable to contribute effectively to the rapidly evolving business environment.

In contrast, the university system in the United Kingdom and the United States facilitates the study of a broad range of subjects at undergraduate level and allows specialisation in unrelated subject areas during postgraduate studies. Graduates with wide-ranging knowledge have a comprehensive range of thinking skills and the resultant ability to contribute creatively to solving business problems. A number of companies stated that they deliberately seek out graduates from non-Commerce disciplines as these staff have diverse thinking skills – it is easier to teach someone about Financial Services than it is to teach them how to think strategically and creatively.

Although undergraduate degrees provide a good foundation, students should be strongly encouraged to complete postgraduate qualifications. Most companies commented that undergraduate degrees impart sound technical knowledge, but do not provide students with enough exposure to practical problems. Graduates often struggle to translate theoretical knowledge into practical application in a business situation. A number of companies also raised the issue that most Information Technology degrees do not teach students programming or software development skills.

Many companies suggested that graduates seek out Internships and vacation work during their studies as a means of gaining practical exposure and work experience prior to formally entering the working environment.

2.6.2. Sought after university degrees and specialisations

Graduates with the following degrees, qualifications or specialisations are highly sought after across the Financial Services sector:

- Accounting
- Actuarial Science
- Bachelor of Commerce
- Bachelor of Business Science
- Chartered Financial Analyst (CFA)
- Computer Engineering
- Computer Science
- Engineering
- Financial Management and Financial Analysis
- Information Systems
- Investment Management
- Masters of Business Administration (MBA)
- Mathematics and Applied Mathematics
- Mathematical Finance
- Politics, Philosophy and Economics (PPE)
- Portfolio Management
- Quantitative Finance
- Quantitative Management
- Statistics

2.6.3. Development of new university programmes

New university programmes are required in the following essential areas:

Financial Services

Postgraduate programmes specifically related to Financial Services with electives in sub-sector specialisations:

- Long-term Insurance
- Short-term Insurance
- Healthcare
- Retail Banking
- Investment Banking
- Asset Management

Risk Management

Current Bachelor of Commerce degrees provide a solid foundation of essential skills, but do not prepare candidates adequately for the specialist requirements of Risk Management roles. A postgraduate qualification is required that specifically focuses on Risk Management as an area of specialisation.

Financial Regulation

Significant changes to the regulatory framework of the Financial Services sector has created the need for a postgraduate programme explicitly focused on Financial Regulation. Legal degrees do not adequately prepare candidates for the specialist expertise required in Regulation and Compliance roles. Companies cited Politics, Philosophy and Economics (PPE) graduates as having the closest match of skills required to solve complex regulatory problems. (Please refer to 2.1.9. Regulation and Compliance skills, for further details.) Over and above these skills, there is also a need for specialist knowledge of financial regulation.

A postgraduate qualification in Financial Regulation needs to include all aspects of Market Conduct and Prudential regulation affecting the Financial Service sector – Basel III, Solvency II, Treating Customers Fairly, etc. It is essential that such a programme also take into account the specific context of the Financial Services sector and the economic environment in South Africa.

2.6.4. Industry qualifications

Financial Services sector training bodies include, but are not limited to, INSETA, BANKSETA and ASISA Academy. Training bodies collaborate extensively with Financial Services sector companies and universities on the development of programmes to address specific skills needs. Training bodies are currently collaborating with universities to professionalise and accredit existing industry education programmes.

3. Overview of the Financial Services sector

3.1. The importance of Financial Services to the South African Economy

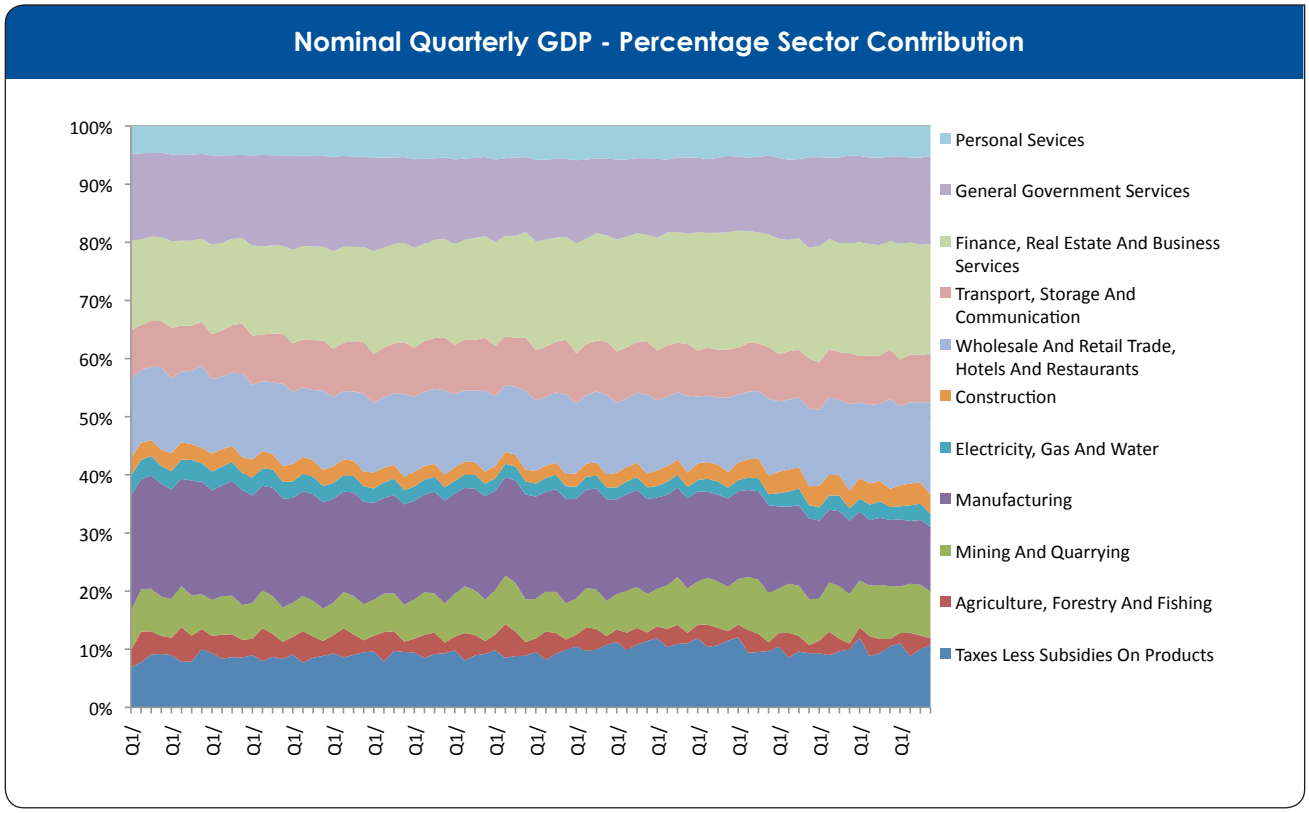
The Financial Services sector consists of all entities that manage money in some way or form. Generally, it consists of the following institutions: Banks, Insurers, Asset Managers, Stock Brokerages, Credit Unions, Micro-financiers and any other private or public sector companies capable of extending credit or other financing activities. Financial Services refers to the economic activities undertaken by such entities, which fundamentally encompass the access to funding/finance or the creation of wealth for consumption purposes or further economic productivity. Less formally, Banking, Savings, Investment, Insurance and Financing assist individuals to consume, save, mitigate risk and accumulate credit, while enabling companies to start up, expand and improve competitiveness both locally and internationally. Financial Services are therefore fundamental to economic development and growth.

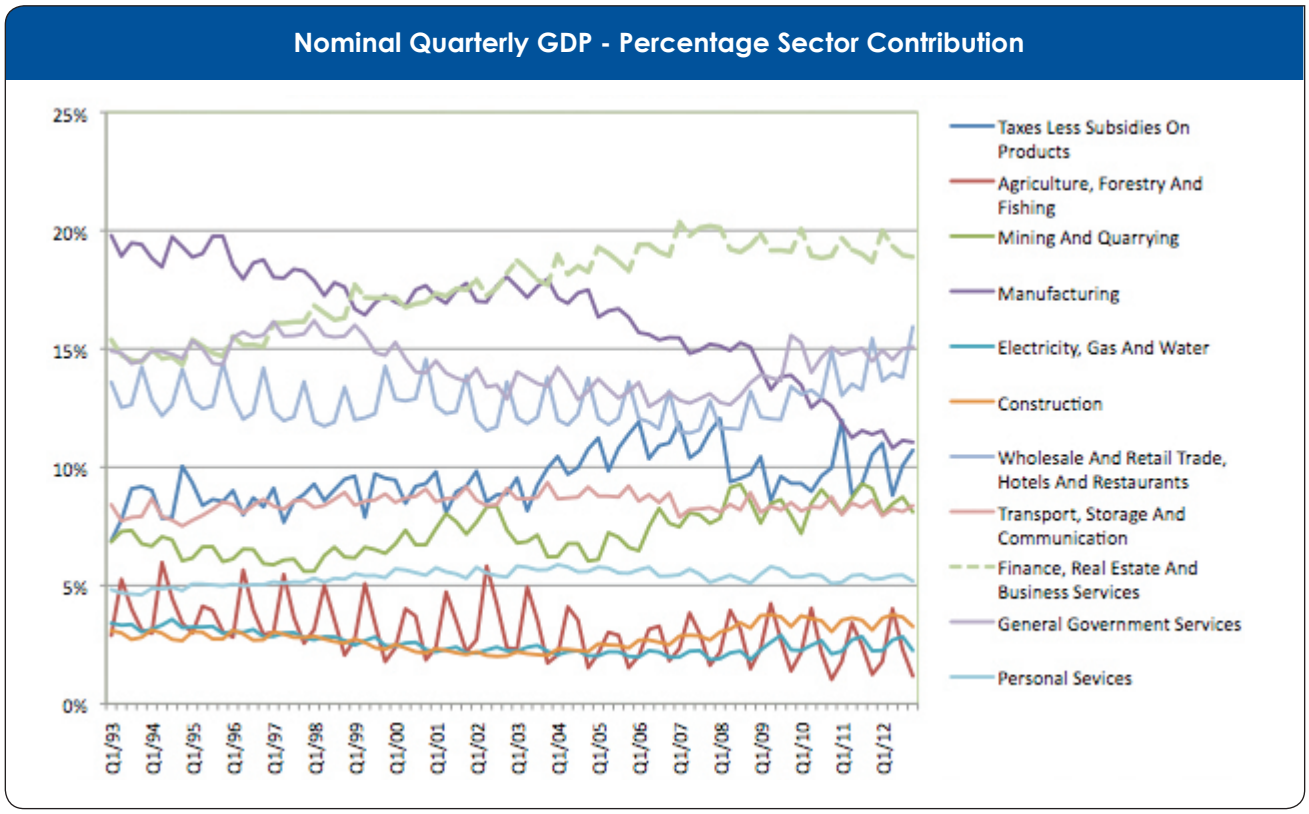
Financial Services are critical to economic activity in the modern economy. It plays a crucial role in intermediating between borrowers and lenders by pricing and facilitating intermediation, in so doing it incentivises savings, which in aggregate facilitates the formation of fixed capital. The growth of fixed capital is critical in driving economic competitiveness and efficiency. Financial Services is key in facilitating globalisation by mediating between the selling and purchasing of risk inherent in both the movement and production of goods. It functions as safekeeping of transactional currency while facilitating cost effective, convenient and safe means for the purchase of goods, services and transfer of funds. Lastly, modern Financial Services play a unique economic role in the Private sector due to the ability to create money through the money multiplier. While Financial Services role in the creation of money through fractional Banking and other Financial Services innovation contributed significantly to the rate of economic growth, it has also been principal in launching economic crises.

The Financial Services sector ranks highly amongst the largest in the world in terms of earnings, with the larger companies having the necessary reputation, expertise and geographic reach to make a significant direct impact on the economies and markets in which they operate. In fact, most institutions are formulating increasingly deliberate and focused strategies that focus on serving poor individuals and small- to medium-sized enterprises, which should have a direct impact on economic opportunity and growth. Furthermore, the sector naturally supports initiatives to build human and institutional capacity, while its overall influence in economies also has a direct impact in shaping and directing policy frameworks.

In 1960, the Finance, Real Estate and Business Services sector contributed 10% to total nominal South African Gross Domestic Product (GDP), while in 2012, the same sector contributed 21.1% to total nominal South African GDP (according to Statistics South Africa). Further, if one looks at the contribution of the same sector to total nominal GDP on a quarterly basis from 1993 up until 2012, one will notice that the contribution of this sector has grown steadily from 15.4% in Q1/93 to 18.9% in Q4/12 (according to Statistics South Africa) – please refer to Figure 1 below. From the sector-based contribution to GDP data, it is rather apparent that the Financial Services sector forms a significant part of the South African economy. In fact, based on this data, the Financial Services sector has been the largest contributor to nominal GDP since the first quarter of 2002.

Figure 1: Percentage sector contribution to total nominal quarterly South African GDP from 1993 to 2012
(Source: Statistics South Africa)





The previously stated statistic may be difficult to comprehend, considering the Financial Crises that have plagued the global economy since 2008, and the associated adverse impact on global economic growth. Nonetheless, the continued growth of the South African Financial Services sector is testament to the prudent nature of the industry and the robust regulatory framework in the country. According to the World Economic Forum's Global Competitiveness

Report, which assesses the competitiveness landscape of 144 economies, South Africa ranked 3rd (out of 144) in the category of "Financial Market Development" and as follows on various categories of thereof:

- Availability of Financial Services – 2nd out of 144;
- Affordability of Financial Services – 22nd out of 144;
- Financing through Local Equity Market – 3rd out of 144;
- Ease of Access to Loans – 30th out of 144;
- Venture Capital Availability – 37th out of 144;
- Soundness of Banks – 2nd out of 144;
- Regulation of Securities Exchanges 1st out of 144;
- Legal Rights Index – 1st out of 144.

Therefore, South Africa has a sophisticated Financial Services sector by international standards. The outcome of the World Economic Forum's Global Competitiveness Report has revealed that experts and practitioners rank South Africa's Financial Services sector very highly and significantly above its average performance in other economic pillars. This further attests to the strength of the South African Financial Services sector and its importance to growth in the economy.

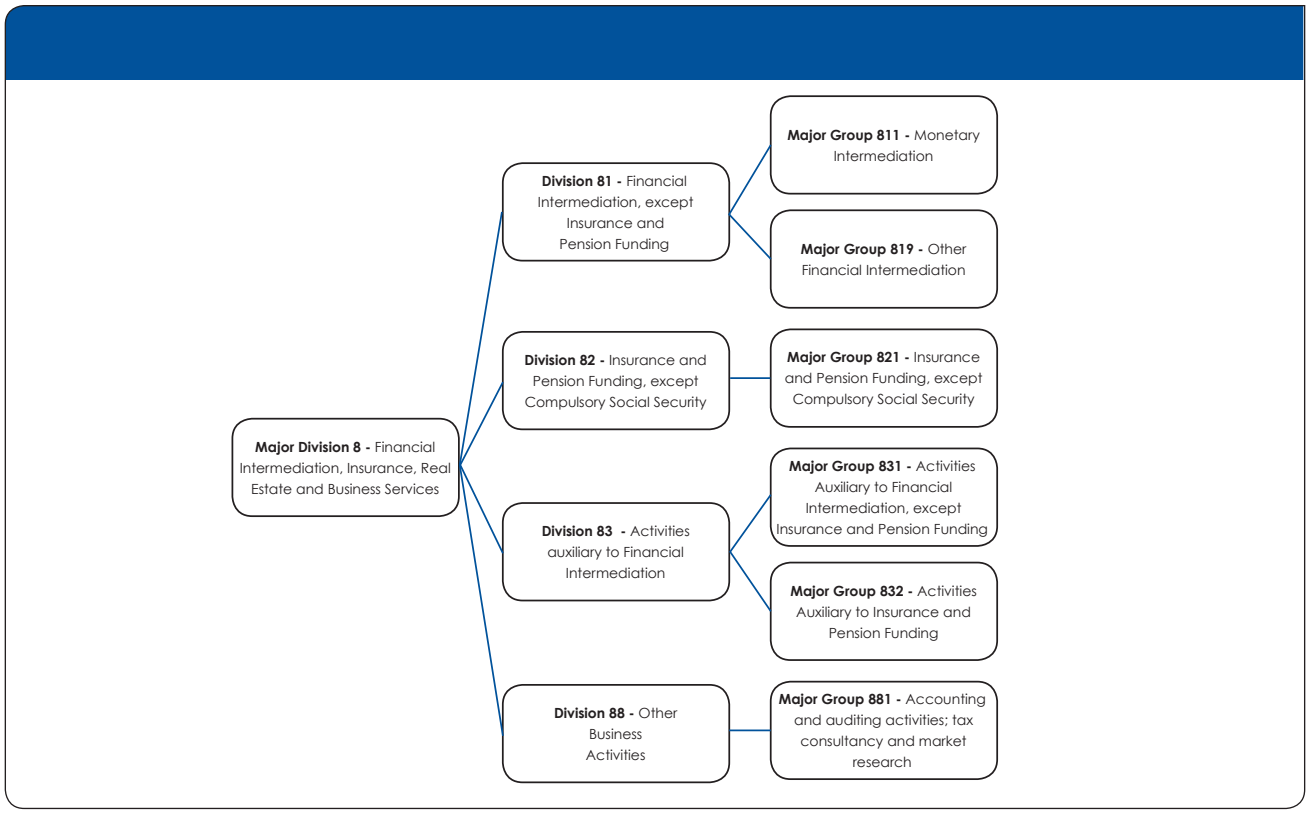
3.2. Description of the Financial Services sector

The Financial Services sector encompasses a broad range of economic activities. Functionally, the Financial Services sector may be categorised into three primary subsectors, which are the key focus of this report, with these being:

- Banking and Credit Services (Banks, Mutual Banks, Credit Unions, Microfinance institutions, etc.);
- Insurance (Long-term and Short-term Insurers covering a variety of perils); and
- Investment and Related Services (Exchanges, Security Broking companies, Asset Managers, etc.).

More formally, one can describe the Financial Services sector's economic activities via the South African Standard Industrial Classifications of all Economic Activities (SIC). The hierarchical diagram in Figure 2 below summarises the economic activities of the Financial Services sector in accordance with the SIC codes (South Africa SIC, 2005).

Figure 2: Overview of the South African Financial Services sector according to the SIC classification



The table below provides a brief description of each of the divisions and major groups that constitute the SIC classification of the Financial Services sector. (South African SIC, 2005)

Table 5: Description of divisions and major groupings of the South African Financial Services sector according to the SIC classification *(Source: South African SIC 2005)*

SIC Code	Description
Division 81	This division includes the activity of obtaining and redistributing funds, other than for the purpose of Insurance and Pension funding.
Major Group 811	This group includes the obtaining of funds in the form of deposits. Deposits are defined as funds which are fixed in money terms, obtained on a day-to-day basis and which are, apart from Central Banking, obtained from non-financial sources.
Major Group 819	This major group includes Financial Intermediation other than that conducted by monetary institutions.
Division 82	Only contains Major Group 821. This group includes Long-term and Short-term risk spreading with or without a savings element.
Division 83	This division includes the provision of services involved in or closely related to Financial Intermediation, but not involved in Financial Intermediation themselves.
Major Group 831	This major group includes activities involved in or closely related to Financial Intermediation, other than Insurance and Pension funding, but not involved in Financial Intermediation themselves.
Major Group 832	This group includes activities involved in or closely related to the management of Insurance and Pension funding, other than Financial Intermediation. It includes the activities of Insurance Agents, Average and Loss Adjusters, Actuaries and Salvage Administration.
Division 88	This division includes other business activities, viz. Legal, Accounting, Bookkeeping and Auditing activities; Tax Consultancy, Market Research and Public Opinion Research; Business and Management Consultancy; Architectural and Engineering activities and related Technical Consultancy; Advertising and a variety of other support services.
Major Group 881	Group 8812 is the most relevant which involves the recording of commercial transactions for businesses or others, the preparation of financial accounts, the examination of these accounts and the certification of their accuracy and the preparation of personal and business income tax returns. Included are related advisory activities and representation (other than legal representation) on behalf of clients before tax authorities.

The National Treasury's 2011 proposal on Financial Sector reforms, in order to create a safer South African Financial Services sector, provided the following snapshot of the sector - this delivers a quantitative description of the sector relative to the economy as a whole.

Table 6: Size of Financial Services sector relative to the South African economy (Source: National Treasury *(2011), SARB, Stats SA, SARS)*

	June 2000	June 2010	Relative to Economy June 2010
Size	**R 69 bln**	**R 204 bln**	**11% of GDP**
Assets	**R1,890 bln**	**R6,040 bln**	**252% of GDP**
Banks	R 730 bln	R3,040 bln	127% of GDP
Long-term Insurers	R 630 bln	R1,440 bln	60% of GDP
Short-term Insurers	R 50 bln	R 90 bln	4% of GDP
Pension Funds	R 470 bln	R1,480 bln	62% of GDP
Employment	**286,000**	**356,353**	**3.9% of Formal Employment**
Tax	**n/a**	**R 21 bln**	**15.3% of Corporate Taxes**

Notes:

- **Size** – Gross value added in nominal rand of the Financial Intermediation and Insurance component of the Finance, Real Estate and Business Services sector.
- **Long-term Insurers** – The Long-term Insurer assets figure includes assets of Pension funds managed by an Insurance company.
- **Employment** – Financial Intermediation, Insurance, Pension funding and auxiliary services.
- **Tax** – Estimate as detailed disaggregated data is not available. The total Financial Services, Business Services and Real Estate sector contribute R39.6 bln or 29% of Corporate Tax (this excludes VAT and other taxes).

The following section provides an overview of the three primary segments of the South African Financial Services sector by analysing certain financial aspects and relating these to current and emerging trends and issues that influence the financial environment.

3.2.1. Description of the Banking sub-sector

Four major diversified Financial Services companies, viz. ABSA, FirstRand, Nedbank and Standard Bank, dominate the Banking sub-sector. As such, one may glean a profound macro understanding of the sub-sector by analysing the financial aspects of these four companies. Key financial statistics for the past couple of years aggregated across the aforementioned major Banks follow below. *(Source: PWC (2012a, 2013)*

- Headline earnings increased by 8.9% in 2012 versus an increase of 17.7% in 2011;
- Average return on equity amounted to 15.8% in 2012 versus 16.0% in 2011;
- Bad debt expenses increased by 36% in 2012 versus a decrease of 14.8% in 2011;
- Total operating income increased by 12.4% in 2012 versus an increase of 5.1% in 2011; and
- Total operating expenses increased by 11.1% in 2012 versus an increase of 2.6% in 2011.

The following observations are noteworthy about the financial performance of the Banking sub-sector over the past five financial years:

- **Headwinds of Change** – Recent Financial Results of the major Banks reflect the challenges facing the industry, with reduced profitability and heightened expenditure emerging as common themes. Nonetheless, results amongst major Banks have also diverged somewhat, as each faces a unique set of challenges in accordance with their chosen strategies.
- **Economic Scenario** – Global economic concerns (the US fiscal cliff crisis, a potential division of the Euro zone and the slowdown in the Chinese economy) have gradually faded. On the other hand, renewed domestic concerns (labour market unrest, unemployment, a widening current account deficit, increasing national debt, the potential end of the commodity boom and prospects for the mining sector) have gained traction in recent times culminating in an unexpected interest rate cut in July 2012, and the downgrade of South Africa's sovereign debt in September 2012. Despite these challenges, growth prospects for the BRICS countries (which account for 20% of global output) remain bullish. Therefore, the economic environment for Banks has proved to be challenging and suggests modest growth for the short- to medium-term.

- **Capital Adequacy Ratios** – Given the current and pending changes to the regulatory environment, Banks have maintained their capital bases, with average Capital Adequacy Ratios rising from 15.4% in 2011 to 15.5% in 2012 *(Source: PWC, 2013)*.
- **Reduction in Earnings** – Compared to the previous two years double-digit growth in Headline Earnings, the 2012 growth was reduced to single digits.
- **Return on Equity** – Reduced profitability as well as sustained relatively high levels of capital has resulted in a reduction in average Return on Equity. In particular, average Return on Equity across the major Banks reduced from 20.38% in 2011 to 16.39% in 2012, according to Bloomberg. It is believed that Return on Equity for South African Banks shall now transition into an era whereby 15-18% will now denote the upper band and not the lower band for this quantity *(Source: PWC, 2013)*.
- **Operating Income and Expenses** – Aggregate Operating Income has grown by 12.4% across the four major Banks in 2012 versus 5.7% in 2011 and 3.4% in 2010, reflecting a reversal of subdued credit growth in the past. In relation, aggregate Net Interest Income grew by 11.1% in 2012, while Non-interest Revenue also gained by 13.7%. Aggregate operational expenses on the other hand grew by 11.1% in 2012. Inflationary pressures, the weaker Rand (particularly the cost impact of this on expansions into the rest of Africa) and salary costs are the primary contributors to the increase in expenses. Nonetheless, the gain in expenses has not had an adverse impact on efficiency, as the combined Cost-to-Income Ratio reduced to 55.8% in 2012 from 56.8% in 2011. *(Source: PWC 2013)*.
- I**mpairments and Credit Loss Ratios** – Banks renewed focus on credit, risk and pricing models, has seen the absolute level of impairments stabilise while coverage ratios have also improved. Income statement impairments however increased by 36% in 2012 (versus a decrease of 14.8% in 2011), resulting in a slight deterioration in the combined Credit Loss Ratio (impairment charge as a percentage of average advances) to 1.2% in 2012 from 0.9% in 2011. The general expectation is that this ratio will continue to deteriorate, given the current market environment. *(Source: PWC 2012a, 2013)*.
- **Net Interest Income** – Net Interest Income continues to be the primary driver of Banking revenue, comprising 50.6% of total combined revenues for 2012 versus 49.5% in 2011. The combined Net Interest Margin of the major Banks has continued to grow from 3.7% in 2010 to 4.2% in 2012, largely due to changes in balance sheet composition. In terms of assets, Banks have focused on higher-margin products, improving loan pricing mechanisms and revising deposit pricing structures to diversify funding structures and lengthen funding profiles. *(Source: PWC 2012a, 2013)*.
- **Asset Quality** – Over the past year, higher yielding assets have been the primary drivers behind growth in Banks' loan portfolios, with Card Debtors increasing by 27.4% (to R79 bln), Instalment and Vehicle Finance increasing by 13.1% (to R304 bln) and other loans (including unsecured lending) increasing by 16.2% (to R413 bln). The Home Loan and Corporate and Investment Banking loan portfolios on the other hand have experienced modest growth of 0.4% and 4.0% (to R833 bln and R882 bln) respectively. The state of the economy as well as the pending new regulatory capital regime are the primary drivers behind the subdued growth in the Banks' largest loan books. *(Source: PWC 2013)*.
- **Non-Interest Revenue** – Fee and Commission income continue to dominate Non-interest Revenue, constituting approximately 70% of the total figure as at 2012. Bank's general focus on financial inclusion, or more informally Banking the unbanked, has resulted in a proliferation of cost-effective products and services geared toward ease of access, control and flexibility, which has in turn bolstered Fee and Commission income. Trading income remains highly volatile and subject to prevailing market sentiment and dynamics. Natural Client Flow business continues to be the main contributor to Trading income, however market volatility and disparate dynamics combined with subdued demand for Risk Management products has weighed on this source of revenue. As such, Banks have focused on capturing flows emanating from emerging markets, in particular those on the African continent. *(Source: PWC 2013)*.
- **Future Prospects** – While economic sentiment has appeared to improve slightly, as evidenced by the stellar performances of equity markets over the latter part of 2012 and early part of 2013, the risks mentioned earlier are still prevalent and largely unresolved. Therefore, prospects for the Banking sub-sector going forward remain subdued and cautiously positive. Furthermore, the local Banking sub-sector appears to be well capitalised and managed, with future expansion projects beginning to bear dividends. As such, continued astute management and technological evolution in the sub-sector does bode well for future performance, provided the execution and implementation of such strategies are efficient and effective.

3.2.2. Description of the Insurance sub-sector

The Insurance sub-sector is dichotomous in nature constituting two major areas, viz. Long-term Insurance and Short-term Insurance. For the purpose of this introduction to the South African Insurance sub-sector, we provide the aggregated Financial Results of the major Long- and Short-term Insurers within this sub-sector, as presented in PWC (2012b, 2013a). As with the Banking sub-sector, key financial statistics aggregated across these institutions follow in the statistics and analysis below.

Long-term Insurance

The combination of the purely South African operations of the following Long-term Insurers is representative of the South African Long-term Insurance sub-sector:

- Discovery Holdings Ltd;
- Liberty Holdings Ltd;
- MMI Holdings Ltd;
- Old Mutual plc; and
- Sanlam Ltd,

Key combined financial statistics for the past couple of financial years follow below. (Source: PWC, 2012b, 2013a)

- Group IFRS earning increased by 2% in 2012 versus 23% in 2011;
- Group Return on Average Equity of 19% in 2012 versus 19% in 2011;
- Group Embedded Value profits up by 53% in 2012 versus 16% in 2011;
- Value of New Business written increased by 27% in 2012 versus 23% in 2011; and
- Margin on New Business improving to 3.2% in 2012 versus 2.6% in 2011.

The following observations are noteworthy regarding the financial performance of the Long-term Insurance sub-sector over recent financial years:

- **Reduction in Earnings** – Despite impressive gains on the Equity (JSE All Share Index gaining 23% in 2012) and Bond markets (All Bond Index yielding a total return of 16% in 2012), combined earnings increased modestly in 2012. Long-term Insurers were not able to capitalise on this in its entirety because the majority of policies offer Policyholders linked market returns, while onerous regulatory or solvency capital requirements have swayed Insurers away from riskier assets for Shareholder and technical reserve investments. Nonetheless, it is worth noting that the muted industry growth in earnings is primarily due to Old Mutual's Emerging Markets business, which recorded a massive 32% drop in earnings largely due to a combination of poor investment allocation and hedging activity. MMI Holdings, on the other hand, recorded an impressive doubling in earnings growth; therefore, performances amongst Insurers were vastly varied and disparate. Additionally, it should be noted that the yield on the 10-year government Bond reduced by more than 100 basis points in 2012, which had an unfavourable impact on those Insurers who offered investment guarantees in a large proportion of their products. *(Source: PWC 2013a)*.
- **Return on Equity** – Highly volatile financial markets have led to an increase in risk aversion amongst Insurers, manifesting in increased conservative investments, hedging strategies and generally higher levels of capital. Shareholders' equity increased by an average of 8%, resulting in a decrease in the combined group return on average equity from 20% in 2011 to 19% in 2012. *(Source: PWC 2013a)*.
- **Strong Growth in Embedded Value Earnings** – Lower South African interest rates, which have favourably affected valuations, as well as buoyant local financial markets have been the significant contributors to the rampant growth in Embedded Value Earnings. Aggregated Embedded Value Earnings grew by 53% in 2012 versus a far more subdued 16% in 2011. *(Source: PWC 2013a)*.
- **New Business Growth** – Despite a difficult economic environment, plagued with uncertainty, Insurers still succeeded in increasing New Business volumes. The present value of New Business premiums increased by 7.4% in 2012 versus 6.6% in 2011, thereby reflecting steady and stable demand for Insurance products, while lower interest rates also had a favourable effect. In addition to increasing the present value of New Business premiums, Insurers were also able to increase margins on New Business to 3.2% in 2012 versus 2.7% in 2011. The combination of growth in present value of New Business premiums and the margins thereon, resulted in an increase in the Embedded Value of New Business of 27% in 2012 versus 24% in 2011. Further, the average

payback period, related to the Embedded Value of New Business, remained constant at 6.3 years for the combined group (this is a crude measure, which indicates the average earning period for the majority of the Embedded Value on New Business). *(Source: PWC 2013a)*.

- **Acquisition Costs and Annual Premium Equivalents** – Acquisition costs (a measure of commission and other costs incurred in attracting New Business) for the group considered, increased by 8.9% to R12.8 bln in 2012. The Annual Premium Equivalent (a measure of annual New Business, calculated by taking 10% of all Single Premiums received and 12-months' worth of Recurring Premiums) increased by 7.7% to R23.6 bln over the same period. It is worth noting that in general, the ratio of acquisition costs incurred to the Annual Premium equivalent across Insurers has been declining over recent years, largely due to the change in commission regulations in 2009, which altered the commission structure from upfront payments to pro rata payments, contingent on the Policyholder meeting the premium obligation. This observation may also be due to Insurers focusing more on investment type products, as opposed to pure risk products, which attract a relatively lower commission charge. Nonetheless, this ratio has increased from 53.8% in 2011 to 54.4% in 2012, with Discovery being the primary contributor to this increase. The reason for this appears to be two-fold: (1) Discovery's product mix remains heavily slanted in favour of risk products, which offer higher commissions; and (2) Discovery has significantly increased the proportion of New Business written by Agents. *(Source: PWC 2013a)*.
- **General Expenses** – According to statistics presented in PWC 2013a, Long-term Insurers' expenses, over the past four years, have increased at a rate faster that the South African Consumer Price Index, across the entire industry. General inflationary pressures as well as the cost of changing and more stringent regulation are the primary factors contributing to this continuous increase in expenses. *(Source: PWC 2013a)*.
- **Capital and Solvency** – The Capital Adequacy Requirement cover ratios have all remained fairly stable over the past couple of years and are reflected in the table below, for the Long-term Insurance companies under consideration. The pending introduction of the South African Solvency Assessment and Management regulatory regime will result in a significant increase in the capital requirement of Long-term Insurers, which essentially results in the capital coverage ratio reducing from 3.4 to 1.7, based on the most recent Quantitative Impact Study undertaken by the FSB for the group of Insurers under consideration.

Table 7: Current capital adequacy ratios of Long-term Insurers *(Source: PWC 2013a)*

Insurer	2010	2011	2012
Discovery Holdings Ltd	3.9	4.4	3.9
Liberty Holdings Ltd	2.7	2.9	2.7
MMI Holdings Ltd	2.5	2.3	2.4
Old Mutual plc	3.9	4.0	3.9
Sanlam Ltd	3.4	3.7	4.3

Short-term Insurance

The collection of the following Short-term Insurers is representative of the South African Short-term Insurance sub-sector *(Source: PWC, 2013a)*:

- ABSA Insurance Company Ltd;
- Mutual & Federal Ltd;
- Outsurance Holdings Ltd;
- Santam Ltd; and
- Zurich Insurance Company South Africa Ltd.

Key combined financial statistics for the past couple of financial years follow below. *(Source: PWC, 2012b, 2013a)*

- Gross written premiums increased by 10% in 2012 versus an increase of 5% in 2011;
- Claims ratios deteriorated to 66% in 2012 versus 62% in 2011;
- Underwriting margin reduced to 4.6% in 2012 versus 9.1% in 2011;
- Investment returns increased by 37% in 2012 versus a decline of 31% in 2011; and

- The international solvency margin reduced to 43% in 2012 versus 45% in 2011.

The following observations are noteworthy about the financial performance of the Short-term Insurance sub-sector over recent financial years:

- **Increase in Gross Written Premiums** – Short-term Insurers' gross written premiums increased by 10% to R44.8 bln in 2012, compared to an increase of 5% in 2011. Outsurance's Australian business heavily influenced growth in premiums in 2012, which doubled in size in 2012 – when excluded, the growth in written premiums reduced to 7.6%. Nonetheless, this is still a substantial improvement compared to 2011. *(Source: PWC 2013a)*.
- **Effects on Other Ratios** – The table below summarises key ratios for the Short-term Insurance industry, as reported in PWC (2013a). One should note that 2012 was a challenging year for South African Short-term Insurers, mainly due to three significant events: (1) Mpumalanga floods, (2) Gauteng hailstorms, and (3) St Francis Bay fires. These events resulted in a dramatic increase in claims during 2012, with losses for the industry accumulating to approximately R2 bln. The impact on different Insurers depended on their exposures to these specific events, as well as the nature of their hedging or Reinsurance strategies. Nonetheless, the net impact on the major players in the industry in ratios follows in the table below. With escalating climate concerns, for example, the need for robust Underwriting methodologies is of paramount importance, particularly to Short-term Insurers who tend to attract highly correlated and concentrated exposures. All of the major Short-term Insurers recorded deteriorations in Claims Ratios in 2012, while Acquisition Cost Ratios continued to decline and Expense Ratios sustained its increasing trend, albeit to a lesser extent from 2011 to 2012. The playoff between acquisition costs and other expenses is attributed to the general move from Broker or Agency based distribution channels to Direct Marketing distribution channels. Given the catastrophes of 2012, along with growing concerns over more potential disasters, most Insurers in this space have communicated that they will be reviewing certain exposures and repricing on a selective basis. The need for such is clearly apparent, considering the erratic behaviour of Underwriting margins, which is primarily attributable to the associated volatility of claims expenses. *(Source: PWC 2013a)*.

Table 8: Key ratios for the Short-term Insurance sub-sector *(Source: PWC 2013a)*

	2010	2011	2012
Claims Ratio	65.3%	61.9%	66.3%
Acquisition Cost Ratio	15.0%	11.6%	11.3%
Expense Ratio	13.4%	17.2%	17.8%
Underwriting Margin	6.3%	9.3%	4.6%
Total	100.0%	100.0%	100.0%

- **Favourable Investment Performance** – Favourable performance of both the local Equity and Bond markets assisted Short-term Insurers – investment returns were up by 37% year-on-year for the group of Insurers under consideration. This helped certain Insurers to reduce some of the losses incurred on the claims front. A repeat of the 2012 financial market performance seems unlikely; therefore, Insurers are focusing on reducing costs and enhancing their Underwriting capabilities. *(Source: PWC 2013a)*.
- **Deterioration in Capital Adequacy** – Based on the international solvency margin, the industry wide Capital Adequacy position or Combined Solvency Margin reduced from 49% in 2011 to 43% in 2012. The pending introduction of the South African Solvency Assessment and Management regulatory regime will cause a significant increase in the capital requirement of Short-term Insurers. This essentially results in the Capital Coverage Ratio reducing from 2.4 to 1.5, based on the most recent Quantitative Impact Study undertaken by the FSB.

Looking ahead, the following are important themes for the Insurance industry:

- Escalating local inflation, continued global and local economic concerns and increased competition in the market should put pressure on premium growth.
- The above economic backdrop, in conjunction with a low interest rate and weaker Rand local environment creates substantial challenges for Insurers, particularly Long-term Insurers.

- In general, Insurers will be innovating and investing heavily in processes to improve their access to and availability of information, in order to enhance their pricing and risk management frameworks.
- Changes in regulation and the associated costs will remain topical and a significant area of focus for both Long- and Short-term Insurers.
- South African Insurers will seek to expand their reach and capability across the African continent, in the hope of exploiting, leveraging and maximising the opportunities brought about by the sustained economic growth of many countries.

3.2.3. Description of the Asset Management sub-sector

South Africa's Investment Management industry is a vibrant, sophisticated environment, with investors having access to a wide variety of investment products, ranging from traditional to alternative strategies. The wake of the recent Financial Crisis has seen a proliferation of new investment products, as Portfolio Managers attempt to respond to the new volatile financial market environment. As a result, the local industry has also undergone significant change, which has presented both restraints to and opportunities for growth. Unfortunately, this industry is not accessible to all South Africans, due to the lack of financial literacy, the high level of unemployment and the general inability to save.

According to the Association for Savings and Investments South Africa (ASISA), as at the end of December 2012, assets under management in the Long-term Insurance, Collective Investment Schemes and Retirement Funds industry amounted to R1.74 trillion, R1.23 trillion and R2.40 trillion respectively (ASISA Annual Review 2012). The growth in the Collective Investment Schemes industry has been exponential over the past fifteen odd years. At the end of December 1997, there were only 149 registered Collective Investment Schemes, with total assets under management amounting to R45.5 billion. By December 2002, this had grown to 460 funds and R179.8 billion under management. As at the end of December 2012, there were 967 registered Collective Investment Schemes in South Africa, with total assets under management amounting to R1.23 trillion.

As at the end of March 2013, the number of funds in the Collective Investment Schemes market had grown to 988, while the number of Asset Managers stood at 47. Considering only South African funds (i.e. those with 70% or more invested in local assets) which comprise 93.5% of the entire industry, MoneyWeb show that the top seven Asset Managers in South Africa control 59.9% of all South African funds. These Asset Managers are Allan Gray, Investec Asset Management, Coronation, STANLIB, ABSA, Nedgroup Investments and Old Mutual.

4. Banking

4.1. Overview of the Banking sub–sector

4.1.1 Economic Context

"A Bank is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly by loaning or indirectly through capital markets. A Bank is the connection between customers that have capital deficits and customers with capital surpluses." (*Wikipedia, Article: Bank)*

"An institution that deals in money and its substitutes and provides other Financial Services. Banks accept deposits and make loans and derive profit from the difference in the interest rates paid and charged, respectively." *(Encyclopaedia Britannica)*

Banks constitute a key component of the Financial Services system and the economy, as a whole. In its most basic form, the Banking system is a key driver of the South African economy as it facilitates the liquidity (amount of capital available for investment and spending) required by households and corporates for consumption and future investment. The credit and loans extended by Banks to the real economy[1] imply that households do not have to save up in order to make large purchases, while companies can also start hiring and making capital expenditure now, in anticipation of future demand and expansion. In non-technical language, a Bank works as follows:

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1 The rapid growth in the Financial Services sector over recent times has prompted the need to distinguish between the real economy and what is now commonly termed the "paper economy". The real economy refers to that part of the economy concerned with the production of goods and services, while the paper economy refers to Financial Services component of the economy.

2 Deposit Insurance is implied in South Africa as the government has a record of reimbursing small depositors in the wake of a Banking failure, historically. In the United States of America (US), for example, deposits are guaranteed explicitly via the Federal Deposit Insurance Corporation (FDIC - an independent agency of the Federal Government, with no Congressional appropriations, funded by premiums from Banks and earnings on investments in US Treasury Bonds).

"A Bank provides a safe place for households and companies to save excess cash – these savings are commonly referred to as deposits. The relevant Banking governing body or government generally guarantees or insures Bank deposits (this does not explicitly exist in South Africa, but rather is implicit[2]). In general, the Bank is then required to hold a proportion of these deposits with the relevant Banking governing body (this is a statutory requirement – also referred to as the Fractional Reserve Banking System), but can then lend out the remainder of the consideration. As remuneration for deposits, the Bank pays interest to depositors, while charging interest to borrowers. A Banks fundamental revenue model is based on charging higher interest rates on their loans versus that which is paid on deposits."

More formally, Allen and Carletti (2008), describe the role of Banks in financial systems and the broader economy as follows:

- Banks ameliorate the information problems between investors (depositors) and borrowers, via appropriate scrutiny of potential borrowers and thereafter continual monitoring and analysis of the credit worthiness of existing borrowers (role as a financial intermediary). This ensures the appropriate and prudent use of investors (depositors) funds, as well as the efficient allocation of resources in the economy.
- Banks play an important role in credit quality improvement by being a lender to ordinary corporates and households but a high quality borrower from these agents. This improvement stems from the benefit achieved from a Bank's diverse asset and capital base, which partially immunises the entity against default by its obligors.
- Banks provide inter-temporal smoothing of risk that cannot be diversified at a given point in time, as well as Insurance to depositors against unexpected consumption shocks. Of course, this role or function naturally exposes the Bank to maturity mismatches between assets and liabilities, which therefore makes the Bank vulnerable to systemic risk as well as "runs" (when a large proportion of depositors seek withdrawal of their deposits at the same time).
- Banks contribute to the operation and growth of the economy, primarily through their role as intermediaries as well as being a provider of payment settlement facilities. Further, seamless execution of these functions instils confidence in the broader financial system.
- Banks perform an important role in Corporate Governance. This role is prominent in countries like Germany and Japan where financial institutions have high equity ownership in local corporates, and a strong market for corporate control is lacking. Banks act as external monitors for large corporations in these respective jurisdictions and therefore provide a potential solution to the agency problem. The key characteristic of this system is the long-term relationship between a Bank and its client company, and the active intervention of the Bank should its client experience financial distress.

The interest gap between lending and borrowing rates underpins the basic Banking model, as stated above. Critical to this Banking model, which we will refer to as the "Good Old Days", is the management of risk, particularly credit default and interest rate risk.

Credit default risk is the potential loss the lender experiences in the event that the borrower defaults on interest or capital loan repayments. Broadly, Retail Banks engage in two primary types of credit extensions; secured lending and unsecured lending. As the appellations might suggest, secured lending provides a degree of security to the lending institution in the event of a default, whereas unsecured lending, which takes the form of credit card and overdraft loan extensions does not offer a security. The implication is that unsecured lending carries a higher risk, which, all things being equal, articulates through higher risk premiums and by higher lending interest rates.

Interest rate risk arises if a Bank has, on aggregate, assets and liabilities with varying degrees of sensitivity to changes in interest rates. That is in the event of interest rate movements; assets and liabilities on aggregate do not price concurrently, or when cash flows do not adjust simultaneously. The gap in sensitivity may affect both Bank liquidity and ultimately Bank solvency. During the Savings and Loan crisis in the U.S. in the 1980's, hundreds of Banks failed when Banks financed fixed interest, long-term mortgages with variable short-term liabilities. When interest rates increased, Banks could not attract deposits to finance long-term mortgage extensions. This initially manifested itself as a Liquidity Crisis and then evolved into a Solvency Crisis, which was the cause of mass banking failures during the 1980's. The Solvency and Liquidity in the U.S. demonstrates risks inherent in asset and liability mismatches in interest rate sensitivity on Banks' balance sheets.

Notwithstanding thousands of banking failures, particularly in the U.S, over the last century, the model prevalent during the Good Old Days were significantly less complex than Banking models that evolved over the last three decades.

4.1.2 Types of Banks

As alluded to above, banking failures have been a relatively common experience. Causes of banking failures are, nearly always, a consequence of not understanding risk or more technically the incorrect pricing of risk. As one might imagine, not all banking activities share the same risk profile, for the individual Bank, the Banking industry and the wider economy. The globalisation of Financial Services has introduced global banking and economic risks. The following is an extensive, yet possibly non-exhaustive, description of the various types of Banks or Banking Divisions of larger Financial Services institutions that are functional in the global economy.

Retail Banking

Retail Banks offer Personal Banking services and products to individual consumers, households and small businesses. The term "Retail Bank" clearly differentiates this entity from other Banking entities, or divisions within a larger entity, such as those involved with investment, merchant, commercial or wholesale services. The term "Commercial Bank" is common in this regard, which is a function of history, born in the wake of the Great Depression[3] and the advent of the Glass-Steagall Act in the United States of America (US). The Glass-Steagall Act most commonly refers to four provisions of the 1933 Banking Act, aimed at separating Commercial Banking from Investment Banking and other companies dealing with pure capital market activities. While this is somewhat of a misnomer, often a normal Retail Bank/Division is referred to as a "Commercial Bank"[4]

Common names for Retail Banks: Commercial Bank, Community Bank, Community Development Bank, Credit Union, Postal Savings Bank, Private Bank, Offshore Bank, Savings Bank, Building Society and Landesbank, Ethical Bank, Direct or Internet Only Bank.

Business (Commercial) Banking

Business or Commercial Banks offer a variety of services and products to medium-sized corporations. More recently, these Banks/Divisions are usually associated with the Retail arm of larger Banking institutions, and therefore are not clearly distinguishable from the Retail Bank/Division.

Corporate Banking

This Bank/Division provides services and products focused at, and tailored to the needs of large corporations and Governments. Services offered range from Cash Management, Financing, Underwriting and assistance with raising capital, by issuing of Stocks, Bonds or other similar instruments. Due to the customised and more sophisticated Financial Services requirements of large corporate clients, most large Banking institutions prefer to segregate this division from the Retail and Business Banking Divisions.

Private Banking

Private Banking refers to Financial Services and products offered to private high-net-worth individuals/households. These individuals have high financial liquidity and are therefore able to invest in sizeable quantities. "Private" refers to the fact that this Bank services their clients on a more personal basis – in most cases; each client has a dedicated advisor/Banker. This is vastly different to the services rendered to the mass-market in Retail Banking. This arm of larger Banking institutions play an integral role in overall wealth management and financial decision making, with advisors assisting clients with standard banking services, discretionary and non-discretionary Asset Management, Tax Advisory as well as basic concierge-type services.

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3 The severe worldwide economic recession/depression in the decade preceding World War II.

4 This is also somewhat ambiguous as "Commercial Bank" may also refer to a Bank or division of a Bank that deals with financial activities of large corporations.

Investment Banking

An Investment Bank/Division provides the private (individuals, households and companies) and public sectors (government, municipalities, etc.) with the avenue and opportunity to raise capital, either via underwriting and/or acting as an agent in the issuance of securities to the primary and secondary financial markets. This capital raising service or function falls more generally within the broader ambit of Corporate Finance, which is at the heart of all traditional Investment Banks. The primary goal of Corporate Finance is to maximise Shareholder value, and therefore the Investment Bank achieves this goal by analysing a company's financial needs and proposing the necessary strategic financial decisions and plans to succeed. Usually, an Investment Bank would also achieve the aforementioned goal by advising on appropriate Merger and Acquisition activity. Due to the nature of their core business, large Investment Banks also tend to possess a Treasury function that provides supplementary services such as access to financial markets, and thereby a variety of asset classes, including Market Making of various financial products.

Mutual Banks

The business model of Mutual Banks differs significantly from conventional Banks as depositors share in the profitability of the institution. This is in stark contrast to conventional Banks, where Shareholders own capital in the institution, which entitles them to a share of the profitability. Mutual Banks prioritise security and are therefore conservative in their approach to investments – this prudent behaviour protects depositors from general systemic volatility or catastrophes, thereby attracting risk-averse depositors.

Development Banks

These are financial institutions focused on the funding of new businesses and economic development projects (primarily infrastructure) within both the Private and Public sectors, via the provision of equity or loan capital.

4.1.3 South African Context

This section provides an overview of the South African Banking industry based on the sector profile provided in the BANKSETAs (Banking Sector Education and Training Authority) Sector Skills Plan for 2013 – 2014. In particular, the BANKSETA considers the contribution of the sector to the economy; distinguishes between different sub-sectors; provides a summary of key players, operational structures and product offerings along with a general indication of the relevant skills required to support this industry.

According to the World Economic Forum's Global Competitiveness Report, which assesses the competitiveness landscape of 144 economies, South Africa ranked 3rd (out of 144) in the category of "Financial Market Development". This ranking is testament to the robustness of the South African Banking sub-sector, from a regulatory and functional perspective. Furthermore, the ranking also resonates with the resilience of the South African Banking sub-sector during the recent global financial crises.

According to estimates provided by the BANKSETA, total nominal gross value added by the sub-sector increased from R56.5 billion in 2005 to R109.9 billion in 2011. Moreover, the BANKSETA estimated that Retail Banking and Investment Banking accounted for around R79.8 billion (73%) and R30.1 billion (27%) of the total nominal gross value added in 2011. The BANKSETA further estimated that these numbers imply that the Banking sub-sector contributed 4.7% of the total gross value added in the economy in 2011, which is up from 2009 (4.2%), but below 2008 (5.1%).

In terms of employment, the BANKSETA estimated that total employment in the sub-sector amounted to approximately 157 000 in 2011 which was up from around 155 000 in 2010, with Investment Banking contributing to 11% of the total number for 2011, while Retail Banking accounted for the remaining 89%.

The South African Banking sub-sector constitutes standard Banking institutions as well as other Financial Services organisations such as those involved in Microfinance, that cater for the unbanked population of South Africa. The Microfinance sub-sector is a new emerging area that is relatively unsophisticated yet highly regulated. According to the South African Reserve Bank's list of Registered Banks and Representative Offices, there are currently 10 locally controlled Banks, 6 foreign controlled Banks, 13 branches of foreign Banks, 41 foreign Bank representatives, 3 Mutual Banks and 2 Banks in liquidation (Islamic Bank Limited and Regal Treasury Private Bank Limited).

Four major Banks dominate the South African Banking sub-sector, viz. ABSA Bank Limited, FirstRand Bank Limited, Nedbank Limited and The Standard Bank of South Africa Limited. According to the Banking Association of South Africa's (BASA) South African Banking Overview 2012, total Banking assets amounted to R3.5 trillion as at the end of June 2012, with the four major Banks representing 84% of this total. Of these assets, Loans and Advances

contribute approximately 76%, with Home Loans and Term Loans contributing 32% and 19% to total Loans and Advances respectively. Total liabilities of the Banking sub-sector amounted to R3.2 trillion as at the end of June 2012, with Deposits comprising 86% of this total (Fixed and Notice Deposits making up 31% and 19% of Deposits respectively). Further, the RoE (Return on Equity) and RoA (Return on Assets) for the sub-sector improved to 16.7% (15.1%) and 1.2% (1.1%) respectively in June 2012 (June 2011), while the overall efficiency of the sub-sector also improved, with the Cost-to-Income ratio falling to 54.8% from 56.8%. Operating expenses, however, increased from R92 billion in June 2011 to R99.8 billion in June 2012. In terms of shareholding, foreign ownership amounted to 43% of the total nominal value of shares in issue at the end of December 2011, while domestic and minority Shareholders held approximately 28% and 29% respectively.

Further, the aforementioned BASA report also reflects that the aforementioned major Banks have roughly 35 million Retail Bank accounts, housed at 2 740 branches countrywide and serviced via 21 000 Automated Teller Machines (ATM's). Despite these statistics, FinScope's 2012 South African Survey highlights that approximately 19% of the population remains financially excluded, i.e. no Bank account or access to formal or informal Financial Services.

4.1.4 Operational/Functional Context

Business Models

Banks have access to a variety of revenue streams, viz. interest income (difference between cost of funding and interest rate charged on loans), transaction or brokerage fees and consultative fees charged for financial advice. Historically and traditionally, Banks have relied on interest income as their main source of revenue. However, due to the cyclical nature of interest income (which depends on the state of the economy and the demand and quality of consumers) Banks have had to diversify their offerings and value propositions. Since service-based fee income provides a more stable alternative, Banks have gradually evolved their offerings in this direction.

Internationally, Banks have evolved significantly over the past couple of decades, most notably following the introduction of the Gramm-Leach-Bliley Act in the US. The Gramm-Leach-Bliley Act (or Financial Services Modernization Act of 1999), repealed part of the Glass-Steagall Act of 1933, and provided a prudential framework for the combination of Commercial Banks, Investment Banks and Insurance companies, thereby affecting competition within the Financial Services sector. With the advent of this act in the US, and similar legislation in other jurisdictions, traditional Banks were now able to cater to growing demands from consumers for consolidated Banking and Insurance services. Merging Banking, Investment Banking and Insurance services also enables cross selling of products and services, thereby catalysing diversification of revenue streams and enhancing profitability.

Other major changes to the sub-sector have been the pervasion of risk-based pricing, as well as the increased methods of payment processing that are available for individual and corporate clients. Risk-based pricing refers to the mechanism employed to price loans to clients of varying credit quality – clients with higher credit risk are charged a higher interest rate when borrowing and vice versa. This "risk premium" assists the Bank to: (i) offer relatively attractive loans to those with less credit risk; (ii) offset losses from non-performing loans; and (iii) offer loans to clients with high levels of credit risk. Methods of payment refers to products and services such as debit cards, credit cards, cheque cards, etc., which facilitate the ease of consumption spending. Banks generate revenue through these products and services via transaction fees charged to both the client and the vendor, as well as interest charged to the client.

The larger banks in South Africa operate as Universal Banks[5] or diversified Financial Services companies. While their divisional structures and associated product offerings are similar, the actual operational, system architectural and management structures differ rather significantly across banks. In general, though, a typical large South African Bank consists of the following divisions (as defined above):

- Retail Banking,
- Private Banking,
- Business Banking,
- Corporate Banking, and
- Investment Banking.

5 Universal Bank is the term commonly used to refer to a diversified Financial Services company, offering not only the full array of Banking services but Insurance services as well.

The Development Banking sub-sector is another area that plays an important role within South African Banking. The Development Bank of Southern Africa, The Land Bank and Postbank are the primary institutions within this sub-sector, with their main objectives revolving around the promotion of economic development and growth, human resource development and institutional capacity building. In most cases, these banks play multiple roles within each development project, being the financier, the partner/advisor and the implementer/integrator; thereby providing both access to funding as well as the relevant expertise necessary to catalyse development and promote the chances of success.

4.1.5 Products/Offerings

From a Retail Banking perspective, the following products and services are most common across Retail and Private Banks in South Africa:

- **Transactional Accounts** – Commonly referred to as Current or Cheque Accounts, Transactional Accounts are demand or demand deposit accounts, as money in a deposit account is easily accessible on demand via various channels. Clients can deposit and withdraw (subject to availability of funds) from this account as many times as they wish. Due to the convenience offered by this type of account, it is not interest bearing and is not suitable for savings purposes.
- **Savings Accounts** – These are interest bearing accounts, whereby a client can deposit money with a Retail Bank and receive a proportionate amount of interest in return (depending on the level of prevailing interest rates and the tenor of the investment). In general, Banks restrict immediate access to money deposited in a Savings Account, i.e. the money is not immediately callable. Due to this feature, Savings Accounts are viewed as liquid, i.e. cash that is readily available; while in certain jurisdictions Retail Banks are not required to hold reserves against such accounts.
- **Cheques** – A Cheque is a legal financial document that provides instructions for a Bank to make a payment of a certain sum of money from a given Bank account (the drawer's transactional account) to a specified drawee (or payee) on a specified date. Cheques developed as an alternate payment mechanism for transactions involving large sums of money. With the advent of electronic payment systems, the popularity of Cheques has faded gradually.
- **Automated Teller Machine (ATM) Cards** – An ATM Card is a plastic card distributed by banks that provides the holder the ability to withdraw, deposit and perform other transactions via Automated Teller Machines, generally electronically linked on an Inter-bank network.
- **Debit Cards** – A Debit Card is a plastic payment card distributed by banks that provides the holder with secure electronic access to their transactional account, and therefore replaces the need for cash. The client uses the card to withdraw funds or make electronic purchases on-site; the card is digitally linked to the client's transactional account. Debit Cards have almost entirely replaced the use of Cheques and cash in most countries. Debit Card systems have developed in a country specific manner; therefore a large amount of work has been undertaken in recent times to integrate systems across jurisdictions.
- **Credit Cards** – A Credit Card is a plastic payment card distributed by Banks that provides the holder with a revolving line of credit, used for consumption purposes, subject to pre-specified interest charges and a maximum credit limit. The issuing Bank assesses the credit worthiness of the client, before issuance of the card, which informs the maximum credit limit as well as the level of interest rate charges (Credit Cards are the most basic form of unsecured lending).
- **Fixed Deposits** – A Fixed Deposit, also referred to as a time or term deposit, refers to a monetary deposit at a Bank, which earns the depositor a fixed rate of interest over a fixed period. The money cannot be accessed during the fixed period without paying a penalty. In general, the longer the fixed period, the higher the fixed rate of interest offered by the Bank. The opposite of Fixed Deposits are On-call Deposits where the money can be withdrawn at any time, without any notice or penalty (of course the rate offered on these accounts are lower than that offered on a comparable Fixed Deposit account).
- **Personal Loans** – Personal Loans refer to unsecured loans over the short- to medium-term (in general, a maximum of five years) for a relatively small amount. A loan being unsecured means that the borrower offers no collateral in return for the loan. As a result, unsecured loans generally charge a higher rate of interest than a comparable secured loan.

- **Mortgage Loans** – A Mortgage Loan refers to a secured loan, in particular, one secured by property or more generally, real estate. Upon default of the borrower, the lending Bank seizes the real estate and executes the recovery process via foreclosure[6]. The characteristics of the loan, like notional size, tenor, interest rate, payment schedule, etc. are all highly variable, and usually decided upon at the convenience of the client.
- **Home Equity Loans** – A Home Equity Loan refers to another form of a secured loan, one in which the loan is secured or collateralised by the equity value[7] of a property or more generally, real estate. Home Equity Loans are commonly termed second mortgages, and are usually offered in two variants, viz. closed-ended (fixed term, traditional home equity loan) or open-ended (variable home equity credit line). Naturally, a Home Equity Loan creates a lien against the borrower's house, thereby reducing equity value. Further, a Home Equity Loan may only be used for refinancing purposes, and therefore may not be utilised to purchase another home.
- **Vehicle Finance** – Banks provide a wide variety of financing products for individuals seeking to purchase motor vehicles. Vehicle Finance differs from pure unsecured loans due to the partial collateral offered by vehicles – the efficacy of the second-hand vehicle market implies that these assets offer a relatively high future value. Types of financing that are most common include standard loans, hire purchase, leasing or personal contract purchase (combination of hire purchase and leasing).
- **Asset Finance** – In addition to Vehicle Finance, most Banks also provide specialised asset financing services, including expertise and advice on administering and structuring specialised transactions. These services span across a variety of sectors and industries, with most Banking entities having tailored expertise within each of these sectors and industries.
- **Retail Insurance Products** – Most of the larger South African Banks offer Retail clients a wide variety of Insurance products. The following constitutes a comprehensive yet non-exhaustive list of such products:
  - Home and Vehicle Insurance,
  - Loan Insurance (home, vehicle, asset finance and credit card),
  - Travel Insurance,
  - Accident and Health Insurance,
  - Funeral Insurance, and
  - Life Insurance.
- **Retail Investment Products** – Almost all of the larger South African Banks also offer Retail clients a variety of investment products. The following constitutes a comprehensive yet non-exhaustive list of such products:
  - Financial Planning services
  - Investment Deposits,
  - Unit Trust Investments, and
  - Offshore Investments.
- **Wealth Management** – Most universal Banks have a Private Banking division that offers a holistic Banking and Wealth Management service to clients. In particular, most Private Banks offer the following services:
  - Dedicated Relationship Manager,
  - Transactional Banking services,
  - Specialised Lending services,
  - Financial Planning services,
  - Short-term and Long-term Insurance,
  - Tax Advisory services, and
  - Complete Investment and Advisory services.

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6 Foreclosure refers to a specific legal process whereby a lender attempts to recover the balance of a loan via the forced sale of the asset used as the collateral for the loan, in the event of default by the borrower.

7 Equity value or home equity value, in particular, refers to the owner's unencumbered ownership of said property or real estate, i.e. the difference between fair market value and all liens on the property or real estate.

From a Business, Corporate and Investment Banking perspective, the following products and services are most common across Business, Corporate and Investment Banks in South Africa:

- **Business Banking** – Banks offer a range of products and services mirrored, enhanced and in certain cases tailored to the needs of small- to medium-sized corporate companies. As a brief summary, the Business Banking divisions of South African universal Banks offer the following products and services to Retail clients:
  - Dedicated Business Bankers and Specialists,
  - Transactional Accounts,
  - Cash Management, Legal, Accounting and Tax Advisory services,
  - Business Cards,
  - Business Loans and Revolving Credit,
  - Business Mortgages,
  - Vehicle and Asset Finance,
  - Fleet Management (assistance with the control and management of company fleets),
  - Insurance, Assurance and Estate Planning, and
  - Business Investment and Advisory services.
- **Transactional Services** – In addition to standard transactional services offered to small- to medium-sized corporates, larger corporates also have the benefit of access to the following advanced services via the Corporate and Investment Banking divisions of South African universal Banks:
  - Cash Management (Account, Liquidity Management as well as Payments and Collections),
  - International Trade services (Transactional and Cash Management services for international trade and other operations),
  - Custodial and Securities services (settlement for local and cross-border trades, safekeeping, servicing, administration, accounting, compliance and performance measurement of all financial market securities).
- **Financing** – Supplementary to the standard financing options available to small- to medium-sized corporates, larger corporates also have the benefit of the following financing and capital raising alternatives via the Corporate and Investment Banking divisions of South African universal Banks:
  - Access to Debt Capital markets (issuance of Bonds or similar derivatives to raise capital),
  - Access to Equity Capital markets (company listings, initial public offerings, share placements, rights issues, share buybacks, preference shares, subordinated debt, convertible bonds and other equity-linked securities)
  - Access to Securitisation (the conversion of illiquid assets of high associated credit quality and fairly predictable cash flows into a tradable security offers a corporate an attractive source of term funding),
  - Access to Project Finance (Banks act as Advisors and Underwriters of senior, mezzanine debt and equity for large capital projects),
  - Leveraged and Acquisition Finance (financing solutions for privatisations; recapitalisations; corporate, leveraged and management buyouts and black economic empowerment deals), and
  - Structured Trade and Commodity Finance (pre-production, pre-export, import, export, stock, storage, inventory and repurchase agreement financing; pre-payments; administration; derivative hedging and Insurance).
- **Advisory Services** – As part of the Investment Banking division, a universal Bank offers a host advisory services to the private and public sectors, most notably:
  - Corporate Finance advisory service (advice on mergers and acquisitions, leveraged acquisitions, corporate restructuring, equity restructuring, valuations and black economic empowerment deals),
  - Exchange Control advisory service (advice on Exchange Control regulations, administration and facilitation of Exchange Control approvals), and
  - Research (economic as well as financial market research).
- **Global Markets (Sales and Trading)** – The global markets division of an Investment Bank offers a range of trading and risk management solutions across all financial markets and all asset classes. In particular:
  - Foreign Exchange trading (spot, forward, futures, options, exotic options, warrants, trading research and advice, hedging research and advice and structured solutions),

- Money Market trading (interest bearing call accounts, fixed or floating term deposits, negotiable certificates of deposit, call and term loans),
- Interest Rate trading (government bonds, corporate bonds, interest rate swaps, cross currency swaps, options, exotic options, structured products),
- Credit trading (corporate bonds, credit-default swaps, credit-linked notes, total return swaps, structured products),
- Equity trading (spot, forward, futures, swaps, options, exotic options, warrants, convertibles, variance swaps), and
- Commodity trading (spot, forwards, futures, options, structured products, financing, risk management and advisory).

In order to access these products and services, South African Banks offer a wide variety of distribution channels; in particular, the following are worth noting:

- **Retail Branches** – According to BASA's 2012 Sector Overview, the major four Banks had 2 927 Retail branches across the country as at the end of December 2010, while all Banks (including African Bank, Capitec, Ithala, Ubank and SAPO) had 6 303 branches at the same time.
- **Automated Teller Machines (ATM's) and Points of Sale (POS's)** – According to BASA's 2012 Sector Overview, the four major Banks had 23 512 ATM's across the country as at the end of December 2010. At the same time, the four major Banks had 172 912 ATM's and POS's, and all Banks had 173 016 ATM's and POS's.
- **Relationship Managers** – As mentioned in the product offering section, beneath the categories of Private Banking and Business Banking, most Banks provide clients with dedicated relationship managers to cater for all of their Financial Services needs.
- **Call Centres** – Most of the major Banks have a host of call centres, which are primarily outbound in nature, i.e. these centres serve to market new products and services, perform market research as well as assist with debt collection.
- **Mail** – Most Banks still communicate with clients via conventional mail through the postal service system (offering statements and new product brochures), while also accepting Cheque deposits via mail.
- **Telephone Banking** – This is a less popular service, due to the advent of Mobile and Internet Banking, however most Banks also offer clients the opportunity to conduct Banking transactions over the phone (generally using automated agents/attendants).
- **Internet Banking** – With the proliferation of Internet based services, Banks now offer their entire product suite online, with all clients being able to apply for credit, finance, new products and services as well as transacting electronically.
- **Mobile Banking** – Given the evolution of mobile phone and tablet technology, the complete functionality offered by Internet Banking is now available on handheld devices.
- **Video Banking** – Less common to the South African market (and probably emerging markets in general), however Banks do offer the mechanism of performing Banking transactions as well as professional Banking consultations via a combination of audio and visual mediums.

4.1.6 Employment

According to BASA's 2012 Sector Overview, the Banking sub-sector in South Africa employs over 150 000 people, with the four major Banks contributing the most to this total – ABSA (34 244), First National Bank (36 398), Nedbank (28 494) and Standard Bank (45 755).

4.2 Retail Banking - Interviews

4.1.2 Regulation and Compliance

Basel III has been a major regulatory change for the Banking sub-sector. Although Banks support and understand the need to make the financial system safer, regulation increases the cost of capital. Basel III requires that Banks hold more liquid capital; this means that less capital is available for investment in long-term assets. Banks anticipate that the change to the net stable funding ratio due to be implemented in 2018 will render them unable to grant Mortgage Loans. In essence, Banks will have to match the terms of lending with the terms of deposit. This means that a 20-year home loan will require a 20-year term deposit coming in at the same price. Most Retail Banks are already substantially reducing the numbers of new Housing Loans in anticipation of this change, due to concerns about being unable to meet future capital requirements.

Since the Financial Crisis there has been a "global regulatory wave"; if countries want to compete in the global financial system, there is no choice but to adopt international regulation. South Africa was one of seven countries that implemented Basel III on 1 January 2013. Certain Retail Banks highlighted the irony that the countries that caused the Financial Crisis have not implemented Basel III, while countries like South Africa, Singapore and Australia have. Overall, the perception is that Basel III is important as it focuses on enhancing the stability and safety of the financial system as a whole.

Other regulatory changes that affect the entire Financial Services sector are enhanced Consumer Protection, Financial Inclusion, Combatting Financial Crime and the planned Twin Peaks implementation. Banks commented that Consumer Protection issues have a far greater impact in Banking than in other retail areas; for example, a poorly designed Banking product could result in an individual losing their house or life savings. The lack of consistency of information and standard of data provided by Credit Bureaus and unregulated Personal Credit Insurance is a cause for concern.

Regulatory change occurs at a rapid rate; over the past two years, on average a new or changed law or policy is issued every two weeks that affects the Banking sub-sector. Banks have to scrutinise legislation to determine any possible impact, for example, ARTO affects the legal risk undertaken when providing finance for motor vehicles. There are also concerns that Regulators are becoming more intrusive; the proposed Twin Peaks regulation requires that the Market Conduct Regulator must approve new products prior to launch. Retail Banks anticipate that this will have a negative impact on their ability to innovate and will increase the amount of time taken to release a product.

There is general agreement that regulatory changes are logical when viewed individually, are highly beneficial and are usually formulated with the best of intentions. However, the sheer volume and pace of regulatory change is overwhelming and the management of this is a massive undertaking. Banks have to invest in the monitoring of, and compliance with, regulatory changes, while ensuring that changes do not have a negative impact on customer experience. A further issue is that most Retail Banks have built up many Legacy systems over time that have been customised repeatedly and the process of changing systems in order to comply with regulatory reporting requirements can potentially put Legacy systems at risk.

Cumulatively, regulation has an immense impact and many companies in the sub-sector feel frustrated that the government has no mechanism in place to examine regulation holistically. Each Regulator focusses on the particular regulation under their jurisdiction and are unaware of the collective impact of regulatory compliance on companies. In addition, there is duplication of effort in regulatory reporting, as certain requirements are the similar or identical for different legislation. Institutions hope that the proposed Twin Peaks model, which combines regulation into two streams – Prudential and Market Conduct, will mitigate the fragmentation issue.

A perception within the sub-sector is that the South African Reserve Bank (SARB) is the only Regulator that has an accurate understanding of the issues and risks that Banks face. Companies proposed that it would be extremely useful if a South African Regulatory Impact Analysis could be undertaken. Different aspects of regulation affect all businesses in the country, to a greater or lesser extent. An example was given that University College London conducts regulatory impact studies, but no similar research exists in South Africa.

Inconsistent regulatory requirements in other African countries are a challenge when establishing operations in the rest of Africa. (Please refer to 4.2.2. Growth – Expansion into Africa and other Emerging Markets for further details.)

4.2.2 Growth

Growth areas

Within the sub-sector, companies anticipate higher than Nominal GDP Growth in Private Banking, Vehicle and Asset Finance and Business Banking, on par growth in Personal Loans and lower growth in Home Loans.

Consumer Banking in South Africa is sluggish due to a high level of market saturation and companies compete to expand market share. Existing business moves between Retail Banks without a significant increase in new business. Companies differentiate themselves through innovating systems, products and client value propositions. Cheque accounts are attractive as income accounts – this means that there is less risk to the Bank when granting credit to a customer. Holding the transactional relationship with a customer is key and it is far easier to leverage further product offerings off transactional relationships.

It is challenging to entice customers to change Banks in Consumer Banking (R100 000 income per annum and above) as customer loyalty is relatively high. Value-adds and rewards programmes help to retain and attract

customers and customer expect have customised, on-demand services at low costs. Banks reward customer behaviour, for example, by offering lower rates for less costly services like Internet Banking. In the Mass Market segment (below R100 000 income per annum) has a high attrition rate and far less loyalty - customers will move Banks due to a simple price change. Banks have high Debit Order return rates in this segment as customers abandon Bank accounts to avoid Creditors.

The introduction of the National Credit Act and the effect of the 2008 Financial Crisis resulted in slowing of growth in the sub–sector. Increased Capital Adequacy requirements have also restrained the ability of institutions to provide finance to consumers; as a result, growth is no longer credit-led. There has been a marked reduction in credit and housing loans and most Retail Banks believe it is unlikely that growth in unsecured lending will continue as it has in the recent past.

Expansion into the rest of Africa and other Emerging Markets

Most Retail Banks are focussing specifically on expansion into the rest of Africa as a growth strategy and in some cases, other Emerging Markets like India. Partnerships with in-country institutions in the rest of Africa is the preferred means of conducting business as it is difficult to establish operations in existing markets. The partnership method also reduces the impact of present issues and risks associated with setting up business operations in the rest of Africa – specifically expropriation, concessions and indigenisation. Institutions commented that takes time to establish operations and to realise profits – South African Financial Services companies cannot expect to simply transplant an their existing business models into other African countries; each country is different and investigation is required to ascertain the best method in each unique context.

Further challenges around setting up business in the rest of Africa are that countries have different regulatory environments and there is far less maturity around electronic infrastructure; these aspects drive operating costs up and therefore reduce profit margins. For example, a Retail Bank planned to use their South African-based Banking system for their Namibian operations; however, the Regulator stipulated that the system needed to be located in country, resulting in substantially increased costs. Regulators across Africa change requirements erratically and there is no opportunity for negotiation; companies have to work around these issues.

Costs

Staff costs and Information Technology are the two principal overheads for Retail Banks. Most Banks maintaining extensive branch networks and contributes to high costs and operational inefficiencies. Understanding the drivers of each cost and the benefits of each cost is key to profitability. Institutions believe that there will be an overall net reduction in employment in the Retail Banking sub-sector over time.

Profitability has become increasingly important in light of various factors affecting Retail Banks - changing technology that has the potential to eliminate the traditional role of Banks as an Intermediary, new kinds of Retail competitors like Google Pay and the increasing cost of regulatory compliance. Retail Banks focus on profitability through optimisation of processes, operational efficiency, systems automation, diversifying revenue streams and product innovation.

In the past, institutions did not pay much attention to client value propositions. In recent years, there has been a massive drive to innovate and offer improved banking services to clients, using the latest technological developments. The realisation that institutions needed to differentiate themselves from competitors in order to sustain growth drove this change.

Certain institutions believe that internally developed banking systems provide a strategic advantage, as these are agile and sustainable in the long-term and there is no capital depreciation on the balance sheet for implementing expensive external systems like SAP and Oracle. Internally developed systems enable advantages like direct access to customer data, the ability to innovate rapidly and the capacity to launch new products swiftly. They have confidence that the cost, effort and potential operational risks associated with replacing an existing Banking system outweighs the possible benefits of moving onto a new platform. On the other side of the equation, an institution chose to replace the core banking system with an external system at a massive cost – the project includes a complete replacement of all existing Legacy systems. (Please refer to 4.2.2. Growth – Outsourcing for further details.)

Historically, Retail Banking fees have been high in South Africa; mainly due elevated operating costs caused by expensive Legacy systems and extensive Branch networks. The large established Banks prematurely reduced fees in response to serious competition from a new entrant to the sub-sector, before they could complete the process of reducing costs by streamlining processes. Increased competition resulted in improved affordability of Retail Banking, this in turn, has led to a significant reduction in the numbers unbanked individuals in the country.

Retail Banks concede difficulties in measuring the credit risk associated with certain products has resulted in incorrect pricing. High fees provide a buffer for implicit credit risk; it is very difficult to disentangle the cost of credit risk, the margin extracted by the Bank and administration fees associated with products.

The most significant barrier to entry for new Retail Banks is the excessive cost of developing an interface to the existing payment and settlement system. A significant new entrant to the sub-sector bypassed this cost barrier by leveraging off the existing infrastructure of an Investment Bank.

Outsourcing

A Retail Bank commented that they sourced offshore Information technology skills for the project to replace the core banking system and this pushed up their costs tremendously, though they were able to source programming and testing skills from India, a much cheaper location. As a general practice, the company avoids outsourcing wherever possible, despite the fact that it would be cheaper to outsource many business functions. Outsourcing is only undertaken if critical expertise are unavailable in South Africa – for example certain Engineering and Information Technology skills.

Risks to growth

The economy has been slow in the 5 years since the Financial Crisis and this has taken a toll on all businesses. In 2008, the general view was that the economy would be back to normal within 3 years; this has clearly not been the case. South Africa has been in the privileged position of being relatively unaffected by the Financial Crisis in comparison to other markets around the world. However, the macro-economic environment is challenging and this translates into less economic growth overall; businesses are reluctant to make additional investments and increased capacity, which hinders employment growth. Banks have an increasing number of established business clients that have access to funds, but are not making use of the money. Lack of business confidence is a huge issue; companies are very cautious about using financing to expand, due to the uncertain economic environment. Low business confidence restrains growth and the ability of Banks to stimulate the economy.

During the apartheid era, the major Retail Banks invested heavily in an excellent market infrastructure for payments, settlements and clearing. The VISA/MasterCard monopoly on secure electronic payments in South Africa has resulted in high fees for these services; this contributes the perception that the Banking system is inefficient.

Institutions anticipate that it will be difficult for Long–term Insurers to acquire Banking licenses and enter the Banking sub-sector, as traditional Banks may lend against deposit holders money, whereas Life Insurers are not permitted to use Insurance policies as collateral. Rumours around Life companies attempting to acquire Banking licenses appear to be rooted in an attempt to find alternate mechanisms for collecting policy premiums and to avoid paying banking fees. Two Life Insurers have requested the National Treasury to serve as a central clearing settlement agent for premiums. This proposal is currently under review.

Currently the four major Retail Banks in South Africa own the national clearing system (ACB – Automated Clearing Bureau) which operates under South African Reserve Bank oversight. These four Banks generate the bulk of the transactional volume and carry all of the prudential risk associated with ownership of the clearing system. Retail Banks believe that if an independent clearing system becomes a requirement, then ownership of the system needs to shift to a government entity.

Retail Banks also cite credit exposure as a potential risk, especially if global and local interest rates change. Increasing interest rates will adversely affect both the economy and consumers and lead to escalating bad debt.

4.2.3. Education

Training and development

Training and development programmes vary across Retail Banks and most have internally run programmes covering key areas, including Graduate Development, Chartered Accountant Development, Branch Manager Development, Branch Employee Training and Internship programmes.

Tertiary education

Regulation and Compliance roles are have increased in importance and complexity since the Financial Crisis, due to rapidly changing regulation. Retail Banks feel there is no formal education programme that adequately prepares candidates for these roles. Regulation and Compliance staff need to be able to assess legislation and make appropriate recommendations taking into account all aspects; regulatory reporting, compliance requirements, business operations and strategic goals. They need an in-depth understanding of the business

and the Financial Services sector in order to be able to negotiate with business areas to find ways to balance compliance requirements and business needs; this requires high level thinking skills. Some companies suggested that PPE (Politics, Philosophy and Economics) graduates have a range of knowledge that is suitable for these types of roles.

There is a general view that undergraduate degrees do not prepare staff for the roles that they are required to fill. For example, Bachelor of Commerce graduates cannot fill Risk Management roles; UNISA only recently introduced a Bachelor of Commerce specialising in Risk Management. Companies commented that in general graduates with Information Technology degrees lack programming skills, as most universities do not teach software development and programming at undergraduate level.

A certain Institution commented that new types of skills are required in the context of the changing Banking environment. The key requirement is the ability to collaborate, as Retail Banking is a process driven environment built on cooperation. Emotional Quotient (EQ) and the Spiritual Quotient (SQ) are incredibly important – they have opted not to employ very intelligent individuals with excellent strategic thinking skills and a high Intelligence Quotient (IQ) because these candidates would not fit into the organisational culture. Being part of a team means there is no possibility for individual greatness – qualities like the ability to work with others, to influence without power and to make friends are extremely important, especially at senior level. The issue of IQ is not hugely relevant as most people are smart enough – the important question is whether a person can stimulate a team to achieve a particular outcome.

Tertiary education provides an essential foundation, but certain skills require a level of exposure before learning can occur. The following key attributes differentiate individuals in the working environment; making sound judgments, influencing people and situations and the ability to consider the factors of larger society and the context of the environment when making business decisions. University programmes are isolated and narrowly focussed; graduates of business programmes do not have exposure to the classical education that promotes flexibility in thinking and this makes it impossible to create meaning. The purpose of a Leader is to create meaning, to put business into context and translate to people how they have contributed to the world.

In general, business degrees are too specialised and focus on providing technical skills, but lack practical application. For example, a Chartered Accountant should be able to understand a Credit Scorecard after a day of training, not after a week. A Credit Scorecard is multi-layered, but it is still a Regression Analysis. It seems that most individuals at university tend to learn things literally and do not actually understand the overall gist of the topic – the result is an inability to translate theoretical knowledge into practical application. However, learning and the internalisation of learning takes time and this is a subordinate issue to the other factors mentioned.

The same Institution runs a traditional Graduate Development Programme that takes about 50 graduates per year from standard Financial Services sector disciplines. They also run a Graduate Development Programme for unemployed graduates that do not have standard business qualifications normally required by Financial Services. They take approximately 1000 graduates per year, from a wide variety of disciplines, including Biblical Studies, Languages, Music and Philosophy. This introduces much needed diversity in thinking skills into the organisation.

4.2.4 Skills deficits

Retail Banks consistently stated that Information Technology skills are in high demand and roles are difficult to fill, specifically Java and COBOL Developers, and Business Analysts. SAP or other specialist programming skills are virtually impossible to find. Systems Developers are particularly difficult to retain, partly as banking systems use specific programming languages that are not necessarily widely used anymore. Developers often leave institutions gain wider technical development experience. In addition, Information Technology candidates in Banking are required to have a high cognitive capacity; often, qualified candidates do not meet pre-employment Psychometric testing requirements.

Branch Managers are required in large numbers across the sub–sector and there is competition between institutions for trained Branch staff. There is an on-going need for Actuaries and Masters of Business Administration (MBA) graduates and Quantitative skills are highly sought after, specifically for data analysis.

The number of Chartered Accountants employed by one of the surveyed institutions is limited, as the lack of role variety does not encourage staff to remain with the institution for an extended period. As a result, they focus on graduates that have basic Accounting skills and the ability to forecast Financial Statements instead.

Staff with regulatory knowledge are in high demand; specifically with an understanding of Bank for International Settlements (BIS) and Basel III regulations. One institution mentioned that they have great difficulty filling two

regulatory vacancies and have very few applicants. These roles require a combination of skills; specifically the ability to influence and work with Regulators to negotiate the best method of implementation of legislation, thus ensuring a win-win outcome for all parties. There is strong competition between Retail Banks for these particular skills and salaries have become inflated as a result. Institutions have difficulty in benchmarking the appropriate salary for newer Regulatory and Compliance roles. Compliance Officers are at a lower hierarchical level than Chief Financial Officers, yet remuneration is comparable due to the high demand and level of accountability of the role.

The perception of a certain institution is that the kind of people that are required is fundamentally changing and that Engineers may run Banks in the future. The drive towards cost reduction means that the focus is on Process Engineering – this requires serious end-to-end process design and management. They seek out candidates with this type of experience that would have previously entered the Manufacturing sector.

4.2.5 Recruitment

Retail Banks commented that certain vacancies are particularly difficult to fill as new roles have emerged and graduates with traditional professional qualifications do not meet the requirements. (Please refer to 4.2.4. Skills deficits and 4.2.3. Education – Tertiary education for further details.)

4.3 Investment Banking - Interviews

4.3.1 Regulation and Compliance

Investment Banks noted that the primary Regulator for the Banking sub-sector is the South African Reserve Bank (SARB) and to a lesser degree the National Credit Regulator (NCR), the Financial Intelligence Centre (FIC), the Johannesburg Stock Exchange (JSE) amongst others. Each authority currently regulates an aspect of Market Conduct and Consumer Protection or Prudential Conduct within their jurisdiction. The main change with the Twin Peaks implementation is that the SARB will become the Market Conduct Regulator and the FSB the Prudential Regulator. The core difference is that both will have equal status for Financial Services companies, whereas until now, the Banking sub-sector has been regulated predominantly by the SARB, and Insurers and Asset Managers by the FSB.

Companies agree that the underlying cause of the Financial Crisis in other economies was due to deregulation. The stability of the Financial Services sector in South Africa is largely because it has always been highly regulated. Countries with a concentrated Banking sub-sector like South Africa, Australia and Canada seem to be less vulnerable, whereas, the large number of Banks in countries like the United States led to increased competition and a related escalation in risk-taking.

Due to the global nature of finance, it is important that South Africa has a reputation for upholding the highest standards of Banking regulation. This was the key driver for South Africa to be an early adopter of Basel III - it is a badge of honour. It affects the country's Standard and Poor's rating and the ability of Financial Services companies to operate in global markets. In addition, global regulation on securitisation has changed as Regulators made a conscious decision to sacrifice growth for financial stability - they are striving to reduce the overly dominant role of finance in favour of greater stability in economies. As far as relationships with Regulators is concerned, it is inevitable that a healthy tension will exist between Financial Services institutions and their Regulators.

Regulation is appropriately conservative and intrusive and this is the reason that South African investors do not have to apprehensive about their savings and investments vanishing due to Banking failures. However, for regulation to be effective, it should have certain characteristics. Regulation should be unambiguous, compliance requirements clearly outlined and adequate time allocated for companies to prepare for the implementation of regulation. Reporting requirements ought to be rationalised to prevent companies from having to submit the same information to multiple Regulators in slightly different formats. Companies suggested that conducting regulatory impact assessments before implementing new regulation would be of great benefit, as authorities would have a more holistic picture of the impact of the combined effect of different regulation.

There is consensus that the current system of multiple Regulators causes duplication of effort in regulatory reporting, as there are major overlaps in reporting requirements for legislation. As a result, the reporting process is onerous – Investment Banks are optimistic that Twin Peaks will address this issue when existing Regulators consolidate into the two pillars; this should enable a more inclusive view of regulatory reporting. Institutions hope that over time a streamlining process will take place that eliminates overlaps in existing regulation and results in less arduous regulatory reporting.

Basel III is the third iteration of Basel regulation. In South Africa, Investment Banks view Basel III as a further layer added to existing regulation and not a major change. The core feature of Basel III is an increased focus on liquidity to ensure the soundness of Banking institutions; there are two aspects, an implicit and an explicit liquidity guarantee. The implicit liquidity guarantee means that Banks have to be able to withstand a run of 30 days of stress to liquidity, where the taxpayer is not required to meet the liabilities of a Bank in the event of Bank failure. The explicit liquidity guarantee is a Liquidity Fund created by SARB, which Banks are required to contribute to and can access in the event of liquidity challenges. Overall, Basel III should not have a significant impact as institutions already operate using prudent economic principles instead of attempting to take advantage of existing regulations (regulatory arbitrage). The bulk of the new Basel III requirements already form part of existing reporting structures.

4.3.2. Growth

Growth areas

Investment Banking services are dependent on the performance of the wider economy in South Africa. A key focus of growth strategies is the innovation and evolution of client value propositions. Companies expect steady growth above Nominal GDP in Flow Business (regular trading, transactional and investment activities), Private Equity, Alternative Investments, Financing and Restructuring. Market Making and Advisory activities are anticipated to be lower or on par with Nominal GDP growth due to the current slow economic conditions. Global Markets should remain a smaller component of business as derivatives trading has become more expensive under Basel III.

One Investment Bank mentioned that they restructured after the Financial Crisis with the intention of reducing operational risk in line with the stringent capital adequacy requirements of Basel III. Market risk arising from trading activities declined because of a decision to exit outright proprietary trading. The company now focuses predominantly on passive client–based activities like market making in local markets and client facilitation, instead of speculative trading. They strictly monitor and manage market risk exposures for new and existing business, and risk appetite and limits are set in relation to the size of the earnings and capital base.

Expansion into the rest of Africa and other Emerging Markets

Most Investment Banks typically have a presence in the rest of Africa and other Emerging Markets. Market penetration and services vary and can include infrastructure development projects, transactional services, corporate debt facilities, funding solutions and advice relating to interest rate, currency and commodity exposures.

Investment Banks that fall under Holding companies with Retail Banking divisions typically utilise their existing Retail Bank infrastructure in foreign locations – this reduces expansion costs. Existing clients gain from the opportunity to diversify their investment exposure into the rest of Africa and other Emerging Markets. Mergers and partnerships with existing institutions is the preferred method of expansion as this reduces the impact of the risks associated with establishing operations in developing countries.

Payment risk is a particular issue for Investment Banks operating in the rest of Africa. Institutions provide support and transactional services for clients trading with African countries. All transactions are subject to dual FICA and diligence related processes – firstly, between the in-country Bank and the client and secondly, between the South African Investment Bank and the in-country Bank. Local institutions therefore play a fiduciary role in ensuring the legitimacy of the client and the details of the transaction. This is an inefficient process, which is ultimately a hindrance to growth on the African continent.

Investment in the rest of Africa is a long-term strategy where it takes a lengthy period before reasonable profits can be realised. Typically three markets are identified; 'mature markets' where growth is possible over a short interval, 'invest and grow' markets where growth takes longer and 'green fields' markets where a substantial investment only generates revenue after an extended period.

Costs

Investment Banks stated that over time regulatory changes have led to additional costs in terms of systems development to cater for additional reporting requirements and specialist staff for critical Regulation and Compliance roles. Senior management also spend between 25 and 30% of their time on regulatory issues.

Outsourcing

Generally, companies prefer not to outsource business functions, and prefer to develop skills within South Africa as this contributes to development and economic growth. Outsourcing often has hidden costs that only become

apparent after a period of time, resulting in less cost saving than initially anticipated. One company mentioned that they opted to send a number of Information Technology graduates to India for training rather than resorting to outsourcing to meet these skill requirements.

Risks to growth

Companies mentioned various international issues that could potentially impair world economic growth; the worsening of the economic crisis in the Europe region, the "Fiscal Cliff" threat in the United States and the slowdown of economic growth in China. (Please refer to 10.1. Appendix 1 – Risks to growth, excerpt from United Nations, 2013 World Economic Situation and Prospects, for further details.)

One Investment Bank expressed concern over South Africa's Liquidity Risk – in particular, the National Treasury tends to use short–term, relatively volatile assets to fund deficits in the current account, instead of longer–term or more stable assets. This makes the country vulnerable to international economic events that influence the economy via the financial markets through "risk–on" and "risk–off" trades. South Africa appears to be weaker than other Emerging Markets in this regard and has had more "risk–off" trades during international economic events; this has a negative impact on the value of the Rand.

Investment Banks do not view government products like the RSA Retail Savings Bond as a threat, provided the government competes fairly, which is not currently the case. For example, FICA requirements do not have to be adhered to when consumers purchase the RSA Retail Savings Bond; this reduces the cost of the product and gives the government an unfair competitive advantage. Unfair competition has not become a major issue yet, as the RSA Retail Savings Bond has not gained momentum due to poor distribution, but may do so in the future.

4.3.3 Education

Training and development

Investment Banks use Graduate Development Programmes as a key strategy to meet skills requirements. Over time, such programmes significantly reduce specialist skills deficits via a steady supply of graduates. Institutions realise that it is not feasible to expect such individuals to be usefully productive immediately due to a lack of work experience. Employee development programmes provide a sustainable method of addressing the on-going issue of shortages of experienced, skilled individuals in South Africa. A particular company mentioned that the investment in each graduate is in the region of R500 000.00 over an 18 month period.

Tertiary education

An Investment Bank stated that they struggle to make placements in the regulatory area, as candidates do not have a broad enough range of skills to meet the role requirements. For example, when examining the impact of legislation, a Lawyer struggles to assess the larger economic, political and business implications. Most candidates who are a product of the South African university system do not have critical thinking skills and the broad knowledge to meet the requirements of evolving roles. Complex problems require multi-disciplinary solutions; the company identified Philosophy, Politics and Economics (PPE) as the degree providing the closest possible foundation for the diverse expertise needed for regulatory roles. The company further commented on the requirement for a postgraduate qualification that teaches Prudential, Market Conduct and Financial Crime regulation, as well as the context of South Africa's development needs and economic environment.

Companies generally view the structure of South African undergraduate degrees towards entering a specific profession as a weakness of the South African education system. In the United Kingdom and the US undergraduate degrees are generalised and specialisation only takes place at postgraduate level, this produces graduates that have superior thinking skills.

4.3.4 Skills deficits

Investment Banks made the following comments regarding skills deficits in the sub-sector:

There is a critical shortage graduates with Quantitative and Mathematical skills in Investment Banking.

Information technology skills are scarce and graduates with Computer Engineering, Computer Science and Information Systems degrees are particularly difficult to find. A particular institution regularly employs traditional Engineers; these are also in short supply.

Banks absorb large numbers of Bachelor of Commerce, Bachelor of Business Science graduates and Chartered Accountants; there is a reasonably well established pipeline of graduates in these areas.

4.3.5 Recruitment

There are various levels of recruitment difficulties experienced by Investment Banks.

Women do not seem to be attracted to Information Technology roles and it is difficult to implement gender equality in this area. There is a general shortage of Information Technology skills in the country and Financial Services is not the first choice for these candidates; as a result, companies across the sector have to work much harder to attract applicants.

An institution mentioned that over time they have come to realise that if they are going to be able to address gaps in the Middle Management tier, they need to consider individuals that come from a non-Banking background, but have skills that are easily transferred into Banking. It is easy to fast track these type of individuals through professional and associate programmes, for example, Masters of Business Administration degrees.

5. Insurance

5.1 Overview of the Insurance sub–sector

5.1.1 Economic Context

"Insurance is the equitable transfer of the risk of a loss, from one entity to another in exchange for payment. It is a form of Risk Management primarily used to hedge against the risk of a contingent, uncertain loss." (*Source: Wikipedia, Article: Insurance)*

"Insurance, a system under which the Insurer, for a consideration usually agreed upon in advance, promises to reimburse the Insured or to render services to the Insured in the event that certain accidental occurrences result in losses during a given period. It thus is a method of coping with risk. Its primary function is to substitute certainty for uncertainty as regards the economic cost of loss-producing events." *(Source: Encyclopaedia Britannica)*

In its most elemental form, Insurance refers to a form of Risk Management, which is available to all who wish to transfer the cost of a potential loss onto another entity, in exchange for a periodic monetary contribution, commonly referred to as an Insurance premium. Insurance therefore allows individuals, households, corporates as well as other entities to protect themselves against a significant potential financial loss at an affordable cost. The word "significant" is imperative, as the potential loss needs to be a substantial monetary amount, to warrant the need for one to seek and pay for Insurance.

Most research and academic studies have focused on the importance of Banking systems and Securities markets to the functioning, development and growth of the economy. Little, no or merely passing attention has been paid to the importance and role of Insurance in economic development. While financial markets, the Banking system and Insurance are all inter-related, Insurance serves rather different economic functions as opposed to the aforementioned conventional Financial Services. Due to the unique role of Insurance within an economy, it also requires a rather unique set of conditions in order to flourish and to contribute fully. Recently, some studies have begun to unearth the specific contributions of Insurance to the growth of an economy as well as to the well-being of the poor. Overall, most research reveals that Insurance contributes significantly to economic growth via improvement of the investment climate and the promotion of a more efficient and diverse set of economic activities – a large proportion of which would not be usually considered, in the absence of Insurance or Risk Management activities. Further evidence of the material yet subtle role fulfilled by the Insurance sector is the associated growth and development in the rest of the Financial Services sector.

Several empirical studies suggest that Life Insurance, in general, has a substantial impact on growth in wealthier countries – since Life Insurance constitutes a relatively small component of the total Insurance market in poorer countries. Non-life Insurance, on the other hand, appears to contribute to growth at many different levels of development across all countries. Indeed, in general, there exists a strong positive relationship between income and Insurance coverage or penetration in any given country. Nonetheless, the relationship that exists between Insurance consumption and income, at lower levels of income, is rather disparate. It is not entirely clear whether lower income levels reduce the demand for Life Insurance products and the associated supply side constraints (regulatory and supervisory environments, and their associated impact on the cost of Insurance).

Apart from being a catalyst for economic growth and development, the risk management mechanism of Insurance also provides a strong case for social Insurance for the poor, from a social welfare perspective. Those that

are living below the poverty line are particularly vulnerable to catastrophic shocks to income and consumption, which warrants the need for some type of social risk management system. Moreover, the escalating interest in Microinsurance[8] pays testament to this observation, as increasing numbers of private non-profit or charitable entities are considering Microinsurance as a viable alternative to conventional Insurance for the poorest segments of society.

As explained by Brainard (2008), Insurance fulfils various economic functions that are distinct from other financial institutions. In order to understand the Insurance sector, it helps to focus on services that are unique to the sector and not provided by other financial institutions (excluding the contractual savings features of Universal Life products). More formally, Brainard (2008) describes the role of Insurance in financial systems and the broader economy as follows:

- The indemnification and risk pooling properties of Insurance facilitate commercial transactions and the provision of credit by mitigating losses as well as by the measurement and management of non-diversifiable risk more generally.
- Typically, Insurance contracts involve small periodic payments in return for protection against uncertain, but potentially severe losses. Among other things, this income smoothing effect helps to avoid excessive and costly bankruptcies and facilitates lending to businesses.
- Most fundamentally, the availability of Insurance enables risk averse individuals and entrepreneurs to undertake higher risk, higher return activities than they would do in the absence of Insurance, promoting higher productivity and growth.
- The management of risk is a fundamental aspect of entrepreneurial activity. Entrepreneurs manage the risk of accidental loss by weighing the costs and benefits of each alternative. In a structured risk management process, this involves: (1) identifying the exposures to accidental loss; (2) evaluating alternative techniques for treating each loss exposure; (3) choosing the best alternative; and (4) monitoring the results to refine the choices. Those who do not apply a structured process still make decisions about risk, although sometimes by default rather than design. The scope of an economy's Insurance market affects both the range of available alternatives and the quality of information to support decisions. A manufacturer might only produce for the local market and forgo lucrative opportunities in distant markets, in order to avoid the risk of losing goods in shipment, Transport Insurance can mitigate this loss exposure and enable the manufacturer to expand. Similarly, to avoid the risk of total loss from drought, a commercial farmer may keep half of his seed in reserve. Crop Insurance can protect against drought – this enables a farmer to plant all of the seed for a smaller premium than the cost of holding half in reserve. Thus, public policies that encourage Insurance operations improve the economy's productivity by broadening the range of investments.
- Insurers also contribute specialised expertise in the identification and measurement of risk. This expertise enables them to accept carefully specified risks at lower prices than non-specialists. They also have an incentive to collect and analyse information about loss exposures - the more precisely Insurers measure the cost of risk, the more they can expand. As a result, the Insurance market generates price signals to the entire economy, helping to allocate resources to more productive uses.
- Insurers also have an incentive to control losses, which is a significant social benefit. By offering discounts for seat belts, smoke detectors, or other measures that reduce the frequency or severity of losses, they lower their eventual claims costs, in the process saving lives and reducing injuries.
- On the investment side, due to the long-term nature of their liabilities, sizeable reserves, and predictable premiums, Life Insurance providers can serve an important function as institutional investors providing capital to infrastructure and other long-term investments as well as professional oversight to these investments. Of course, these benefits are fully realised only in markets where Insurance providers invest a substantial portion of their portfolios domestically.
- The net result of well-functioning Insurance markets should be better pricing of risk, greater efficiency in the overall allocation of capital and mix of economic activities, and higher productivity. Importantly, these unique functions of Insurance should be complementary to the Banking and Financial Services sector deepening more broadly. For instance, Insurance facilitates credit transactions such as the purchase of homes and cars and business operations, while depending in turn on well-functioning payment systems and robust investment opportunities.

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8 Microinsurance is the protection of low-income people against specific perils in exchange for regular premium payment proportionate to the likelihood and cost of the risks involved. This definition is exactly the same as one might use for regular Insurance except for the clearly prescribed target market: low-income people. The target population typically consists of persons ignored by mainstream commercial and social Insurance schemes, as well as people who have not previously had access to appropriate Insurance products.

5.1.2 Types of Insurers

The following is an extensive, yet possibly non-exhaustive, description of the various types of Insurers or Insurance Divisions of larger Financial Services institutions that are functional in the global economy.

Life versus Non-life

In general, Insurance companies may be categorised into two broad groups, viz. Life Insurance companies and Non-Life or General Insurance companies. Life Insurance companies sell Life Insurance, Annuities and Pension products. Non-Life Insurance companies deal with more general types of Insurance or Risk Management, for e.g. Vehicle-, Property-, Casualty-, Liability Insurance, etc. In most countries, Life and Non-life Insurers are subject to different regulatory regimes and different tax and accounting rules. The main reason for the distinction between the two types of company is that Life, Annuity, and Pension business is very long-term in nature - coverage for Life Assurance or a Pension can involve risks over many decades. By contrast, Non-life Insurance cover usually covers a shorter period, such as one year.

Mutual or Proprietary

Insurance companies are generally classified as either Mutual or Proprietary companies. The Policyholders own Mutual companies, while Shareholders (who may or may not own policies) own Proprietary Insurance companies. Demutualisation of Mutual insurers to form stock companies, as well as the formation of a hybrid known as a Mutual Holding company, became common in some countries, such as the United States, in the late 20th century. Other possible forms for an Insurance company include Reciprocals, in which Policyholders reciprocate in sharing risks, and Lloyd's organisations.

Reinsurance

Reinsurance companies are Insurance companies that sell policies to other Insurance companies, allowing them to reduce their risks and protect themselves from very large losses. A few very large companies, with huge reserves, dominate the Reinsurance market. A Reinsurer may also be a direct writer of Insurance risks as well.

Captive

Captive Insurance companies are limited-purpose Insurance companies established with the specific objective of financing risks emanating from their parent group or groups. This definition can sometimes extend to include some of the risks of the parent company's customers. In short, it is an in-house Self-insurance vehicle. Captives may take the form of a "pure" entity (which is a 100% subsidiary of the self-insured parent company); of a "mutual" captive (which insures the collective risks of members of an industry); and of an "association" captive (which Self-insures individual risks of the members of a professional, commercial or industrial association). Captives represent commercial, economic, tax advantages to their sponsors because of the reduction in costs they help create, and for the ease of Insurance Risk Management and the flexibility for cash flows, they generate. Additionally, they may provide coverage of risks that is neither available nor offered in the traditional Insurance market at reasonable prices.

The types of risk that a Captive can underwrite for their parents include property damage, public and product liability, professional indemnity, employee benefits, employers' liability, motor and medical aid expenses. The Captive's exposure to such risks may be limited by the use of reinsurance.

Captives are becoming an increasingly important component of the Risk Management and Risk Financing strategy of their parent, in the context of the following background:

- Heavy and increasing premium costs in almost every line of coverage;
- Difficulties in insuring certain types of fortuitous risk;
- Differential coverage standards in various parts of the world;
- Rating structures which reflect market trends rather than individual loss experience;
- Insufficient credit for deductibles and/or loss control efforts.

Insurance Consultants

There are also companies known as 'Insurance Consultants'. Similar to a Mortgage Broker, customers pay an Insurance Consultant a fee to shop around for the best Insurance policy amongst many companies. An 'Insurance Broker' also shops around for the best Insurance policy amongst many companies. However, Insurance Brokers receive a fee, usually in the form of commission from the selected Insurer rather than directly from the client.

Insurance Consultants or Insurance Brokers do not bear the risks of Insurance transactions – therefore they not classified as Insurance companies. Third party administrators are companies that perform Underwriting and sometimes claim handling services for Insurance companies. These companies often have special expertise that the Insurance companies do not have.

The financial stability and strength of an Insurance company should be a major consideration when buying an Insurance contract. An Insurance premium paid now provides coverage for losses that might arise many years in the future. For that reason, the viability of the Insurance carrier is very important. In recent years, a number of Insurance companies have become insolvent, leaving their Policyholders with no coverage (or coverage only from a government-backed Insurance pool or other arrangement with less attractive payouts for losses). A number of independent Rating Agencies provide information and rate the financial viability of Insurance companies.

5.1.3 South African Context

South Africa is the leading Insurance market in Africa and ranks as one of the world's top 20 markets for both Life and Non-life Insurance. Based on research compiled by Swiss Re in 2012, South Africa maintains a ranking in the world's top 20 markets for both Life and Non-life premiums. The Life and Non-life markets will continue to hold their 13th and 19th positions by 2021.

South Africa has developed an Insurance sector that is substantial in terms of size, soundness and sophistication. This is a result of the stability of South Africa's financial and economic system, the rigidity of the legal system and the robustness of the financial supervisory and regulatory framework. These strengths constitute a favourable foundation for the local business environment, which encourages households and corporate entities to trust the credit worthiness of financial institutions and their ability to fulfil current and future liabilities. Moreover, the emergence of a financially astute and relatively wealthy middle and upper class population demographic, albeit a minority in relation to the entire population, has also provided impetus for growth in the Insurance sector.

As with the Banking component of the South African Financial Services system, the Insurance sector has evolved in a similar fashion with strong similarities in corporate and competitive structure within the industry. The distribution of organisations is somewhat bipolar in nature – a small number of large companies and a large number of small companies dominate the industry. Historical political circumstances are a fundamental driver of size concentration issues, as South African companies had limited access to capital due to past political sanctions.

Accordingly, the Life Insurance sector, for instance, has developed analogously to the Banking sector where four major diversified Insurance and Savings institutions are prominent, with each having some form of commercial and financial relationship with each of the respective major Banking institutions. These corporate relationships between the Insurance and Banking sectors have proved to be highly beneficial, especially at the initial developmental stages of the Insurance industry, as companies were able to take advantage of existing Banking networks to market and distribute their products. Now though, Life Insurers have a significant presence, absolutely dominating the long-term savings industry in South Africa, with innovative product development capability, substantial brand value, and sales and distribution networks.

With regard to the Non-life Insurance sector, a similar concentrated corporate structural pandemic has materialised. However, an overall robust economic framework combined with financially adept economic agents has been the catalyst for significant sophistication in the Non-life Insurance sector – to the extent that one may draw several parallels between the local sector and it's more developed global counterparts, barring specific fundamental social, political and geographical considerations.

According to the Financial Services Board (FSB), the statutory independent organisation constituted to regulate and supervise the Non-banking Financial Services industry; there were 193 Insurers registered and operational in South Africa as at March 2012 (FSB Annual Report, 2012). There are 193 registered Insurers, classified as 87 Long-term Insurers and 106 Short-term Insurers. Further, there are two Insurance trade associations that are active in South Africa – the South African Insurance Association (SAIA) is the representative body for Short-term Insurers (58 members), while the Association for Savings and Investment South Africa (ASISA) represents Life Insurance corporations (21 voting members, 89 non-voting members). According to INSETAs (Insurance Sector Education and Training Authority) Sector Skills Plan for 2011 - 2016, 1 774 companies were registered with INSETA. Of this total, 108 organisations are considered as large (having 150 or more employers), 83 are considered medium-sized (having between 50 and 149 employers, inclusive), while 1 583 organisations are considered as small (having less than 50 employers). Moreover, these registered Insurers employed approximately 111 840 skilled and highly skilled people between April 2011 and March 2013 – more granularly, large organisations employed 94 002, medium-sized institutions employed 7 211, while small companies employed 10 627 people.

As previously stated, a small number of large diversified Insurers with strong associations to the four major Banking institutions dominate the South African Insurance sector. In particular, one should make note of the following organisations and associations:

- Old Mutual is a shareholder in Nedbank, owning 55% of the Bank, while its South African operations also include Nedgroup Life, NGIB and Mutual & Federal Insurance (second largest Non-life company in South Africa);
- Liberty Holdings, the holding company for Liberty Group is owned by Standard Bank;
- MMI Holdings, which was formed via the merger of Metropolitan and Momentum Group (previously a component of the FirstRand Group) still has a strategic relationship with the FirstRand Group, while OUTsurance also forms part of the FirstRand stable;
- ABSA is more directly involved in the Insurance sector and is active in the Bancassurance space, while also having various subsidiaries that are operating in both the Life and Non-life Insurance sectors.

Another notable organisation in the local market is Sanlam (Old Mutual's rival for largest Life Insurer) which also owns a majority shareholding in Santam – the leading Non-life Insurer in the South African market. One should also note the existence of Hollard, one of South Africa's largest privately owned companies, which operates in various segments of the Insurance market; as well as Discovery, a specialist Healthcare Insurer. The South African market is also open to foreign competition with companies like Zurich, Chartis, ACE and Allianz having a substantial local presence in both segments of the market to varying degrees.

5.1.4 Operational/Functional Context

Business Models

The main source of revenue for Insurers is the premium earned from holders of Insurance contracts. Insurance premium calculations take into account the level of cover provided along with the associated claim probability, given various fundamental factors related to the nature of the Insurance provided and the specifications of the contract.

Insurance companies ensure sufficient liquidity to meet current and future claims through prudent investment, while ensuring profitability and growth for shareholders of the Insurer. Accordingly, in its most basic form, the income generating process for Insurance companies is rather simple and may be summarised as net profit is equal to net premiums earned plus investment income less claim costs, reinsurance costs, government taxies and levies, salaries and other administrative expenses.

More formally, from a financial perspective, one may describe the revenue generation process of an Insurance company as follows:

Net P/L = [Insurance P/L] + [Investment Income from Shareholders Fund]
– [Tax and Other Costs],

where

[Insurance P/L] = [Underwriting P/L]
+ [Investment Income from Technical Reserves],

and where

[Underwriting P/L] = [Net Earned Premium] – [Net Claims Expenses]
– [Underwriting Expenses].

Beginning from the lowest level, the components of the income generating process are:

- **[Net Earned Premium]** – The Gross Earned Premium less Reinsurance Costs, where Gross Earned Premium refers to the total amount of premiums received from policyholders and Reinsurance Costs refers to premiums paid to Reinsurance companies to mitigate risks on certain perils.
- **[Net Claims Expenses]** – The gross amount paid out on claims made by policyholders, which includes the cost of processing claims, less any recoveries (reinsurance, salvage, third parties, etc.) arising from the gross claim.

- **[Underwriting Expenses]** – These are costs associated with researching risk and determining appropriate premiums, administering policy information, marketing, distribution, etc.
- **[Underwriting P/L]** – This is the profit/loss made from the core Insurance business, before any investment income considerations.
- **[Investment Income from Technical Reserves]** – This is the income received from investments that were made using policyholders funds, or rather, funds received from customers paying their premiums.
- **[Insurance P/L]** – This is the profit/loss calculated by adding the Net Earned Premium to the Investment Income from Technical Reserves and subtracting Claims and Underwriting Expenses.
- **[Investment Income from Shareholders Fund]** – This is the income received from investments made using the shareholders' funds. These investments are usually more aggressive than those made using Technical Reserves.
- **[Tax and Other Costs]** – These represent the relevant taxation costs and other company specific costs (interest, amortisation, etc.).
- **[Net P/L]** – This is the final net profit/loss after allowing for income taxes and other company specific costs.

Naturally then, there are four key components which form the foundation of any Insurance company's core business model, and is fundamental to the successful implementation of any Insurance business strategy. These may be summarised as follows:

- **Underwriting** – This refers to the process by which an Insurer selects the risks he/she wishes to insure and decides on the appropriate premium to charge in exchange for bearing such risks. This is the most complex feature of the Insurance business, which encompasses the use of Actuarial Mathematics and Statistics to infer the appropriate premiums for bearing the respective risks embedded in each Insurance policy. After employing Mathematical and Statistical techniques to model the risks and the associated rates and probabilities of occurrences of claims-inducing events, the Insurer will usually overlay an extra layer of discretion when accepting or rejecting specific risks – broadly, this defines the Underwriting process.
- **Investing** – Insurers have two sources of investment income, that derived from the investment of technical reserves (commonly referred to as float or available reserves) and that derived from the investment of shareholders' funds. Technical reserves refer to the amount of money that an Insurer has on hand at any given moment in time, which is essentially the accumulation of Insurance premiums in excess of claims. A robust investment process and strategy for both Insurance and Shareholder's proceeds is pivotal to the viability of an Insurance business. During adverse economic periods when the Underwriting process is fallible, a robust investment process would serve to diversify profitability (and vice versa). Nonetheless, this is a non-trivial task, as bearish economic periods are commonly associated with poor underwriting profitability as well as financial market performance. The Underwriting or Insurance cycle is the terminology commonly used to refer to the ebb and flow of Insurers' profitability over time through different economic cycles.
- **Claims** – Claims and the associated management of losses is the ultimate product offered by the Insurance industry. Insurance company claims departments employ a large number of Claims Adjusters supported by a staff of records management and Data Entry Clerks. Incoming claims receive a severity classification and are assigned to Adjusters whose settlement authority varies with their knowledge and experience. The Adjuster undertakes an investigation of each claim, usually in close cooperation with the Insured, determines if coverage is available under the terms of the Insurance contract, and if so, the reasonable monetary value of the claim, and authorises payment. In managing the claims handling function, Insurers seek to balance the elements of customer satisfaction, administrative handling expenses, and claims overpayment leakages. As part of this balancing act, Insurers have to manage fraudulent Insurance practices, which are a major business risk. Disputes between Insurers and Policyholders over the validity of claims or claims handling practices occasionally escalate into litigation.
- **Marketing** – As with most other industries, effective marketing and distribution is critical to the success of Insurance institutions. Insurers will often use Insurance agents to initially market or underwrite their customers. Agents can be captive, meaning they write only for one company, or independent, meaning that they can issue policies from several companies. The existence and success of companies using Insurance Agents is likely due to improved and personalised service.

The South African Insurance sector is among the most innovative, agile and progressive risk markets in the world. The long-standing favourable history of the sector justifies these notions, supported by strong evidence of an innovative business model, product and distribution channel interventions and solutions. Concurrently, however, the sector is sufficiently fragmented to be characterised as a complex non-homogenous market. This characterisation is a

function of South Africa's socioeconomic disparity, given a large population with vastly different economic and demand attributes for each of the respective population segments. As a consequence of this differentiated market structural phenomenon, a diverse range of business models are viable and competitive, however there are the common themes of quality of product and customer service that pervades all such strategies. Research undertaken by NMG Consulting Group ("South Africa Life Insurance Insights Report 2012"), PWC ("Strategic and Emerging Issues in South African Insurance 2012") and KPMG ("The South African Insurance Industry Survey 2012") substantiates this view.

In light of the non-homogenous development and evolution of the South African Insurance sector, the corresponding Insurance organisations have grown and matured in a manner that contrasts with that of their peers and other comparable organisations in developed markets. While Insurance sectors in most jurisdictions across the world have focused on competition from a pure pricing perspective, combined with a drive toward a standardised and commoditised product suite facilitated by automated, efficient and effective service, South African Insurers appear to focus on a broader set of factors in order to differentiate their organisations and cultivate competitive advantages. Urbanisation and the emergence of a sizeable upper and middle class underpins the majority of the growth in the local Insurance industry. Insurers have taken advantage of the risk-aware and risk-averse nature of the aforementioned demographic group, with the lack of state provided "safety-nets" providing further support, thereby catalysing the demand for Insurance products.

International Insurers or rather those that operate in first-world developed markets strive toward convergence in risk management processes and practices, and standardised underwriting, product features and pricing mechanisms. South African Insurers demonstrate the complete opposite behaviour – diverging in their strategic and operational behaviour. Specifically, there is a high degree of product differentiation amongst Insurers, coupled with varying approaches to Underwriting and Risk Management. While pricing is still relevant and competitive, the diversified product offerings and idiosyncratic assessment and management of risks imply that there are significant allowances for price variations amongst Insurance companies. The fragmented and differentiated needs of different segments of the population along with the unique nature of South Africa's underlying risk exposures support disparate levels of pricing. Operational efficiencies and quality customer service are still of paramount importance, however each organisation face their own specific challenges in this regard, considering the nature of their offerings.

Given South Africa's unique population dynamic, a vast array of non-price related factors are responsible for driving the flow of business to respective Insurance organisations. These industry dynamics are considered to be favourable, as the client has at his/her disposal a significant amount of product flexibility while Brokers and Insurers alike, have access to sufficient profit margins, provided that the market demand can be stimulated and captured. Nonetheless, such diversity and differentiation also creates complexity across all aspects of the organisation, escalating costs and amplifying supply-side constraints. In addition, highly complex and costly business models may only be relevant and applicable for the upper segments of the population, thereby creating hindrances to penetration and growth in lower income segments of the population. The cost of such complex business models, flexible product suites and innovative risk management techniques becomes even more burdensome when considered in the guise of the continuously evolving regulatory environment.

Building on the theme of business and operational models, NMG Consulting also considered the ease with which new Insurers can penetrate and compete in the South African market. Internationally, the general trend appears to favour dominance on the part of older organisations with an established record of accomplishment, irrespective of their competitiveness with regard to pricing or product offerings. However, in South Africa, low barriers to entry to the Insurance market have seen a constant stream of new competitors entering the corporate fray. In fact, a survey conducted by the NMG Consulting Group as part of the previously mentioned research paper, notes that the top three Insurers, ranked on Broker perceptions in terms of competitiveness from a value perspective, are recent entrants to the South African market.

One should also take note of the distribution channels available to South African insurers. The local market has almost every type of distribution method, viz. Bancassurance, Direct/Affinity Channels, Productive Agencies, Independent Financial Advisors (IFA's) and variants thereof. In their research document ("South Africa Life Insurance Insights Report 2012"), NMG Consulting note that distribution channels, in particular the Broking industry, are as fragmented as the markets they service. This implies that relatively small Insurance Intermediaries are still financially viable. Nonetheless, the level of differentiation and fragmentation presents significant challenges from a cost perspective when viewed in the light of the changing regulatory environment. NMG Consulting further note that parts of the Insurance industry are subject to caps on commissions (for example, Life Insurance) – in this instance, they claim there are more profitable alternatives to Independent Broker models, with semi-aligned and Franchise type models proving more effective. This however is in stark contrast to the natural movement

observed in the international market, and is unsurprising considering the specific nuances of the South African market. However, it is also noted that Brokers (or IFA's, to be precise), in general, are less important in the South African market than in other global markets. The fact that an Insurer need not be prominent in the higher-end Broker market to be profitable qualifies this statement. Rather, a simplified effective product combined with robust risk and cost management processes could still see an Insurer capture mass markets via the diversity of alternative distribution channels.

5.1.5 Products/Offerings

Auto Insurance

Auto Insurance (also known as Vehicle Insurance, Car Insurance or Motor Insurance) is Insurance purchased for cars, trucks, motorcycles, and other road vehicles. Its primary use is to provide financial protection against physical damage and/or bodily injury resulting from traffic collisions and against other resultant liabilities. The specific terms of Vehicle Insurance vary with legal regulations in each region. To a lesser degree, Vehicle Insurance may additionally offer financial protection against theft of the vehicle and possibly damage to the vehicle, sustained from events other than traffic collisions.

Public Policies: In many jurisdictions, it is compulsory to have vehicle Insurance before using or keeping a motor vehicle on public roads. Most jurisdictions relate Insurance to both the car and the driver, however; the degree of each varies greatly. Several jurisdictions have experimented with a "pay-as-you-drive" Insurance plan paid through a gasoline tax (petrol tax). This would address issues of uninsured motorists and charge based on the miles (kilometres) driven, which could theoretically increase the efficiency of the Insurance, through streamlined collection (Wenzel (1995)). South Africa allocates a percentage of the money from gasoline to the Road Accident Fund, which goes towards compensating third parties in accidents (see Department of Minerals and Energy (2006) and South African Government (2009)).

GAP Insurance

GAP Insurance (also known as Guaranteed Auto Protection Insurance or Guaranteed Asset Protection Insurance) covers the difference between the actual cash value of a vehicle and the balance still owed on the financing (car loan, lease, etc.) – this is used mainly on new and used small vehicles (cars and trucks) and heavy trucks. Some financing companies require it. Most fully comprehensive Car Insurance policies only offer 'new car replacement' during the first 12 months of ownership. GAP Insurance covers the difference in the loan amount between the asset value and the amount covered by another Insurance policy. Some GAP policies also cover the deductible, usually on low down payment loans, high interest rate loans and loans with 60 month or longer terms. Finance companies typically offer GAP Insurance at the time of purchase. Most Auto Insurance companies offer this coverage to consumers.

Health Insurance

Health Insurance is Insurance against the risk of incurring medical expenses among individuals. By estimating the overall risk of Healthcare and health system expenses, among a targeted group, an Insurer can develop a routine finance structure, such as a monthly premium or payroll tax, to ensure that money is available to pay for the Healthcare benefits specified in the Insurance agreement. A central organisation such as a Government agency, private business, or not-for-profit entity administers the benefit.

Disability and Unemployment Insurance

Disability Insurance policies provide financial support in the event of the policyholder becoming unable to work because of disabling illness or injury. It provides monthly support to help pay such obligations as mortgage loans and credit cards. Short-term and Long-term Disability policies are also available to individuals, but generally, only those with higher income levels take Long-term policies due to the expense. Short-term Disability Insurance covers a person for a period typically up to 6 months, paying a stipend each month to cover medical bills and other necessities. Long-term Disability Insurance covers an individual's expenses for the long-term, up until such time as they are considered permanently disabled and thereafter. In preference to this, and before declaring a person unable to work and therefore permanently disabled, Insurance companies often try to encourage the person back into employment.

Casualty Insurance

Casualty Insurance, often equated to Liability Insurance, is Insurance not directly concerned with Life Insurance, Health Insurance, or Property Insurance. It is mainly Liability coverage of an individual or organisation for negligent

acts or omissions. Property Insurance, Aviation Insurance, Boiler and Machinery Insurance, Glass and Crime Insurance also use this term. It may include Marine Insurance for shipwrecks or losses at sea, Fidelity and Surety Insurance, Earthquake Insurance, Political Risk Insurance, Terrorism Insurance, or Fidelity and Surety bonds.

Life Insurance

Life Insurance (or Life Assurance) is a contract between an Insured (Policyholder) and an Insurer or Assurer, where the Insurer promises to pay a designated beneficiary a sum of money upon the death of the Insured person. Depending on the contract, other events such as terminal illness or critical illness may also trigger payment. The Policyholder typically pays a premium, either regularly or as a lump sum. Other expenses (such as Funeral expenses) are sometimes included in the benefits. Life policies are legal contracts and the terms of the contract describe the limitations of the Insured events. To limit the liability of the Insurer, specific exclusions are often included in the contract; common examples are claims relating to suicide, fraud, war, riot and civil commotion. Life-based contracts tend to fall into two major categories:

- **Protection Policies** – Designed to provide a benefit in the event of specified event, typically a lump sum payment.
- **Investment Policies** – Where the main objective is to facilitate the growth of capital by regular or single premiums.

Funeral Insurance

Funeral or Burial Insurance is a very old type of Life Insurance paid out upon death to cover final expenses, such as the cost of a funeral. Again, the Policyholder typically contributes a regular periodic payment (premium) to the Insurer, who pays out the agreed upon Insured amount after the death of the Insured person.

Property Insurance

Property Insurance provides protection against most risks to property such as fire, theft and some weather damage. This includes specialised forms of Insurance such as Fire Insurance, Flood Insurance, Earthquake Insurance, Home Insurance, or Boiler Insurance. Typically, there are two ways of insuring property:

- **Open Perils** – This covers all the causes of loss not specifically excluded in the policy. Common exclusions on open peril policies include damage resulting from earthquakes, floods, nuclear incidents, acts of terrorism and war.
- **Named Perils** – This requires the listing of the actual cause of loss in the Insurance policy. The more common named perils include such damage-causing events as fire, lightning, explosion and theft.

Liability Insurance

Liability Insurance is a part of the general Insurance system of risk financing to protect the purchaser from the risks of liabilities imposed by lawsuits and similar claims. It protects the Insured if sued for claims covered by the Insurance policy. Originally, individuals or companies that faced a common peril formed a group and created a self-help fund out of which to pay compensation should any member incur loss (in other words, a mutual Insurance arrangement). The modern system relies on dedicated carriers, usually for-profit; to offer protection against specified perils in consideration of a premium. Liability Insurance offers specific protection against Third Party Insurance claims, i.e., someone suffering loss who is not a party to the Insurance contract receives payment. In general, Liability Insurance policies do not cover damage caused intentionally or contractual liability. The Insurance carrier has the duty (and right) to defend the Insured upon claim. The legal costs of a defence normally do not affect policy limits unless the policy expressly states otherwise; this default rule is useful because defence costs tend to soar when cases go to trial.

Credit Insurance

Credit Insurance (or Payment Protection Insurance or Credit Protection Insurance or Loan Repayment Insurance) is an Insurance product that enables consumers to insure repayment of loans if the borrower dies, becomes ill or disabled, loses a job, or faces other circumstances that may prevent them from earning income to service the debt. It is not to be confused with Income Protection Insurance, which is not specific to a debt but covers any income. PPI is widely sold by Banks and other credit providers as an add-on to the loan or overdraft product. Credit Insurance insures all kinds of consumer loans including car loans, loans from finance companies and home mortgage borrowing. Credit Card agreements may include a form of PPI cover as standard. Policies are also available to cover specific categories of risk, e.g. Credit Life Insurance, Credit Disability Insurance, and Credit

Accident Insurance. The benefit paid in the event of a claim goes to the company that extended credit to the consumer, not the consumer/borrower.

5.1.6 Employment

According to INSETAs (Insurance Sector Education and Training Authority) Sector Skills Plan for 2011 – 2016 (2013 update), Long-term Insurance is the largest segment of the South African Insurance market, accounting for 75.2% of the market's overall gross premium income, while Non-life Insurance generated the remaining 24.8%. This provides one with a feel for the relative sizes of the Long- and Short-term Insurance industries in South Africa.

In terms of employment, INSETA expects employment in Short-term companies to increase between 2012 and 2015, the number of Brokers and Intermediaries to decrease and the number of Short-term Policyholders to increase over the same period.

Table 9: INSETA's projections for the Short-term Insurance industry

	2012	2015	Change	Percentage Change
Branches	179	162	-17	-9.5%
Brokers/Intermediaries	15 847	14 408	-1 439	-9.1%
Full-time Employees in SA	15 991	17 353	1 362	9.0%
Policy Holders (millions)	9.6	12.7	3.1	32.3%

According to INSETA, Long-term Insurers plan to increase their number of branches by just 3.2% between 2012 and 2015, and they expect the number of Brokers and Intermediaries to increase by 36.2%. (A single outlier significantly inflates this number – if removed from the group, the percentage increase drops to 9.8%). The expected increase in the number of full-time employees is 6.8% between 2012 and 2015, and Policyholders by a substantial 28.8% over the same period.

Table 10: INSETA's projections for the Long-term Insurance industry

	2012	2015	Change	Percentage Change
Branches	1 514	1 562	48	3.2%
Brokers/Intermediaries	37 840	51 540	13 700	36.2%
Full-time Employees in SA	57 667	61 600	3 933	6.8%
Policy Holders (millions)	22.2	28.6	6.4	28.8%

5.2 Interviews – Long-term Insurance

5.2.1 Regulation and Compliance

Generally, Long–term Insurers agree that regulation and compliance necessitate additional staff and systems upgrades in order to meet reporting requirements. Most companies are trying to automate reporting as much as possible in an effort to reduce the cost of the reporting process and ensure that the company also benefits from reporting. Certain companies mentioned Executives typically spend up to 50% of their time on regulatory and compliance issues.

The majority of Life companies have opted to use the Financial Services Board (FSB) model for Solvency II reporting, largely due to the cost and complexity of building internal models and the stringent FSB approval process. The FSB conducted a quantitative study on the implementation of Solvency II (SAM) in South Africa and estimated the upfront cost at approximately R1,8 billion and R800 million per annum thereafter.

The general concern is that although legislation makes sense and is well intended, the implementation and monitoring thereof is not optimal and often leads to inadvertent negative consequences. For example, the fee-based commission structure implemented in the United Kingdom in January 2013 caused the Insurance market to start shrinking. Companies worry local implementation of fee-based commission could exclude access to individuals needing Financial Services, as the majority cannot afford to pay up-front fees.

5.2.2 Growth

Growth areas

Distribution channel efficiency is cited as an important Long-term Insurance growth driver, along with product innovation, customer service and administration efficiency. Retention of existing business and investment market performance are key factors in maintaining profitability levels. Economic growth is the most important underlying factor contributing to overall growth in the sub-sector, as the level of employment in the country affects the ability of consumers to purchase Financial Services products.

The Retail business area in Long–term Insurance companies characteristically generates a high proportion of the company profits – usually more than 50%. Revenue in other business areas like Employee Benefits is generally lower; the operational costs are higher in this area due to the complexities of this type of business.

Growth in the Long Term Insurance market in South Africa is steady, but companies anticipate market saturation in the future. Market penetration in the Middle Income segment is very high and as a result, growth is low in that area. A further indication is significant movement of existing business between Life companies, rather than substantial growth in new business within the sub-sector.

Growth in new business predominantly occurs through two mechanisms; improved access to potential customers in under–represented geographical regions and increased penetration of the Entry Level Market or Mass Market segment, comprised of previously uninsured low-income individuals. Insurers target a high volume, low price and low profit margin model and offer a simple and limited range of products. Typically, the highest need is for Funeral products, with a limited demand for Investment products. Despite most Insurers targeting the Entry Level Market as a growth area – the perception is that Economists regularly overestimate the amount of growth that is possible in this area.

The Affluent segment is a steady growth area for Insurers; this segment comprises high net worth individuals who require sophisticated products.

Expansion into the rest of Africa and other Emerging Markets

Most Long–term Insurance companies have strategies in place for expansion into the rest of Africa and other Emerging Markets, although a particular Life company commented that they do not expect that growth in the rest of Africa and other Emerging markets will ever reach the point of subsidising their South African operations.

Emerging Market growth for Insurers tends to be focused on Asia, specifically South East Asia, India and China, although one company also has operations in Latin America. In general, Asian countries have a wider range of available skills and less input is required from South African companies, other than Actuarial expertise.

Life companies commented that the Indian market is markedly different to South Africa and Financial Advisers in particular, are a lot less productive – this affects the profitability of Indian operations. Moreover, the labour force in India is becoming unionised and companies predict that the "Indian cheap labour bubble" will burst at some point. Indian employees are becoming increasingly dissatisfied with the realisation that their remuneration is a fraction of that of their counterparts in other countries.

In the rest of Africa, Life companies generally collaborate with existing local organisations and use an expansion model based on a combination of acquisitions, joint ventures and organic growth. They prefer to use resident skills wherever possible as this builds strong relationships with partner companies. Technical expertise, mostly Actuarial, generally comes from South Africa due to a scarcity throughout the rest of Africa. There is strong resistance from in-country authorities regarding issuing work permits to foreign nationals, as Governments understandably prefer placement of local candidates. Companies mentioned that it would be extremely useful if the South African government could establish agreements to facilitate the transfer of skills between South Africa and other Africa nations for training and development purposes.

Costs

Staff and increased regulation are the largest operational overheads for Long–term Insurers. Companies generally have a policy of not retrenching staff – they prefer to reduce headcount via natural attrition and redeploying existing staff into other business areas when job functions become redundant. Systems automation and streamlining business processes are the preferred methods of reducing operational overheads.

Life companies generally invest heavily in Information Technology. There is on-going debate about the cost benefits of consolidating different systems across business areas. The majority opinion is that consolidation leads

to a significant reduction in the flexibility that having different systems allows. Different Insurance products vary in levels of complexity – this makes it difficult to apply one technological solution across product types and reduces the ability to innovate within a product type.

The majority of Long-term Insurers develop systems internally, a tendency that also extends across the entire Financial Services sector. Internal systems development is partially a legacy from the past, when South African companies did not have access to overseas companies to provide external Information Technology services and expertise. Companies commented that the alternative of purchasing off-the-shelf systems leads to sub-optimal outcomes; extensive customisation is required for the system to function effectively for existing products and business processes. Customisation becomes costly over time – due to version upgrades and rewriting code to ensure previous customisations are still functional. A particular company changed this approach in order to minimise costs – when purchasing an off-the-shelf system they alter their business processes to fit with the technology, rather than the other way around.

Outsourcing

In general, Long-Term Insurers attempt to minimise outsourcing business functions. There is a strong desire to employ South Africans wherever possible, due to a sense of responsibility towards contributing to development in South Africa. Companies outsource as a last resort only when an essential combination of expertise and experience is unavailable locally. A particular Long-term Insurer commented that they outsourced a portion of systems development offshore due to the unavailability of required skills in South Africa. Another Insurer outsourced the management of their systems infrastructure to a local service provider – they stated that Information Technology is not the core business of Life companies and is therefore an unnecessarily costly overhead to manage internally.

Risks to growth

Long-term Insurers mentioned a number of potential inhibitors of growth in the sub-sector. Connectivity inhibits large-scale expansion into the rest of Africa, Asia and other international markets. Consumer over–indebtedness is a threat in the Middle Income and Affluent Markets, but does not affect the Entry Level Market, as low-income earners do not generally have high levels of debt and are relatively unaffected by changes in interest rates.

Increased competition from Banks and non–Financial Services companies selling Insurance products impedes growth in the sub-sector, including rivalry from the South African government. The introduction of the RSA Retail Savings Bond has not had a large impact thus far, chiefly due to poor product marketing. However, the government could become a major competitor in the future, and companies believe that if this materialises, it would constitute unfair competition.

5.2.3 Education

Training and development

Many Long–Term Insurers have internal training programmes for Financial Advisors. In addition to initial training, further training requirements arise periodically due to new products, changes to existing products, regulatory and compliance requirements, and other business needs. A Life company mentioned that the total cost of training each Financial Advisor over a period ranges from R150 000 to R200 000.

A particular Long-term Insurer regards skills development as a core strategy, to the extent that they consistently overspend in this area; they believe that even if a staff member leaves the company, they need to have portable skills. The company focusses on developing existing local staff for business operations in the rest of Africa, as they require senior level staff with extensive Financial Services and organisational experience in certain key roles.

Tertiary education

Organisations require more than technical skills from graduates and believe that degree curricula need to be holistic. They suggested that the core of every degree should continue to teach technical skills, but should include options from other disciplines, like Philosophy etc. for non-Major subjects. Universities are too restrictive with electives and as a result, graduates lack flexibility – this affects their ability to think creatively and adapt to ambiguity in the workplace. Graduates need to be able to influence in addition to being functional specialists. Change Management and Project Management skills need to be included as a component of every degree as these skills are required to a certain extent in all Management and Specialist roles in today's business environment.

Compulsory Induction programmes address work place behaviour, organisational culture, how the business operates etc. for all new employees. Companies believe that universities could do more in terms of workplace

preparation or at least partner with industry on this issue. A degree is an entry into an organisation – the real value of an employee lies in work performance and adopting company culture and values. They acknowledge that universities are limited in the extent of work preparation they can provide students as certain knowledge only comes through experience and on-the-job training.

5.2.4 Skills deficits

Sales and Distribution skills are in high demand in the Long-term Insurance sub-sector on an on-going basis, particularly Financial Advisors. There is a high turnover of Intermediaries in general, as Insurance sales is a difficult way to make a living. Financial Advisors typically focus on a particular segment of the Life industry (Entry Level, Middle Income or Affluent markets).

Intermediaries fall into three different categories:

- Agents or Tied Intermediaries (only sell Insurance on behalf of a particular Insurer)
- Franchise or partially-Tied Intermediaries (sell limited amounts of Insurance on behalf of other Insurers, but the bulk of sales are tied to a particular Insurer)
- Brokers (sell multiple Insurers' products)

The split of Financial Advisors at Life companies is usually in the region of 50% Agents, 30 – 40% partially Tied Intermediaries and the balance are Brokers.

Life companies need underwriters, Actuaries and Chartered Accountants on an on-going basis. Underwriting skills take a long time to develop as Underwriters become better with experience. A particular company mentioned needing Mergers and Acquisitions expertise for expansion into the rest of Africa.

Business Analysts are in high demand as they perform a vital function in ensuring that technology solutions fulfil business requirements. Digital skills are becoming increasingly sought after – particularly candidates that have Financial Services experience.

Information Technology skills are scarce – specifically Software Developers and Systems Architects. Java and .NET skills are particularly difficult to find in South Africa. Skills requirements have changed for Systems Developers – it is vital that they have an understanding of Insurance products and calculations when building systems. This need has emerged due to increasingly complex regulatory requirements and sophisticated Insurance products. Internally developed systems provide limited scope and exposure for Information Technology staff and their skills become outdated rapidly.

Experienced Professionals and experienced Leaders are in short supply across the sub- sector. There is a steady supply of graduates, but a lack of experienced individuals for Senior Management positions. In addition, Stakeholder Management skills are required at senior levels across roles – senior staff need to have the technical skills and experience to understand the regulatory environment and the soft skills to manage and influence Stakeholders.

5.2.5 Recruitment

Long-term Insurers generally have a policy of avoiding retrenchments wherever possible, as it does not make good business sense to lose people with organisational and Financial Services knowledge. Companies ensure that headcount is contained in non-Sales areas, and reduce headcount via natural attrition and also develop and redeploy superfluous staff into other areas of the business.

Recruiting employment equity candidates is a challenge, particularly when attempting to entice candidates from Gauteng to relocate to the Western Cape.

Certain companies offer consistently higher salaries than the benchmark to ensure that they can attract the best candidates.

5.3 Interviews – Short-term Insurance

5.3.1. Regulation and Compliance

Short-term Insurers have differing views on the overall impact of regulation on the sub-sector. On the one hand, regulation is beneficial, but there has to be a balance between the principles and the implementation thereof.

The extra effort required to comply with changing regulation translates into an increase in people cost and central operating costs for Short-term Insurers. Up until now, Shareholders have absorbed the increase in costs due to regulation and compliance – however, recent Short-term Insurance loss ratios have reached unsustainable levels and this will inevitably result in increased costs for Policyholders.

While there is an appreciation of the good intentions and necessity for increased regulatory requirements, the evolving regulatory environment imposes some constraints in terms of costs and the ability of Short-term Insurers to differentiate themselves particularly around Broker contracts and product innovation. Companies remarked that generally liquidity requirements are not a major change as most Insurers already have well correlated inflows and outflows from a duration perspective and little mismatch in terms of assets and liabilities.

A certain Short-term Insurer commented that regulatory compliance does not cause significant extra cost burden and this should be as a standard part of business operating costs. They stated that they already meet the capital requirements of Solvency II. The company has used an internal model for many years and they do not anticipate any substantial difference between using their existing model and the FSB model for Solvency II reporting.

Overall, Short-term Insurers believe the reality is that South Africa Financial Services companies have no choice but to comply with international regulation in order to remain globally competitive. Solvency II is principle based and addresses capital adequacy and risk management. The Regulator did not initially set rules around this - Insurers approached the Regulator and requested rules to apply the principles. Even though the FSB has a model used for Solvency II compliance, Insurers need to make a fair amount of informed decisions around this.

There is some apprehension regarding the planned implementation of Twin Peaks. Currently Insurers have well-established relationships with the Financial Services Board and are uncertain about the initial impact of having to build new relationships with the South African Reserve Bank.

On the issue of compulsory Third Party Insurance, Insurers commented that in order to ascertain whether Third party Insurance is the most appropriate solution, an investigation is required into the causes of the risks on South African roads. The government needs to address various issues before implementation – compulsory Third Party Insurance would be unaffordable for the majority of South Africa's population, and the government cannot afford to subsidise this.

5.3.2. Growth

Growth areas

Gross Domestic Product growth has slowed in South Africa and Short-term Insurers do not expect much of an increase in GDP in the short- to medium term. Growth opportunities in Short-term Insurance are different between Personal lines (Household, Motor vehicle etc.) and Corporate and Commercial lines of business.

Diversifying into Reinsurance is a potential high growth area for Short-term Insurers. Previously uninsured markets like the lower income market are also an area of potential growth although profitability is unlikely to be significant in this area. Companies maintain profitability by balancing growth with risk and are optimistic that it is possible to meet growth targets in a sluggish economy through risk diversification and stringent risk management.

The Personal line of Short-term Insurance is very competitive, as a number of Insurers using a direct business model have entered the sub-sector. The operating costs of a direct business model are much lower, with resultant reduced premiums. Insurers using a distribution channel model have higher operating costs and struggle to compete. Customers choose a Short-Term Insurer based on price and operational efficiency at claim stage and are not interested in value-adds. These two factors determine which Insurers are successful over the long-term.

The general view across the sub-sector is that growth in direct business seems to have stabilised – most individuals who would opt to buy Short-term Insurance directly have already done so. Traditionally, Short-term Insurers use an intermediated business model – this is more expensive than a direct business model due to the cost of commission and maintaining distribution channels. However, intermediaries are crucial for the specialised products sold in Commercial and Corporate Insurance and this type of business is substantially more profitable than Personal Insurance. Growth in these lines of business is dependent on development opportunities and an increase in GDP.

The real opportunities in this area lie in the rest of Africa – for example, Capital Investment, Mining, Engineering and Solar projects. Short-term Insurers have developed a sound understanding of how to price these projects and assess the risks and opportunities associated with them. Reinsurers play a major role in Corporate and Commercial Insurance as the amount of risk involved is often substantial.

A particular Short-term Insurer uses a partnership model and distributes less than 10% of business directly to the market. They write business using a network of 100+ partners that include Brokers, Retailers, Banks, Underwriters and Affinity groups. The company commented that they take a long-term strategic view and recently acquired an Insurer that is a leading provider of Intermediated Corporate and Commercial Insurance products and services. This is key to their growth strategy and they expect 40 to 50% of bottom-line growth over the next 5 years to originate from Corporate and Commercial Insurance, including projects in the rest of Africa.

Expansion into the rest of Africa and other Emerging Markets

Akin to other areas of the Financial Services sector, Short-term Insurers use a partnership model for expansion into the rest of Africa and other Emerging markets. A certain Short-term Insurer has a presence predominantly in Namibia, Botswana, Mozambique and Zambia, where they operate both Long-term and Short-term Insurance licenses. They also have a number of partnership initiatives in other countries in the rest of Africa, for example Ghana.

The company focusses on building relationships in China and India and to a lesser extent in Brazil from a Reinsurance perspective – in addition to existing joint ventures in Insurance in India and China. Each business manages day-to-day operations in-country including administration and claims processing. Each country is unique and different products and operational methods are appropriate to each environment. For this reason, the Insurer generally deploys different systems apposite to each specific location. The parent company provides input in terms of strategic direction, Actuarial skills, company culture and high-level management oversight. The company remarked that the idea of South Africa as a gateway to the rest of Africa is overplayed – there is a substantial amount of capital flowing into African countries that is unassisted by South Africa.

Costs

One of the principal overheads for Short-term Insurers is staff. The reasons for high staff costs is the need for specialist staff in various roles, including, but not limited to Risk Management, Compliance and Data Analysis. Companies also cite information technology, claims and distribution channel costs as major areas of expenditure. (Please refer to comments regarding claims costs under 5.3.2. Growth - Risks to growth, below).

Operational efficiency is a key profitability driver for Short-term Insurers. An important aspect of this is systems automation – a particular company is in the process of replacing Legacy systems with a more agile platform and streamlining related business processes. This is an expensive undertaking and adds a substantial cost to their income statement – expenditure includes the external system, implementation and customisation thereof, and training existing Information Technology staff to manage and maintain the system in the future. The systems migration project incurs costs in US Dollars and the decrease in the value of the Rand caused the financial outlay to increase dramatically.

The company adopts a holistic approach to operational efficiency and streamlines aspects of business wherever possible – specifically business processes and claims efficiency. The promise of Short-term Insurance is only realised at the point of claim and an agreeable experience is the most effective means to build customer loyalty.

Outsourcing

Historically, Short-Term Insurers using a distribution channel model outsource certain business functions. Often Brokers manage their own policy administration and charge an additional fee separate from commission, and Portfolio Administrators create product packages for clients where parts of the overall product reside with different Short-term Insurers. Companies state that these arrangements are not optimal from a risk perspective. The Short-term Insurer has reduced control, but retains overall accountability for the outsourced process and is responsible for the product, regardless of who manages the administration.

Companies anticipate that new regulation will assist in reducing these practices – for example, new regulation interprets being a Broker and a Policy Administrator as a conflict of interest. Direct Insurers do not dispense advice or charge commission and therefore do not fall into this category.

Risks to Growth

Short-term Insurers mentioned the following factors in the external environment as hindrances to growth; the economic slowdown negatively influences development opportunities, low interest rates affect investment returns and high levels of unemployment reduce consumer appetite for Financial Services products. In general, companies react too slowly to the rapidly changing external environment – consumer expectations have changed and this requires different kinds of products and services.

Various factors make profitability levels unpredictable for Short-term Insurers – particularly natural phenomenon like weather, fires etc. A certain Insurer commented that they attempt to reduce these risks wherever possible; specifically the factors where they can exert some influence. For example, in St. Francis Bay, the company insures thatched homes and this poses a massive risk due to the lack of adequate fire fighting infrastructure in the area. They are attempting to influence local authorities to put the correct fire fighting infrastructure in place, as this would substantially reduce the claims risk.

Motor Vehicle Insurance spiked in 2007 due to an increase in the number of middle class consumers in South Africa, resulting in an increase in motor vehicle ownership. However, in the last 5 years there has been a minimal increase in the number of insured cars on the roads. In fact, only 1/3rd of all motor vehicles in South Africa have Insurance cover. Stagnation in the Motor Vehicle Insurance market resulted in competition between Short-term Insurers for existing business and a price war that drove premiums down.

Premium reduction leads to the under-pricing of risk related to the cost of claims. Insurers commented that Short-term Insurance rates have to increase for companies to remain profitable. Profitability in the sub-sector is not only affected by economic conditions – for example, environmental events like hailstorms cause massive increases in claims, and a depreciation in the value of the Rand causes an increase in the cost of parts as many motor vehicles are imported.

In theory, there should be an increase in car ownership and a related increase in Motor Vehicle Insurance over the next 10 years. However, this is dependent on employment growth and this in turn reliant on improved economic conditions. Possible reasons for low rates of Motor Vehicle Insurance are an absence of perceived value and a lack of education regarding the protection Motor Vehicle Insurance provides. There is a high percentage of old cars on the road in South Africa and once a car depreciates below a certain level, it seems financially unviable to insure it.

5.3.3. Education

Training and development

Short-term Insurers made no comments related to training and development.

Tertiary education

One of the deficits of the South African Tertiary education system is that students specialise at undergraduate level. This is not the case in the United Kingdom and the United States, where undergraduate degrees are multi-disciplinary and specialisation occurs at postgraduate level. Students can also study different disciplines at undergraduate and postgraduate level, whereas in South Africa, the progression is linear – this leads to individuals in specific qualification groups that think uniformly. Short-term Insurers believe that graduates in these countries have a broader spectrum of knowledge and this translates into greater flexibility and superior thinking skills. There is a need for senior, strategic and key staff that have an extensive range of competencies. Candidates require environmental, systems and governance thinking, with a strong mathematical background.

A particular Short-term Insurer mentioned a need for a new qualification with a Financial Services core and electives in various specialisations; Long-term Insurance, Short-term Insurance, Retail Banking, Investment Banking and Asset Management. Many candidates have financial qualifications like Bachelor of Commerce degrees, but there is a big gap in industry specific knowledge.

5.3.4. Skills deficits

The way consumers use technology will inform the core skills requirements for the Short-term Insurance sub-sector over the next 5 to 10 years. A certain company stated that technology and data analytics would dominate development in the Financial Services sector. Gathering useful insights and identifying trends from big data is a vastly under-utilised area and a company's ability to develop strategic initiatives from data at their disposal will become a massive competitive advantage. Translating data accurately will enable companies to pinpoint consumer needs and anticipate changes in the internal and external environments. Specialists in data analytics will be increasingly crucial in the near future.

Along similar lines, there is an increasing demand for Business Architects who can translate business needs into Information Technology solutions. It is critical that Information Technology areas respond effectively and efficiently to changes in business direction and any disconnect leads to sub-optimal outcomes that have cost implications. For example, systems development takes longer, companies compromise on solutions if platforms cannot meet

development needs and products get to market slower than they should. Business Architects require a higher level of strategic ability than traditional Business Analysts.

Underwriting skills were cited as scarce, specifically Underwriters with 10 to 15 years of experience. A particular Insurer mentioned Underwriting skills have evolved past the traditional role of applying loadings or exclusions to policies. Underwriting is required from a Risk Management perspective rather than just a Risk Assessment standpoint. It is critical for business sustainability to assess risks in terms of the underlying influencing factors, with a requisite understanding of the risk involved. For example, Healthcare companies introduced Wellness programmes to help members manage their health – this benefits both parties by improving the health of members and reducing the cost of claims. Short-term Insurers need to find solutions to manage risk effectively in their particular context.

Surveyors and Assessors are critical roles as Short-term Insurers are highly dependent on these skills. Traditionally, older males occupy such roles, as young people do not perceive this as a particularly exciting or interesting career. It is an aging specialist area, which is a cause for concern across the sub-sector.

The stream of Actuaries has increased, but demand still exceeds overall supply. There is a shortage of registered Short-term Insurance Actuaries – companies now need Actuaries urgently due to the scheduled implementation of Solvency II. There are many registered Long-term Insurance Actuaries, but very few on the Short-term side.

5.3.5. Recruitment

Short-term Insurers stated that Financial Services companies across the sector are consistently exceeding their internal recruitment budgets to acquire certain critical skills – this is a simple case of supply and demand driving up the recruitment cost.

5.4. Interviews – Healthcare

5.4.1. Regulation and Compliance

Companies cite the Community Rated Guaranteed Acceptance Policy and Prescribed Minimum Benefits regulation as a risk to growth in the sub–sector. ((Please refer to 5.4.2, Growth - Risks to growth for details.)

The Department of Health and the Council for Medical Schemes regulate Healthcare companies, whereas the Financial Services Board regulates other Insurers. Companies mentioned there is no regulatory consistency across the Financial Services sector. The Healthcare sub–sector operates on solidarity principles and therefore cannot exclude individuals, whereas the remainder of the sub–sector follows principles of mutuality and risk rates and can exclude high-risk people.

Additionally, clear demarcation of regulatory frameworks is lacking. For example, certain Short–term Insurers issue Healthcare products in the form of Hospital Plans ¬– Healthcare companies believe this leads to sub–optimal outcomes for the members. Hospital Plans pay a certain amount of money to a member per day spent in hospital. Individuals do not understand that hospital plans are not a replacement for medical aid cover as the payment is not sufficient to cover hospitalisation costs.

All medical schemes are required to report to the Council for Medical Schemes on a monthly, quarterly and annual basis.

5.4.2. Growth

Growth areas

Growth in the Healthcare industry in South Africa is at a reasonably consistent rate of 4% to 6% per annum. Healthcare companies acknowledge that the South African market will reach saturation point, but feel that they are still far from that point. The cost of private Healthcare is a hindrance in a country where the majority of the population are low-income earners. Approximately 8 million individuals have private Healthcare cover (or 3 million families) in South Africa.

Wellness programmes focusing on preventative care are a growth area in the Healthcare industry. Healthcare companies also focus on retaining existing business and ensuring low lapse rates as part of growth strategies. One company mentioned that they attribute steady growth of their business to a focus on product integrity and strong distribution channels.

Some Healthcare companies fall under Holdings companies that also have Long–term Insurance business. These companies state that they do not actively pursue cross selling as a growth strategy. Cross selling often occurs as

a natural side effect – from a customer perspective it makes sense to have Life Insurance and Healthcare with the same company.

Expansion into the rest of Africa and other Emerging Markets

The majority of Healthcare companies have a presence in various countries in the rest of Africa. Like most institutions in other Financial Services sub–sectors, Healthcare companies mentioned that their presence in other African countries is most often a partnership arrangement with an existing local company.

Companies have a presence in a variety of locales including the United Kingdom, the United States and China, and conduct offshore business through partnership arrangements as this reduces the cost of international expansion. Call Centres are located in each foreign country for cultural reasons and non–client facing functions are based in South Africa.

Costs

Companies cite the Community Rated Guaranteed Acceptance Policy and Prescribed Minimum Benefits regulation as a source of increased costs in the sub–sector. (Please refer to 5.4.2, Growth - Risks to growth for details.)

Supply–side factors and demand–side factors lead to increases in Healthcare costs in approximately equal measures. On the demand–side, people get older and the burden of disease increases. Individuals also transfer between different Healthcare plans in terms of their own best interests, which is seldom in the interests of the risk pool.

On the supply side, South Africa has a dearth of Doctors and Specialists, resulting in high fees for these services. A shortage of nurses severely affects hospitals, while consolidation of hospitals and laboratories is increasingly common. These factors all lead to a lack of meaningful competition and a consequent increase in Healthcare costs.

Healthcare companies stated that despite general criticism about high administration fees, this is the only component of Healthcare costs that is lower than inflation. A certain Healthcare company stated that their competitors often misquote administration fees. Some companies operate using a split model – they only provide certain functions in the spectrum of Healthcare activities. Administration fees charged for a particular function like Healthcare administration appear lower. Administration fees are significantly higher if consolidated across the full spectrum of Healthcare services. Another company stated that they use economies–of–scale to keep administration fees to a minimum – well below the Council for Medical Schemes recommendation of a maximum of 10% of contributions for administration fees.

When evaluating the price of medical aid plans, it is important to examine actual benefits in relation to costs. If members receive better treatment and medication for a condition at a higher cost, the individual is still benefitting – there is value in the additional cost. Cheaper medical aid plans mean fewer benefits to the members.

Healthcare companies stated that their highest overheads are staff, with the majority of staff employed in operational, service and Call Centre roles. A certain company mentioned that they invest heavily in Call Centre staff – they offer substantially higher remuneration packages and each Call Centre Agent receives 6 months of intensive training. Another company commented that it is far more expensive to appoint staff in Johannesburg than in the Western Cape, Port Elizabeth and KwaZulu–Natal – as a result, they moved their Call Centres to these regional locations. In Port Elizabeth, they were able to attract highly qualified individuals due to the high rate of unemployment in this area of the country. The company commented that local government support contributed to the success of their regional Call Centres offices. The non–service related intellectual functions remain at their head office – product development, innovation and strategy.

A variety of methods are used to reduce costs – high levels of automation of administration processes, productivity-measuring tools, using wellness data to negotiate better rates with Healthcare providers, systems innovation and electronic communication to reduce the volume of calls.

Outsourcing

Generally, Healthcare companies stated that it is their policy not to outsource functions. They are strongly committed to creating jobs in South Africa, thereby contributing to addressing South Africa's development challenges. They also believe that outsourcing is not always cheaper in the long-term, particularly in the area of Information Technology.

Risks to growth

One of the biggest risks to growth in the Healthcare industry is regulatory – in the form of the Community Rated Guaranteed Acceptance Policy implemented in the late 1990's. The policy made it possible for anyone to join a medical aid, at any time and at the same price as all other members on a particular medical plan. This means that an individual can wait until they are very ill before joining a medical scheme, but companies cannot load premiums or exclude cover for pre–existing conditions. This policy is consistent with Healthcare policy direction worldwide. However, in South Africa there is no mandate that an individual must belong to a medical scheme continuously to be covered.

In the case of employer medical schemes, it is compulsory for all employees to join the scheme when they commence employment and this reduces the risk to Healthcare companies. However, for individual, non–employment linked membership, the Community Rated Guaranteed Acceptance Policy imposes anti–selection on Healthcare companies and the impact is substantial – this is the primary reason why medical aid costs are so high. In the past, lower claims by younger members offset higher medical claims for older members. Nowadays, there is no longer any incentive for younger individuals to join a medical scheme when they are young and healthy. Healthcare companies have to increase prices in order to mitigate the risk of anti–selection and the members of medical schemes are negatively affected.

Further to comments on the Community Rated Guaranteed Acceptance Policy, companies cited regulation around Prescribed Minimum Benefits as a further factor posing a risk to growth in the Healthcare industry. This legislation makes it mandatory for Healthcare companies to cover certain conditions. This is a further case of anti-selection – in the past, cover for a condition was dependent on a member belonging to a medical scheme when the condition appeared. Now, individuals can join a medical scheme with pre-existing conditions like cancer, and the medical scheme cannot refuse to cover the costs of treatment.

National Health Insurance is not an immediate risk to the Healthcare sub–sector. Healthcare companies noted that South Africa would have to develop a great deal before the country would be able to afford to offer full National Health Insurance. Companies believe that it will take many years before individuals can confidently discontinue cover provided by a medical scheme and rely completely on the government to meet their medical needs. If National Health Insurance eventually becomes a viable alternative to a medical scheme, the Healthcare industry would have to adapt and offer different types of Medical Insurance. Companies cited the United Kingdom as an example of a country that has a decent National Health Insurance system that co–exists with a vibrant Healthcare industry – private Healthcare remains a requirement for a certain portion of the population. Implementation of National Health Insurance in South Africa would require massive Healthcare Administration and this could represent an opportunity for existing Healthcare companies as they have the systems capability and experience in this area.

Internet bandwidth was initially an issue from a systems efficiency perspective, particularly in establishing offshore operations. However, the introduction of undersea cables has improved data transfer speed significantly.

5.4.3. Education

Training and development

A company stated that they employ a large number of Matriculants and therefore provide extensive in–house training and on–the–job mentoring.

Another company mentioned that they have a very strong company culture that they believe is part of their competitive advantage. They recruit staff at a junior level and put them through an intensive development process in order to fill senior positions, which are highly sought after, especially in their offshore business. Staff with a strong creative and analytical mindset do well in their environment.

Tertiary education

Education continues to be a critical issue in South Africa. Companies cannot rely on Matric results when employing staff; as a result, they depend on university results and conduct psychometric assessments to determine the suitability of candidates.

5.4.4. Skills deficits

South Africa has insufficient medical professionals, particularly Doctors, Specialists, Midwives, Nurses and Social Workers. There are restrictions on private companies employing medical professionals. Healthcare companies employ Social Workers to assist terminally ill members and Managed Care Specialists as case managers.

There is an on-going need for Actuaries in Healthcare. Information Technology skills are in high demand in all sectors of the economy, particularly Systems Developers.

A particular Healthcare company stated they have a critical need for Statisticians to analyse and extract useful insights from data around individual health and wellness behaviour. Data integration and data analysis are strategic imperatives. Statisticians need to not only apply the correct statistical techniques, but also have sophisticated thinking and analytical skills in order to specify data, select variables, formulate questions and find applications for insights. They believe that part of the reason for the rarity of Statisticians is that statistically-inclined individuals tend to become Actuaries and not specialist Statisticians. The company currently employs a handful of top graduates with Masters Degrees – they encourage staff in this area to pursue higher research qualifications. They indicated that there is a necessity for a tertiary education programme that specifically addresses the requirement for statistical and analytical skills related to data analysis.

5.4.5. Recruitment

Call Centre staff have a high turnover, though this is common to Call Centres regardless of industry. Staff average around 2 years in Call Centre roles and then tend to move on to different roles after gaining experience or completing part–time studies. Information Technology staff also have a high turnover due to the great demand for these critical skills.

A particular Healthcare company mentioned while it is an on-going challenge to employ staff with the right mix of soft skills, technical skills and qualifications, they generally have a high staff retention rate.

6. Asset Management

6.1. Overview of the Asset Management sub–sector

6.1.1. Economic Context

"Investment Management is the professional Asset Management of various Securities (Shares, Bonds and other Securities) and Assets (e.g., Real Estate) in order to meet specified investment goals for the benefit of the Investors. Investors may be institutions (Insurance companies, Pension Funds, corporations, charities, educational establishments etc.) or private investors (both directly via investment contracts and more commonly via Collective Investment Schemes e.g. Mutual Funds or Exchange-traded Funds)." *(Wikipedia, Article: Investment Management)*

"The art and science of making decisions about investment mix and policy, matching investments to objectives, asset allocation for individuals and institutions, and balancing risk against performance.

Portfolio management is all about strengths, weaknesses, opportunities and threats in the choice of debt vs. equity, domestic vs. international, growth vs. safety, and various other trade-offs encountered in the attempt to maximise return at a given appetite for risk.

In the case of Mutual and Exchange-traded Funds (ETFs), there are two forms of Portfolio Management: passive and active. Passive management simply tracks a market index, commonly referred to as indexing or index investing. Active management involves a Single Manager, Co-Managers, or a team of Managers who attempt to beat the market return by actively managing a fund's portfolio through investment decisions based on research and decisions on individual holdings. Closed-end funds are generally actively managed." *(Investopedia, Article: Portfolio Management)*

There exists a multiplicity of connotations attached to the term "Asset Management". In its most generic form, it refers to a system or process designed to monitor, manage, maintain and optimise the physical aspects of assets, along with their associated financial impact within a given entity. Within a financial context however, "Asset Management" is synonymous with the terms "Investment Management" and "Portfolio Management". Investment Management, also commonly referred to as Portfolio Management, refers to the professional management of a wide variety of financial securities as well as certain real assets, with the aim of achieving a pre-specified investment goal or target set forth by the investor(s). Investors may be private individual or other financial institutions, like Banks, Insurance companies or Pension Funds. With the continual evolution and sophistication of financial markets, along with the diversity of associated potential systematic and idiosyncratic risks, the majority of prospective investors seek the services offered by professional Investment Managers.

The process of Investment Management is both an art and a science. The endeavours of the Investment Manager to secure returns within a market environment that is unpredictable and seemingly irrational and illogical at times,

driven by the visceral responses of emotion-driven participants, illustrates the artistic features of the Investment Management process. Scientifically, Investment Managers are required to quantitatively control, manage and mitigate risks of a specific investment process, while optimising the potential returns. The most successful Portfolio Managers abide and adhere to a strict, robust and consistent investment philosophy governed by a disciplined Risk Management process. It is vitally important that an Investment Manager fully comprehends the sources of risk exposure associated with specific investment returns, so that he/she may be able to effectively and transparently tailor and structure investments to suit investor requirements.

The Asset Management industry plays an integral role within the Financial Services sector, acting as an Intermediary that facilitates the flow of capital from investors with spare and excess capital to those who require capital investment. In their capacity as financial agents, Asset Managers therefore provide a critical service across the savings and investment markets. As described earlier, the Investment Management industry caters to the needs of both institutional and individual investors as well on a discretionary and non-discretionary basis, with the latter including a semi-discretionary variant of investment accounts managed according to prescribed mandates. Further, from an individual's perspective, Asset Managers enable the individual saver or investor to access financial markets and investment opportunities that are typically inaccessible to him/her in his personal capacity. In general, Investment Managers offer a wide range of products and services with varying risk and return objectives, along with varying levels of regulation, all of which are customisable for different investors.

The process of Asset Management constitutes a complex series of activities, which includes the intricacies of the core investing philosophy along with the associated administration, compliance and regulatory considerations. The nature and characteristics of the underlying investment objective has a direct correlation with the degree of complexity in the overall investment process. These investment objectives or mandates vary significantly across different clients, investment purposes, asset classes and financial markets. For example, investment purposes may range from simply replicating a stock market index to actively seeking to out-perform a given benchmark index, capital protection strategies or matching a specific stream of liabilities.

While the Asset Management industry forms part of the Financial Services sector, companies within this sub-sector are fundamentally different to other Financial Services institutions, like Investment Banks and Insurers. Most notably, the cordoning off or separation of Asset Manager's assets under management from the management of the company is a requirement of legislative supervision and regulation, thereby ensuring independently held and supervised assets via depositories and custodians. Moreover, Asset Managers are not permitted to trade in a proprietary capacity which inhibits their ability create or contribute to systemic risks.

Traditionally, the "buy-side" and the "sell-side" segregates financial market agents into two spheres. Agents belonging to the "buy-side" are institutions such as Asset Managers, Banks and Insurers, while members of the "sell-side" are stock broking companies and other companies offering intermediation or advisory services. Members of both these spheres play a critical role in the smooth functioning of financial markets. In summary, Asset Managers contribute significantly to the price discovery process in financial markets; they provide liquidity as well as contributing greatly to moderating financial market volatility. With the advancement of the Investment Management industry, thus escalating sophistication and competition, portfolio managers have become more cognisant of costs. As a result, Asset Managers are more concerned about the market impact of their trades, thereby putting more pressure on Brokers to minimise market impact, which ultimately moderates market volatility. Finally, Asset Managers also promote market efficiency by playing a significant role in developing trading activity and eradicating arbitrage opportunities across asset classes and financial markets.

In most countries, the natural undertakings of the Asset Management industry culminate in these institutions having substantial shareholdings in investee companies. Accordingly, in most jurisdictions, Asset Managers have begun to play an increasingly significant role in Corporate Governance, in other words, monitoring investee companies on behalf of investors. In addition, the fundamental and quantitative research undertaken by the Asset Management industry, as part of their investment process, plays a vital role in price discovery in financial markets. With regard to financing and capital raising activities, the Asset Management industry contributes substantially to both equity and debt financing of listed and non-listed entities as well as specialised and alternative projects. As such, the Asset Management industry plays an important and broad role in stimulating economic growth.

6.1.2. South African Context

South Africa's Investment Management industry is a vibrant, sophisticated environment, with investors having access to a wide variety of investment products, ranging from traditional to alternative strategies. The wake of the recent financial credit crisis has seen a proliferation of new investment products, as portfolio managers attempt to respond to the new volatile financial market environment. As a result, the local industry has also undergone significant change, which has presented both restraints to and opportunities for growth.

Given South Africa's low Gross National Savings rate which has reduced from a peak of 35% in 1980 to 16% in 2009 (expressed as a percentage of Gross Domestic Product; World Bank South Africa Economic Update July 2011), it is not surprising that the Investment industry isn't accessible to the majority of South Africa's population. This is largely a function of the high level of unemployment and a significant portion of the population living below the poverty line. The services of Asset Managers and other financial intermediaries are easily accessible to a relatively small proportion of the South African population, mainly comprising high net worth individuals and institutional investors.

According to the Association for Savings and Investments South Africa (ASISA), as at the end of December 2012, assets under management in the Long-term Insurance, Collective Investment Schemes and Retirement Funds industry amounted to R1.74 trillion, R1.23 trillion and R2.40 trillion respectively (ASISA Annual Review 2012).

Table 11: Various descriptive statistics of certain emerging market collective investment scheme industries as at December 2012 *(Sources: MoneyWeb, CIA World Factbook, JSE, NSE of India, Bombay Stock Exchange, Nigerian Stock Exchange, Association of Mutual Funds in India and Zawya.)*

Country	Population	GDP per capita	No. of Listed Companies	Market Cap of Listed Companies	No. of Funds	Assets under Management
South Africa	51.7 mln	$10,700	425	$903 bln	967	$139 bln
India	1.2 bln	$3,500	6,600	$2.3 trln	1,221	$140 bln
Nigeria	166.6 mln	$2,500	198	$55 bln	43	N/A
Morocco	32.8 mln	$4,800	77	$50 bln	175	$14.9 bln
Saudi Arabia	29.2 mln	$24,200	159	$380 bln	228	$22.9 bln

Firstly, one should note that the size of the South African Collective Investment Scheme market is similar to that of India, a much larger economy in terms of population and gross domestic product. Exchange Controls in South Africa played a major role in influencing the size of the local market, as investors have limited opportunities to diversify their investments outside of the local borders. Secondly, it is worth noting the large number of funds in South Africa. While the number of local funds appears to be commensurate with larger economies, like India, having almost a 1 000 local funds is excessive, for the following reasons:

- Retail investors find it increasingly more difficult to decide which funds to invest in;
- Retail investors are not necessarily being offered the best investment products, as it is commonly believed that marketing departments play a major role in producing new funds which are based on current market conditions as opposed to robust investment philosophies;
- There is excessive intermediation, with the Retail investor being steered into products and markets offering the largest amount of fees as opposed to the best investment;
- Retail investors are actually having to make a decision between numerous funds which are essentially offering the same type of performance, due mainly to limits and constraints on the liquidity and the size of the investible universe of assets; and
- The plethora of funds has led to a proliferation of Financial Advisors to help guide investors through the "fund map", resulting in increased costs across the board.

It is widely believed that some sort of consolidation is required to reduce the number of funds within the industry; unfortunately, the form of the required consolidation is unknown. The increasing popularity of passive investment strategies and Exchange Traded Funds, in particular, are likely to help remedy this problem somewhat, as these investments are far more transparent and cost effective for a Retail investor. When considering passive investments, the investment problem shifts from having to select the appropriate Unit Trust or fund, to having to select a range of passive investments with appropriate portfolio weightings to achieve the desired level of risk diversification and potential for return. Currently, there are only 40 Exchange Traded Funds listed on the Johannesburg Stock Exchange (with assets under management amounting to R45 billion), and this number is not expected to grow significantly, unless there is an introduction of new Asset Managers and/or benchmark indices into the market. The market environment is expected to undergo a significant paradigm shift from active to passive investment due to the government's focus on promoting Exchange Traded products and simplifying the Retirement and Savings frameworks. The method and outcome of consolidation in the current dominant actively managed Unit Trusts is likely to define the competitiveness of active investing in the future, which is uncertain.

Having considered the number of funds in the South African Collective Investment Schemes market, it is also interesting to consider the concentration of assets under management. As at the end of March 2013, the number of funds in the Collective Investment Schemes market had grown to 988, while the number of Asset Managers stood at 47. Considering only South African funds (i.e. those with 70% or more invested in local assets) which comprise 93.5% of the entire industry, MoneyWeb shows that the top seven Asset Managers in South Africa control 59.9% of all South African funds. The table below reflects the ranking of the Asset Managers.

Table 12: South African Funds – Assets under Management as at March 2013

Country	Manager	Assets under Management
1	Allan Gray	R 140.7 bln
2	Investec Asset Management	R 122.9 bln
3	Coronation	R 121.3 bln
4	STANLIB	R 96.6 bln
5	ABSA	R 92.3 bln
6	Nedgroup Investments	R 88.6 bln
7	Old Mutual	R 74.0 bln
	Total	**R 763.3 bln**
	South African Funds Total	**R1,314.6 bln**

Altogether, the seven Asset Managers listed above manage 187 funds, with Allan Gray managing the least number of funds of the total, just 6, while STANLIB manages the most, with 48 funds. The success of these Managers is not surprising, given their established records of accomplishment. Newer entrants into the market struggle to compete with established players particularly when it comes to an established track record. Moreover, the bigger marketing budgets, experience of the business development teams and the sophistication of distribution channels of the larger Asset Managers make it even more difficult for new entrants to compete effectively.

6.1.3. Operational/Functional Context

Business Models

Asset Management companies are agency based entities, whereby investors contract the services of the Asset Management company in exchange for a fee – commonly termed the Management Fee. The Asset Management company and the investor agree on the characteristics of the investment, usually documented via an investment mandate, and the company appoints one or more Portfolio Manager(s) to manage the investors' funds in accordance with this mandate, in exchange for the Management Fee. The investment mandate stipulates the conjectured targeted investment objectives as well as the role and degree of discretion that the Asset Manager may exercise. The company appointed Portfolio Manager must abide by the conditions and covenants prescribed by the investment mandate and will be responsible for the management of the resultant Investment Portfolio.

The value that an investor derives from enlisting the services of an Asset Manager is entrenched in the expertise of the respective Portfolio Managers, their understanding of financial markets and their ability to utilise the welter of available information to construct Investment Portfolios that are commensurate with the investor's expectation of returns and appetite for risk. In fact, there are several factors ensuring the alignment of Investors interests with those of Asset Managers; the most notable of which is the process of revenue generation.

Calculation of the Management Fee (remuneration or revenue) payable to the Asset Management company is usually a percentage of assets under management. This implies that the potential revenue generated by the Asset Management company is directly related to the performance of the investments under management. Hence, optimal management of investors' funds is in the best interest of the Asset Management company, which is consistent and aligns with the expectations of the investor.

As an additional factor, a significant aspect of any Asset Management contract entails the drafting of an investment mandate. This industry-wide practice enables the client to clearly translate investment objectives as well as risk appetite. For example, the client may be highly risk averse and may be completely in opposition to the use of derivatives, short selling of securities or illiquid securities. The investment mandate should clearly stipulate such preferences, thereby aligning the behaviour of the Portfolio Manager to the expectations of the investor.

The administrative and reporting capability of an Asset Manager has become as vital as investment skill, even more so recently with an evolutionary legislative and regulatory environment. The ability to provide quality, reliable, insightful and prompt reporting to investors, which outlines the composition, strategic positioning and performance of investments, including the sources of risk and return, is a critical requirement. Investors are generally more risk averse nowadays, considering the recent tumultuous financial market environment, and therefore require constant and timely information regarding the status of their investments. On-going changes in the regulatory environment has placed even more pressure on institutional investors from a compliance and reporting perspective, which reinforces the need for Asset Managers to possess strong administrative and reporting capabilities.

Considering the continual evolution of financial products and markets, along with increasingly sophisticated and demanding investors, the most successful Asset Managers have a clearly defined investment process and philosophy, supported by robust administration. Primarily, Asset Managers aim to beat benchmark indices within the financial markets in which they operate. Nonetheless, in order to be competitive, most managers aim to outperform their peers on average. In the event that a client is not satisfied with the performance of a fund, from either a return or risk perspective (or both), the investor may choose not to renew their investment mandate and withdraw their funds, or simply sell the product. The historical performance of a fund and the Asset Manager is vital. This defines the reputation of the company, which plays a critical role in attracting new investors.

Generally, the Investment Management industry is extremely competitive. Therefore, most Asset Managers tend to specialise and focus on a specific investment philosophy, asset class or financial market, while the larger entities tend to diversify and differentiate their offering, housing teams with specialised expertise in a specific area of investment. Moreover, in the earlier part of this century, numerous independent Asset Management boutiques have emerged, with former employees of larger companies having left to offer specialised expertise and services in a particular field of the investment arena. Further, a growing number of institutions appear to be opting for an open-architecture business model, whereby potential investors have access to products and services offered by a range of Asset Managers, not necessarily belonging to the same group.

As with other segments of the Financial Services sector, the Asset Management industry has been in a state of flux since the recent debt and credit Financial Crisis. Actually, an emergent preference for Retail and Defined Contribution versus Defined Benefit Retirement Funds had an impact even before the Financial Crisis. This phenomenon, coupled with growing risk aversion on the part of investors and their understandable need to have more control over their investments, had already created significant challenges for the industry. Coupling these issues with the advancement of technology, increasing globalisation and the associated advent of lower cost channels for investment, the sub-sector must overcomes substantial hurdles in order to remain competitive. The backdrop of the changing regulatory and compliance environment further compounds these issues. Overall, Asset Management companies are now required to refine and evolve traditional business models and hone in on specific capabilities that are wider than their core investment ability, in order to remain effective and viable in the current uncertain market environment.

In their research paper titled, "Opportunity Amid Turmoil in Asset Management", Booz & Company, a leading global strategy and management consulting company, outline the key changes to the market environment as follows:

- **Clients** – Retail investors are beginning to play a greater role in managing their Retirement assets, while wealthier investors find the services offered by Financial Advisors to be redundant.
- **Client Interface** – The move to low-cost distribution channels is apparent and pervasive, with most companies considering a range of electronic, internet-based channels. Companies are also revising service levels and offerings to be commensurate with revenue levels generated from clients.
- **Investment Management** – Market leaders tend to be focusing on broadening and diversifying their investable universe, by considering emerging markets as well as alternative asset classes. Most Asset Managers are actively seeking lower cost alternatives, particularly for the Retail market.
- Middle Office – Firms are spending significantly more on Information Technology infrastructure to cope with the increasing regulatory demands, enhanced risk management and other administrative and reporting processes.
- **Support Functions** – Globally, there appears to be a growing trend whereby Asset Managers are outsourcing non-core functions and business processes, for e.g. Middle-office and Back-office operations. Companies have adopted Lean and Six Sigma programs to enhance execution speed and quality. This assists to lessen the growing cost burden, particularly from a regulatory perspective, while also creating capacity to focus and leverage core investment capabilities.

Booz & Company indicate that the success of an Asset Manager depends on three factors, viz. (1) the strength of the company's investment philosophy and process; (2) the reliability of a clear yet agile business operating model; and (3) a staff complement with a broad enough skill set to support and sustain the operating model. Traditionally, it appears as though Asset Managers have focused solely on the core function of managing investments, placing little to no emphasis on other aspects of their business model. However, the business landscape has altered to such an extent that ignoring the optimisation of core and peripheral operational processes, as well as marketing and distributional platforms could result in an unviable concern. This realisation is further confounded when one considers increasing costs due to the changing regulatory environment.

6.1.4. Products/Offerings

Asset Management companies manage investments on behalf of retail and institutional clients. They provide this service in the form of a fund, managed according to an investment mandate. A fund may be dedicated to a single investor or be open to multiple investors – in the latter case, such funds are commonly termed "Open Funds" or "Collective Investment Funds/Schemes". Collective Investment Schemes enable individual investors to pool their excess capital and access assets and financial markets that may have been otherwise inaccessible as an individual, due to various reasons. Nonetheless, these open funds are not limited to individual investors, with institutional investors also finding value in the commoditised nature of these schemes.

In general, the asset class that dominates the constituent holdings of the respective funds determines fund classification into categories. On this basis, the main categories of funds are Equity, Fixed Income (including Credit), Money Market, Commodity, Currency, Property and Alternative Investments (like Hedge Fund strategies, Private Equity, Infrastructure or Specialised projects). Other funds that constitute a combination of the aforementioned primary categories are Balanced or Structured funds. Additional levels of fund classification or categorisation usually include geographic, sector-based, investment-style or level-of-risk features.

Broadly speaking, two main streams or philosophies determine Portfolio Management divisions viz. passive and active Portfolio Management. Passive Portfolio Management refers to a quantitative process, where the investment process is algorithmically standardised and Mathematically or Quantitatively driven. The passive Portfolio Manager therefore makes decisions objectively with little or no scope for subjective decision making – the most popular example of passive Portfolio Management is index tracking. On the other hand, Active Portfolio Management describes the investment process where the Manager subjectively selects the securities he wishes to invest in, based on his/her expectation of the future risk and return characteristics of those securities. The process by which the Portfolio Manager assesses the risk and return prospects of a set of securities may be fundamentally, technically or quantitatively driven – or a combination of all of these methodologies. The active Portfolio Manager's performance is measured against some agreed upon market financial indicator, index or combination of these measures.

Based on the investment philosophy, a Portfolio Manager will manage either a Balanced or Specialised Fund. A Specialised Fund would focus on a specific asset class or a specific sector within an asset class (be it instrument, industry or geographical). Specialisation may also refer to a particular investment style, e.g. value and growth investing, or size and liquidity of the fund or constituent components of the fund. Balanced Funds on the other hand constitute a variety of asset classes, with the primary benefit of such funds being their asset class level risk diversification benefit. In the most onerous case, the Portfolio Manager would be responsible for the weighting of each asset class within the Balanced Fund or Portfolio, as well as the composition of the securities that represent each asset class. In other cases, an institution, like a large Pension Fund, would manage the weighting of the asset classes that constitute the Balanced Portfolio in-house and delegate management of the asset class portfolios to specialised Portfolio Managers.

Another offering, which naturally forms part of the investment process, is the production of fundamental and Quantitative research. Asset Managers usually employ Financial and Quantitative Analysts to analyse securities, markets and investment strategies. This "buy-side" research forms an integral part of the investment process and serves as an additional value add product for clients.

6.1.5. Types of Asset Managers

In South Africa, two types of investment institutions are common, these being Collective Investment Schemes and Long-term Insurance companies. The Financial Services Board (FSB) regulates both these institutions – Collective Investment Schemes institutions administer and offer products such as Unit Trusts, while the Long-term Insurance companies offer products such as linked policies. The FSB does not directly regulate Exchange Traded Funds and private investment vehicles (e.g., those housed in partnerships and trusts).

Collective Investment Schemes

Collective Investment Schemes are legally established via an agreement or deed between the Portfolio Manager and trustees or custodians and constitute more than one portfolio or fund. The FSB prescribes the terms of the agreement, which is fairly standardised, and approves the appointment of the respective trustees and manager. From a regulatory perspective, all Collective Investment Schemes in South Africa are open-ended funds that are available for public investment. The manager is responsible for the administration of the scheme, while the trustees oversee the administration thereof.

There are three types of Collective Investment Schemes currently permitted by the FSB:

- Securities (which includes money-market funds, feeder fund and fund-of-funds);
- Property; and
- Participation Bonds.

Naturally, given the nature of the South African financial market, along with the relatively low liquidity and lack of price transparency in the property and bond markets, Collective Investment Schemes in securities are by far the most prominent type of investment structures. These schemes are open-ended, and Managers are typically required to provide valuations and redemptions on a daily basis. Since July 2012 and the introduction of "Board Notice 80 of 2012", Collective Investment Schemes have been subject to stringent prudential regulation, which covers, amongst other aspects, the following:

- Criteria for portfolios that comprise Collective Investment Schemes;
- Types of investments that comprise eligible portfolios;
- Conditions, limits and procedures by which portfolios and securities may be included in a scheme; and
- Rules for the inclusion of listed and unlisted derivative instruments.

Linked Policies

Long-term Insurance companies participate directly in the investment market by issuing financial products called Linked Policies. A Linked Policy is a long-term policy that is in effect a long-term investment. The Insurer holds the assets on behalf of the Policyholder. Considering the circumscribed nature of the Insurer's liability under such a Linked Policy, assets that comprise a Linked Policy do not have any prudential investment requirements. The Policyholder or its Investment Manager usually specifies the assets or types of categories of assets held by the Insurer for the purposes of the policy. The common jargon attached to making use of such an Insurance policy structure, is to make use of a life wrapper.

Other Structures

Passively managed funds have experienced substantial growth in the South African Asset Management sector over recent years. The growth in Exchange Traded Funds has been a significant contributor to growth in the passive investment market, with 40 Exchange Traded Funds listed on the Johannesburg Stock Exchange as at June 2013[9]. In some cases, regulation of Exchange Traded Funds is the same as any other Collective Investment Scheme; otherwise, regulation falls under the Companies Act and the Johannesburg Stock Exchange.

6.1.6. Employment

The Finance and Accounting Services Sector Education and Training Authority (FASSET) is the local body established in accordance with the Skills Development Act, to oversee and administer the implementation of the National Skills Development Strategy III in the Finance and Accounting Services Sector. The Finance and Accounting Services Sector actually refers to the finance, accounting, management consulting and other Financial Services sub-sectors. The sub-sector does not correspond with any of the sectors or sub-sectors reported on in the national accounts nor the labour market reports. It is therefore difficult to glean the relevant information for this sector and its sub-sectors from reported information, therefore FASSET have sought to develop its own data repository.

The segment of the Financial Services sector overseen by FASSET may be better understood by considering the standard industries (based on Standard industry Classifications (SIC)) which constitute the sector, along with FASSET's classification thereof – this is shown in the table below.

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9 Source: http://www.jse.co.za/Libraries/JSE_-_How_to_Invest_-_Educational_Literature/List_of_Exchange_Traded_Funds.sflb.ashx

Table 13: FASSET's subsectors of interest and custom subsector definitions *(Source: FASSET.)*

SIC Code	Description	FASSET Subsector
81904	Investment Entities and Trusts	Investment Entities and Trusts and Company Secretary Services
88103	Company Secretary Services	
83110	Administration of Financial Markets	Stock broking and Financial Markets
83120	Security Dealing Activities	
83121	Stock Broking	
88102	Asset Portfolio Management	
83180	Development Corporations and Organisations	Development Organisations
88101	Tax Services	Accounting, Bookkeeping, Auditing and Tax Services
88120	Accounting, Bookkeeping and Auditing Activities, Tax Consultancy	
88121	Activities of Accountants and Auditors Registered in Terms of the Auditing Profession Act	
88122	Activities of Cost and Management Accountants	
88123	Bookkeeping Activities, including Relevant Data Processing and Tabulating Activities	
83190	Activities Auxiliary to Financial Intermediation	Activities Auxiliary to Financial Intermediation
88140	Business and Management Consulting Services	Business and Management Consulting Services
88142	Project Financial Management	
91108	South African Revenue Services	SARS and Government Departments
9110E	National Treasury Provincial Treasuries	

From an Asset Management perspective, the FASSET subsectors that are of interest are the first two in the table above, viz. the "Investment Entities and Trusts and Company Secretary Services" and the "Stock Broking and Financial Markets" subsectors. Note that these subsectors contain parts of the industry which fall outside the Asset Management space, however the data still provides one with a reasonable understanding of employment trends in the Investment Management sector. In the "FASSET Sector Skills Plan Update for the Period 1 April 2013 to 31 March 2018", FASSET provide the following statistics for employment in the sector as a whole, as well as the two subsectors of interest for the period ranging from 2002 to 2011.

Table 14: Total employment in FASSET sectors along with contribution of subsectors of interest to employment, over the period ranging from 2002 to 2011 *(Source: FASSET.)*

Year	Total Employment	Contribution of Subsectors
2002	87,868	16%
2003	94,838	10%
2004	93,261	11%
2005	97,602	14%
2006	102,087	14%
2007	111,083	17%
2008	119,327	18%
2009	114,761	18%
2010	114,529	17%
2011	126,686	17%

FASSET predicts global employment growth averaging 2,2% per annum in the sub-sector for the five-year period post 2011 in the event of a low economic growth scenario (2.0% per annum real growth); the realisation of baseline economic growth (3.8% per annum real growth) would result in employment growth averaging 3.6% per annum, while high economic growth (5.7% per annum real growth) would result in employment growth averaging 5.3% per annum.

6.2. Interviews – Asset Management

6.2.1. Regulation and Compliance

Asset Managers stated that the increasing burden of regulatory reporting and compliance is costly and hinders the ease with which they can do business. Extra staff need to be employed and systems upgraded to meet additional requirements; even if certain core functions are outsourced, the Asset Manager still bears any extra costs to the external vendor. Smaller companies find that this cost has a negative impact on revenue generation as they do not have the large volumes and economies of scale to spread the cost.

Senior Management spend between 30 and 40% of their time on regulatory and compliance issues. It is difficult to glean the actual cost of regulation and compliance, as there are also many other general compliance requirements – for example, King III Corporate Governance and the Companies Act.

A particular company interviewed has developed or sourced online learning and training interventions to ensure that staff are adept with new and existing regulation. They found that their greatest challenge is bridging skill sets across different fields, like Information Technology, Law, Finance and Mathematics. Training related to the Financial Advisory and Intermediary Services Act (FAIS) is a prominent feature, as the current act does not absolve individual employees from erroneous decisions.

Asset Managers mentioned that further regulatory and legislative changes are imminent and it is very difficult to assess the impact that proposed changes will have on business operations. Regulation 28, the Collective Investment Schemes Act, Hedge Fund regulations, the Treating Customers Fairly Act, the Protection of Personal Information Act, Retirement Fund Reform, Solvency II, Twin Peaks and the Financial Markets Act in South Africa, affect companies. In addition, they also have to comply with foreign regulatory requirements when investing abroad.

The overall perception is that most legislation and regulation is reactive in nature and is not proactive for the industry. Regulatory exams focus on regulation and compliance and largely ignore technical expertise. There needs to be a strong slant toward greater financial literacy in South Africa (for individuals and those working in the industry) in order to demystify the Financial Services sector and drive appropriate constructive regulation and legislation.

There is also a concern that Regulators are creating a double layer of the same regulations. For example, the Financial Services Board has a due diligence process for Mutual Funds, however they also require companies to perform the same due diligence process before investing in a Mutual Fund – the Asset Manager is consequently duplicating the work of the Financial Services Board.

Some companies view Exchange Control as an inhibitor of growth as they constrain the ability of South African companies to invest overseas.

A certain Asset Manager suggested establishing partnerships between the government and industry to resolve issues around regulation and compliance. A neutral industry body like the Association for Savings and Investments South Africa (ASISA) should drive this arrangement.

6.2.2. Growth

Growth areas

Assets Managers pointed out that in the local savings (retail) market, disinvestment occurs at a rate of 7 to 10% per annum. Retirement funds (institutional market) have negative cash flows due to annual retirements. The large movement of cash between retirement funds and savings creates the perception that growth is taking place, whereas the reality is that growth is largely static in these areas.

Companies believe that the South African market is largely saturated and that significant expansion is unlikely. Factors hampering the growth of assets under management are retrenchments, unemployment and other inhibitors of employment as these factors affect the ability of consumers to save. High net worth individuals are less affected by these dynamics, so growth is possible in this area.

International expansion is a key focus area as many global Fund Managers are capping or closing funds to new business. This occurs when the size of the assets under management in a particular fund develops to such an extent that the trade-off between liquidity and the ability to diversify and effectively and actively manage assets hampers performance. This means that there is space in the international market for additional Fund Managers. By offering a wider range of investment opportunities companies are able to diversify risk. Furthermore, steady rates of return from South African Asset Managers are attractive to foreign investors. Companies typically have existing offerings in terms of international funds.

A shift is underway from traditional Asset Management products towards Alternative Investments. These products are primarily infrastructure based and often have a social responsibility dimension – development is largely in the rest of Africa and other Emerging Markets. Public sector investors have a particular interest in this area.

Expansion into the rest of Africa and other Emerging Markets

Most Assets Managers have an existing strategy and presence in the rest of Africa and other Emerging Markets, enabled by the relevant expertise and infrastructure to manage investment in these jurisdictions.

Partnerships with established, in–country companies is the preferred method of doing business in the rest of Africa. Such alliances ease issues like minority shareholder rights, restrictive property rights, expropriation, concessions, language barriers and cultural differences. Alternative Investments in the rest of Africa often involve unlisted investments that require specialised contractual agreements with counterparties.

The main obstacles to investing in the rest of Africa are the lack of understanding of methods of doing business, as well as the legal, legislative and governance structures – all of which vary by country. Companies in developed countries, especially the UK, have greater experience and expertise investing in the rest of Africa than South African companies. Many developed market investors invest directly into the South African or African markets via their own stock exchanges. Investments come in a number of forms – exposure via South African stocks that have investments on the rest of the continent, and dual–listed African stocks or overseas stocks that derive earnings from African investments. International investors do not necessarily approach South African Asset Managers for exposure. This poses a challenge for local institutions and undermines the common belief that South Africa is the 'Gateway to Africa'.

Companies suggested that the government could assist with expansion issues by developing trade agreements and strong relationships with countries in the rest of Africa – this could alleviate investor concerns around African economic and political stability.

Costs

Asset Managers cited regulatory reporting and compliance as factors contributing to increased overheads. (Please refer to 6.2.1. Regulation and Compliance for details.)

In general, there is a direct correlation between the size of the business and the number of people required by the business (across all industries). However, in Asset Management, the effort required to manage funds varies according to the complexities of the asset class under management, and in most instances, the effort is size invariant. For example, cash funds are the least employment intensive, while equity funds are particularly employment intensive, irrespective of size. There is a direct correspondence between the number of employees required and the sophistication of the assets under management.

Outsourcing

A particular Asset Manager outsources a number of its business functions – but remains committed to maintaining core operations in South Africa. This company outsources non–core functions to various service providers that have a local presence, and thus still contributes to job creation. It does not believe that aggressive outsourcing of non–core functions has a negative impact on employment in South Africa.

This company has a low fixed-cost base due to outsourcing and a potentially higher variable-cost base, depending on the impact that fiduciary, compliance, regulatory or economic changes have on the services offered by external vendors. This Asset Manager is critically dependent on the operation of external vendors – therefore any expansion project requires co–operation, knowledge, skills and the necessary technical development on the part of service providers – particularly in the case of non–core operations like administration and distribution of funds. Outsourcing non–core business functions allows the company to reduce technology investment and the consequential operational risk and to focus instead on core fund management and client service activities.

A different Asset Manager plans to implement changes in their Information Technology strategy over a period of 18 months. The company outsources monthly investment reporting to an external vendor, with the objective of automating the process. The planned changes focus on streamlining systems applications wherever possible, in an effort to optimise systems architecture. Their representative commented that purchasing customised systems from suppliers leads to a reliance on external vendors, this hampers their ability to modify systems in an agile manner.

Risks to growth

Existing and proposed regulatory reporting and compliance requirements create hurdles for new business opportunities. (Please refer to 6.2.1. Regulation and Compliance for details.)

A particular company suggested that political uncertainty and particularly the threat of nationalisation is an on-going potential risk to growth.

It is felt that Government products like the RSA Retail Savings Bond constitute unfair competition. There is little clarity on the method used for pricing or funding the associated costs, and partial government subsidies significantly reduce the viability of similar, privately offered investment products. This could potentially reduce the overall efficiency and growth of the private savings system. However, poor marketing of government products has minimised the impact thus far.

Global expansion hinges on the ability of companies to convince global asset consulting companies of the robustness of all aspects of the business. This is achieved through due diligence, which scrutinises all Front, Middle and Back Office processes. Some Asset Managers feel that outsourcing non-core functions is likely to raise concerns about the flexibility and agility of outsourced administrative and distributional processes, particularly in the face of changing fiduciary, regulatory and compliance requirements. From an operational risk perspective, systems infrastructure needs to cater for seamless integration into various markets and jurisdictions.

Companies do not believe that currency risk (fluctuations in the value of the Rand) is a factor that dissuades international investment in South Africa.

Asset Managers commented that the Banking sub–sector represents a closed system in South Africa and that this is a hindrance to growth in Long–term savings. Long–term Insurance companies have large deposits with local Banks due to stringent regulatory liquidity constraints. There is a view that the lack of sufficient liquidly traded bonds available in the market represents a fundamental structural problem. Life companies spread deposits across the major Banks to reduce the concentration of risk.

Individual investors fall into two general categories – the financially educated, who seek higher yields on investments, and the financially uneducated who tend to leave their money in the Bank. High debt–to–income ratios reduce the appetite for risk. Individuals who access their retirement savings early tend to use the money to settle credit card debt or debt related to asset finance; this means that funds naturally flow back into the Banking system. An intrinsic link exists between financial literacy, understanding products, the ability plan financially and individual choice.

6.2.3. Education

Training and development

Regulatory reporting and compliance are factors contributing to the implementation of additional training interventions. (Please refer to 6.2.1. Regulation and compliance for details.)

Issues affecting the amount of time taken to reach productivity in graduates are soft skills and work readiness. (Please refer to 6.2.4. Skills deficits for details.)

A certain Asset Manager stated that attempts to train new members for their core Investment teams (which include Senior Investment professionals, Equity Analysts and Portfolio Managers) have been difficult or an outright failure in some cases. They introduced a Mentorship and Co–portfolio Management framework for new people who join the core investment team in an attempt to ensure continuity of the team. They conceded that there may be no clear solution to the development of new Portfolio Managers.

Asset Managers invest heavily in training and skills development. Training interventions vary from outsourcing training to a variety of external vendors, funding undergraduate level degrees and running internal Graduate Development, Training outside Public Practice, Actuarial Development, Internship and Company Induction programmes. Companies address other training needs as they arise and use external training providers for this purpose.

Tertiary education

Asset Managers specified a need for credible, relevant, industry–driven degrees and qualifications.

Graduates with soft skills and work readiness capability are critical for Asset Managers. Companies consistently estimated that it takes 6 to 12 months to develop graduates to the point where they are productive. Tertiary education teaches technical skills only and neglects other skills required for effective functioning in a corporate environment. Overall, university programmes need to be more role specific.

6.2.4. Skills deficits

Asset Managers require staff with all–round investment skills across the business – from Back Office administrators, Compliance staff, Risk Management staff, Investment Analysts and Traders to Portfolio and Fund Managers. There is a specific need for investment/market knowledge, the ability to price instruments in non-investment roles, and particularly for Systems Developers due to the sophistication of Asset Management systems. Relatedly, it is difficult to find Sales people with the correct blend of technical investment knowledge and sales skills.

Individuals in the core Investment team are required to make decisions based on theoretical knowledge and psychological or behavioural factors combined with economic considerations. Companies require staff that can make sound judgements while maintaining independent thought thus avoiding the influence of "herd" mentality. Staff need agile skills and the ability to adapt to a constantly changing environment.

Asset Managers require Actuaries and Chartered Accountants (as they have a broad foundation of required skills) and graduates with degrees that have a mathematical foundation – for example Bachelor of Science and Bachelor of Commerce degrees.

Companies have an on-going need for staff in the core Investment team – Investment Managers, Equity Analysts and Portfolio or Fund Managers. Specialist knowledge is required for Infrastructure Investments – for example, Engineers.

Compliance staff are consistently in demand due to on-going changes in regulatory and compliance requirements.

The quality of school education requires drastic improvement.

Some Asset Managers mentioned that previously disadvantaged candidates lack the essential soft skills required to operate in a corporate environment, and this renders them unemployable.

There is no formal source of knowledge around investing or development in the rest of Africa. Companies across the Financial Services sector experience similar problems when expanding across the continent – a collaborative body of knowledge would be mutually beneficial.

6.2.5. Recruitment

Asset Managers outlined a number of recruitment difficulties.

There are high volumes of applications for advertised vacancies, but companies have difficulties appointing applicants due to their lack of experience, even though candidates may have the required technical skills. There is a tendency to hire from the narrow pool of experienced individuals already in the industry.

While Asset Managers support Employment Equity, it is increasingly difficult to source suitable candidates in terms of experience and qualifications; this applies across all business areas, but particularly in Risk, Compliance and Governance.

The recruitment process is lengthy for core roles, taking 6 to 12 months or sometimes longer for specialist positions.

7. Service Providers to the Financial Services sector

7.1. Overview of Service Providers to the Financial Services sector

Service Providers offer a broad range of services to companies across the Financial Services sector; these vary between companies and include the following:

- Governance, risk and compliance services
- Regulatory reporting

- Taxation services
- Trading services and optimisation
- Investment and risk management
- Investment performance analysis
- Data management
- Administration services
- Actuarial services
- Accounting services
- Business process outsourcing (BPO)
- Strategy
- Optimisation of business operations and processes
- Technology solutions
- Technical advice
- Research

7.2. Interviews – Service Providers to the Financial Services sector

7.2.1. Regulation and Compliance

Regulations generate change, change generates a need for services and services generate revenue for Service Providers. South Africa is a highly regulated market with sophisticated products that require technology solutions – this is beneficial for companies specialising in software solutions and services. In some countries in the rest of Africa, markets are less regulated and Financial Services companies offer simpler products that can be sold using mobile technology – this creates additional avenues for Service Providers.

While Service Providers may benefit from increased regulation, they believe that this detracts from the core business of Financial Services companies.

Solvency II (S.A.M) is expensive for Long–term Insurers in terms of the additional staff and effort required for reporting and compliance, as well as the cost of upgrading systems to meet these requirements. Initially larger Insurers were in favour of developing internal models for Solvency II reporting, but this has changed due to the complexity of model development and the process of approval by the FSB. Most companies have now elected to use the FSB model for efficiency reasons.

Overall, the FSB is relatively benign and their impact is evolutionary, rather than burdensome. FSB requirements for individuals (Compliance Representatives, Compliance Officer, Key Individuals etc.) are tedious and there is little leeway to interact with the FSB directly to make the process more efficient.

It would be invaluable if the government created a department to assist multinationals in establishing operations in South Africa; including aiding the process of acquiring work visas for foreign staff. This would make South Africa a more attractive destination for offshore companies.

7.2.2. Growth

Growth areas

Globally, revenue growth has slowed across the Financial Services sector and profitability levels have dropped significantly since 2008. However, despite low growth rates and increased consumer indebtedness, there will always be a need for Financial Services. Service Providers expect that low growth rates could lead to an increase in mergers and consolidations amongst small niche companies across the sector in order to benefit from economies of scale.

In 2012, a Service Provider conducted a survey that revealed that the top 12 Assets Managers in South Africa expect around 10 to 12% growth. Globally, Assets Managers are optimistic about growth being slightly higher than GDP per country.

Regarding the growth strategies of Financial Services companies, a Service provider commented that companies should focus on providing offshore services to the United States, United Kingdom, European and Asian markets –

rather than expanding into the rest of Africa. Even though South Africa is not as cheap as other Emerging Markets, it is still cost effective for companies in the United States and United Kingdom to offshore complex functions to South Africa (and move simpler functions to relatively cheap locations like India). South Africa's advantage is that it has a sophisticated Financial Services sector with an experienced and educated talent pool – it offers good value for money to multi-nationals.

Further to the comment above – a certain Service Provider interviewed is a large privately-owned multi-national that offshored the development of various Financial Services software and technology solutions to South Africa. The company is US based and has a presence in Europe, Asia, Africa and the Middle East. In Africa, Kenya is their largest market after South Africa and they have interests in Uganda, Rwanda and Tanzania. They currently employ over 100 staff in Cape Town and Johannesburg and view South Africa as a centre of excellence that sits between onshore and offshore.

South Africa's resources are less expensive than the United States, but much more expensive than India. South Africa's advantage is that, despite being more expensive, it delivers better quality in a shorter period. Initially, software implementation and consultation in their South African operation was at a ratio of 80% external and 20% local resources – this has changed over time and their target is to change the ratio to 80% local and 20% external resources. They expect the South African operation to grow further in the next few years as they gradually add more services, like hosting and application management. The market in South Africa started slower in 2013 than it did in 2012 and this is a cause for some concern, although being a multi-national means that growth in other areas like Asia can result in an increased demand for offerings provided by the South African operation.

Expansion into the rest of Africa and other Emerging Markets

Service Providers have differing views about expansion into the rest of Africa. (Please refer to related comments under 7.2.2. Growth – Growth areas.)

A certain company believes major growth is more likely to come from the rest of Africa than South Africa and as a result, they concentrate on establishing solutions in sub-Saharan Africa markets from their base in South Africa, with assistance from their Dubai operations on certain products. As regulation changes in certain African countries, it creates opportunities for companies offering software solutions and services.

Most Service Providers mentioned that there are a number of hindrances to development in Africa that make expansion a lengthy and difficult process, to the extent that it is sometimes unfeasible to do business. African markets often impose equity limits on foreign companies or put restrictions in place based on narrow issues, while neglecting to view the benefits to the wider economy. For example, a South African Bank had duplicate their Banking system on-site in Namibia, as this is a regulatory requirement of running a Namibian Bank. In India, authorities require that permission to open offices is granted separately for each State. Most Financial Services companies and Service Providers opt for a partnership model with in-country companies as it eases some of the obstacles to establishing a presence in the rest of Africa and other Emerging Markets.

It would be useful if the South African government could facilitate agreements with other African countries to make travel within Africa easier in terms of visas, particularly for business travel. The frequency of available flights is an issue; in some countries, flights are only available to and from South Africa every 3 or 4 days. These types of issues influence the ease of doing business on the continent. Additionally, there are larger concerns regarding political issues around job creation, the flow of profits out of the country, negative perceptions towards foreign businesses and legislation in African countries.

A certain Service Provider adopts a conservative and cautious approach around expansion into the rest of Africa. In fact, they would only consider being involved with sovereign funds in the rest of Africa, as these have real money and assets behind them. This company has on-going concerns about the risk profile across the continent, specifically related to political instability, and they believe that moving into markets in the rest of Africa is not an efficient means of revenue generation or job creation.

Costs

Since the Financial Crisis, there has been a strong focus on cost reduction across the Financial Services sector. Strategies include; systems and process efficiency, centralising functions to benefit from economies of scale and standardisation, managing operations centrally to redirect revenue, and maintaining profits. The emphasis on profitability should focus on improving business efficiency and should not be at the expense of product development and attracting the right clients.

Financial Services companies tend to have a large number of different systems, which contributes to high overheads. However, there are a number of reasons for operating multiple systems. Each system performs complex functions and it is very difficult to move an existing system onto a new platform without experiencing problems; migration issues pose a real risk to business functioning. The cost of migrating existing systems to new platforms is excessive in most cases. Each system is specialised due to differences in types of products and related functions, therefore it is very difficult to integrate multiple systems onto a single platform successfully. There is little incentive to replace a system that runs efficiently for a particular function.

Retail Banking costs in South Africa are often cited as being among the highest in the world – this is a contentious issue in the sub-sector. A contributing factor to high Retail Banking costs is the tendency of institutions to offer the full spectrum of Banking services – Home Loans, Vehicle and Asset Financing, Personal Loans, Credit Cards, Personal and Business Banking etc. Operational overheads in terms of staff, systems and infrastructure required to manage a comprehensive service offering are expensive. Additionally, Retail Banks have a substantial network of Bank branches in small towns across the country – this increases infrastructure and staff costs and is the main cause of high cost-to-income ratios.

A certain Service Provider remarked that although companies across the sector frequently complain about increased costs due to regulatory compliance, companies do not bear the costs themselves as they ultimately transfer these to investors.

Outsourcing

Service Providers made the following comments regarding outsourcing by Financial Services companies.

Most Retail Banks in South Africa have not outsourced any of their operations, not even to the extent of offshoring their own processing centres to cheaper locations. The main reason is that many Retail Banks and Long–term Insurance companies have previously attempted to combine functions internally and were unsuccessful. This has made companies hesitant about considering outsourcing any business functions. For example, various companies attempted to amalgamate separate Call Centres into one central Call Centre and found that this was ineffective as specialised knowledge is required for different products and services. A few Asset Managers still follow an outsourcing model but retain Call Centres, Finance and Sales internally.

Most companies do not outsource Information Technology functions to Service Providers in their entirety, as they cannot risk not having full control of their data, especially in light of regulatory reporting requirements. Companies would have to be 100% certain that the external supplier could provide the correct information for reporting in the required timeframe. Service Providers offering outsourcing services need to be able to meet highly specialised requirements. As a result, companies typically collaborate with Service Providers for systems and support, rather than outsourcing the full reporting function.

A particular Service Provider mentioned that there are two types of companies that outsource functions – those in the process of expanding and effecting efficiencies and those in dire trouble and need to outsource to prevent themselves from going out of business.

Risks to growth

Service Providers cited challenges around expansion into other countries as risks to growth across the Financial Services sector. (Please refer to 7.2.2. Growth – Expansion into the rest of Africa and other Emerging Markets for details.).

Additionally, companies mentioned further challenges around expansion outside South Africa related to both offshore markets and the rest of Africa. Globally, regulatory and legislative complexities are a hindrance as requirements differ per country. Despite having sound strategies, the real challenges around dealing with regulatory and industry bodies in foreign locations only becomes evident during implementation and this hampers development.

Financial Services companies commonly overlook culture in other countries and overestimate the appropriateness of a South African product to a different market. Products often do not gain traction in foreign markets despite using a partnership model with a sound expansion strategy.

Multi-national Service Providers experience challenges when offshoring to different locations for operational efficiency reasons as it is difficult to accomplish without a reduction in the quality of their products and services.

A particular Service Provider commented that mobile phone costs and bandwidth remain extremely expensive in South Africa, despite the reduction in costs over the past few years. For example, non-contract

pay-as-you-go) data provision in Kenya costs the equivalent of R100 for 1.5 GB, yet in South Africa, the cost is around R280 for only 1 GB of data, while the data transfer speed is similar. Furthermore, it costs R100 000's to maintain a 10 MB data connection between Cape Town, Johannesburg and London offices. Companies in Europe generally have a 40MB line as a standard, whereas a 40MB line in South Africa would be completely unaffordable. This kind of technology issue is a constraint to doing business in South Africa.

The company further commented that our government should also try to work with the South African Press regarding negative perceptions of South Africa overseas. Business people who have never been to South Africa are very reluctant to come due to events like Marikana – which make it appear as if South Africa is extremely dangerous and unstable. However, once people have been here, they love it and are happy to return, especially to the Western Cape. There needs to be some reassurance and work done around improving safety and reducing levels of crime to reduce external negative perceptions of the country.

7.2.3. Education

Training and development

Service Providers address skills needs as they arise with additional external training. A certain company mentioned that they do not have an issue spending money on developing staff, as companies in South Africa have to spend 3% of payroll on skills development to maintain their BEE Rating in any event. Money spent on skills development benefits both companies and staff – it is a win-win situation. The company also stated that they have an online portal for new staff to learn about the organisation, and a Mentorship Programme based on on–the–job training with reduced supervision over a period – usually 3 to 6 months.

Another Service Provider mentioned that they set up a Graduate Development Programme and engaged an external training provider to provide 6 months of intensive JAVA development training before the graduates moved into positions in the business. The company expected a higher level of productivity after the completion of the JAVA training, but found that the graduates still required a fair amount of mentoring. Graduates lacked soft skills and additional training provided these skills; specifically office etiquette, business writing, how to interact with others and work in a team. A year later they feel that the programme was a success and a good move towards a sustainable operation; the graduates have now reached the expected level of productivity and the overall perception is that the time spent developing these staff was well worth the effort. They are hoping to run another Graduate Development Programme in a different business area in 2014.

Tertiary education

Shortages of skills in South Africa is a challenge and Service Providers feel that everything being done by universities to address the supply of skills is fundamental and of great assistance to companies across the Financial Services sector. Overall, universities in South Africa have solid business degrees and produce good graduates, but students have poor thinking skills.

A particular Service Provider stated that their best graduates are Bachelor of Business Science graduates from the University of Cape Town because they may have an Actuarial or Mathematical background. The company further commented that the education system in the United Kingdom provides graduates with a broad range of skills as students can study an unrelated discipline at undergraduate level and then complete a postgraduate qualification specialising in Actuarial Science, for example. As a result, staff at their London offices have a broader outlook and this contributes essential diversity in thinking skills to the organisation. They mentioned that some companies within the sector deliberately target graduates from unrelated disciplines for the same reason.

A different Service Provider mentioned that approximately 75% of their staff have university degrees. The other 25% have extensive Financial Services industry experience and this negates the need for a degree. They require solid graduates, but not rocket scientists for their business – the company offers an attractive career path and they develop staff into Managers or Specialists.

One company interviewed specifically mentioned that they would benefit a great deal from an Investment Administration course.

7.2.4. Skills deficits

There is a critical need for Risk and Compliance staff due to increased regulatory requirements across the Financial Services sector. Each company requires between 5 and 10 employees in this area, which may seem like a small number, but these are key roles.

Actuaries are in short supply worldwide, including South Africa, and there is an on-going need for Investment Management and Finance skills. Graduates are required in the areas of Investment Management, Financial Management and Information Technology.

A particular company commented that they do not believe that there is a general skills gap, but there are critical skills shortages in certain areas, Mathematics and Information Technology in particular.

The growth strategy of certain Service Provider requires skills predominantly in Information Technology, specifically in the areas of application and software development, process management, data management, data scrubbing and systems testing.

7.2.5. Recruitment

Investment Banks are more attractive as an employer than other areas of the Financial Services sector due to high salaries and bonus structures. Companies pay higher salaries now because of a general reduction in the practice of paying large bonuses. Investment Banks require a certain level of stability in key roles, e.g. quantitative analysts and risk managers, and are willing to pay to retain those staff members.

Regarding employment within companies that provide services to the Financial Service sector - a certain company mentioned that they expect to increase employment at a steady rate each year. Current staff turnover is at a rate of 9%. Half of this is due to lifestyle changes and the other half is due to poaching by competitors. Another company commented that they have a low staff attrition rate as they carefully manage their relationship with their employees. The company built their South African operation in layers, initially employing a small experienced team and over time, the initial staff became Executives and employed a slightly less experienced layer of Senior Managers. Later they added a layer of less experienced people and finally they needed a junior layer as the operation expanded. They are still able to find resources locally when they need to hire new people, but as more multi-nationals are setting up operations in South Africa the cost of resources is escalating due to increased competition.

8. Industry Bodies

8.1. Overview of Industry Bodies

In South Africa, the government mandates a number of Industry Bodies to support and further the aims of companies across the Financial Services sector. Key Industry Bodies are – Association for Savings and Investments South Africa (ASISA), Banking Association South Africa (BASA), Banking Sector Education and Training Authority (BANKSETA), Insurance Sector Education and Training Authority (INSETA) and South Africa Insurance Association (SAIA).

8.1.1. Association for Savings and Investment South Africa (ASISA)

Members of the Association of Collective Investments (ACI), the Investment Management Association of South Africa (IMASA), the Linked Investment Service Providers Association (LISPA) and the Life Offices' Association (LOA) combined to form ASISA in 2008. These associations disbanded and their staff, assets and activities were transferred to ASISA.

ASISA serves as curator of the majority of Savings, Life Assurance and Investments in the Financial Services sector. ASISA collectively represents industry members and as such holds board membership of related regulatory authorities.

ASISA's strategic purpose and mandate is to strengthen relationships and remain a trusted partner with policymakers in the Financial Services industry and to proactively engage on policy, regulatory and other important issues of common concern. ASISA aims to promote a culture of savings and investment in South Africa by playing a significant role in the development of the social, economic and regulatory framework in which industry members operate, thereby assisting members to serve their customers better.

The ASISA Academy is an independent business school aligned with ASISA and accredited by both BANKSETA and INSETA. The ASISA Academy identifies, defines and develops learning solutions that are informed by and responsive to industry realities, delivered in an academically sound and practitioner-led manner. (*Source: Association for Savings and Investment South Africa (ASISA) website, About Us, ASISA Academy)*

8.1.2. Banking Association South Africa (BASA)

Banking Association South Africa (BASA) had its genesis in the Council of South African Banks (COSAB) in 1992 following the merger of Association of Mortgage Lenders, Merchant Bankers Association, Clearing Bankers Association and Association of General Banks. In 1998, COSAB's name changed to Banking Association South Africa (BASA) and restructured to address the challenges in the Banking sub-sector.

BASA is an industry body representing all registered Banks in South Africa. It is the mandated representative of the Banking sub-sector and addresses industry issues through lobbying, influencing policy, guiding sector transformation, acting as a catalyst for constructive and sustainable change, research and development and engagement with critical stakeholders.

The broad role of BASA is to "establish and maintain the best possible platform on which Banks can do responsible, competitive and profitable Banking". A critical role of BASA is to work with its members to enable this role within the context of the transformation challenges South Africa is addressing. *(Source: Banking Association South Africa (BASA) website, About Us)*

8.1.3. Banking Sector Education and Training Authority (BANKSETA)

BANKSETA has a mandate to develop skills in the Banking sub-sector. It does so by encouraging employers in the sub-sector to develop an active learning environment in the workplace, providing employees with opportunities to acquire new skills and progress their careers, increasing levels of investment in workplace education and training and promoting transformation as guided by the National Skills Development Strategy (NSDS) equity targets.

BANKSETA members are organisations whose main business activities fit into the following categories - Monetary Intermediation, Discount Houses, Commercial and other Banking, Building Society activities, other Financial Intermediation not elsewhere captured, Lease Financing, Securities Dealings by Banks, and activities ancillary to Financial Mediation and Microfinance.

BANKSETAs vision includes recognition as a centre of excellence and innovation for skills development in broader Banking and Microfinance. It aims to support transformation and people development through partnerships and enabling stakeholders to advance the national and global position of the Banking sub-sector. *(Source: Banking Sector Education and Training Authority (BANKSETA) website, About Us)*

8.1.4. Insurance Sector Education and Training Authority (INSETA)

INSETAs purpose is to increase the amount and quality of scarce and critical skills in the Insurance sub-sector, thereby enhancing the sub-sector and supporting the country's transformation.

INSETA aims to be an education and training thought leader and enabler of growth in the Insurance sub-sector. One of its core functions is to increase the talent pool to levels where the skills shortage is no longer critical and provide a comprehensive research base on international trends and best practises.

INSETA represents an industry with a wide range of employers across all 9 provinces, ranging from small employers (about 10 employees) to large employers (in excess of 12000 employees). The majority of the workforce represents skilled and highly skilled employees.

INSETA represents the following constituents within the Insurance sub-sector - Life Insurance, Short-term Insurance, Insurance and Pension Funding, Risk Management, Healthcare Benefits Administration, Unit Trusts, Funeral Insurance, Reinsurance and activities auxiliary to Financial Intermediation. *(Source: Insurance Sector Education and Training Authority (INSETA) website, About Us)*

8.1.5. South Africa Insurance Association (SAIA)

SAIA's vision is to promote and represent the interests of the Short-term Insurance sub-sector, while leading and enhancing the efforts of the industry to become recognised and trusted as an important contributor to the South African economy and society.

SAIA aims to encourage fair and ethical treatment of consumers of Short-term Insurance products, promote an understanding of Short-term Insurance and represent Short-term Insurance with all levels of stakeholders to ensure trust and confidence in the sub-sector.

SAIA also strives to create an environment in which the members of the Short-term Insurance sub-sector can share information, debate important issues, generate opportunities to enhance reputation and create a common vision for the sub-sector.

SAIA's key focus areas include Environmental and Social Risks, Governance, Motor Vehicle Insurance and Reinsurance. *(Source: South African Insurance Association website; About Us and Focus Areas)*

8.2. Interviews – Industry Bodies

8.2.1. Regulation and Compliance

Industry Bodies cited increased regulatory and compliance requirements as factors leading to increased costs across the Financial Services sector. (Please refer to 8.2.2. Growth – Costs for details.)

Implementation of the FSB version of the international Solvency II regulation for South African Long-term and Short-term Insurers and Reinsurers is currently a joint project between the FSB and ASISA. The capital requirements of Solvency II should not have a significant impact on the Insurance sub-sector, as Insurers in South Africa are substantially overcapitalised. That said, Solvency II regulation might be punitive for companies that only have one line of business, particularly in the Short-term Insurance sub-sector. Companies that have a diverse Short-term Insurance offering, for example, Marine, Household, Motor Vehicle etc., are less affected by a catastrophe as claims cost are cross-subsidised. Companies that have multiple lines of business generally have capital in excess of that required by Solvency II regulation. SAM capital requirements are higher for niche Insurers due to the increased level of risk they face from single events.

Industry Bodies question whether the cost of regulation is comparable to the benefits of regulation to the consumer. For example, FAIS regulation costs the FSB around R75 million and Financial Services companies and Brokerages around R500 million per year. Despite the amount of money spent on consumer protection, financial scandals like those involving J Arthur Brown and Share Max still occur.

ASISA are collaborating with the FSB and industry educational service providers to revise existing regulatory examinations and to segment savings and investment legislation to enable the more precise application to affected sub-sectors.

A certain Industry Body commented that they are working with the assistance of the Insurance Industry on the proposed simplification of certain areas of the Pensions Fund Act, which is currently more appropriate for large, complex retirement funds; the purpose is to make the act applicable to smaller funds, which is currently not the case. They have also undertaken an impact study in collaboration with two local universities to assess the possible social and economic impact of planned Social Security and Retirement Fund Reform. They believe that the implementation of a National Security Fund and a mandatory Government Retirement Fund could result in the worst-case scenario of the removal of up to 50% of existing assets from the savings and investments industry.

Fee-based commission on Investment products may result in a focus on high-income investors to the detriment of lower income investors. The general transition away from fixed commission to a fee-based structure could lead to a decrease in Brokers or Independent Financial Advisers and an increase in the number of Agents or Tied Intermediaries.

Industry Bodies expressed similar sentiments to that of Investment Banks, Asset Managers and Long-term Insurers regarding government products like the RSA Retail Savings Bond. There are concerns that the government has an unfair competitive advantage, as they are not required to adhere to the same level of Prudential regulation as private companies, although this is not currently a major issue as growth in government products has been slow due to poor distribution.

A particular Industry Body commented that the view that stringent Financial Service regulation saved South Africa from the Financial Crisis is incorrect. The South Africa government did not have to resort to bail outs like the United States and the United Kingdom, as Financial Services companies are prevented from having large offshore exposures due to Exchange Control. It is a misperception that levels of Financial Services regulation in South Africa are more stringent than in Europe and the United States. Additionally, Financial Services companies in South Africa have a legacy of focussing inwardly and are generally very cautious about expanding and investing offshore; this helped to limit the effect of the Financial Crisis.

A different Industry Body commented that it might be beneficial for economic growth to remove Exchange Control completely. There are currently asymmetries between local and offshore Exchange Controls; it is easier to invest money abroad than to invest money in South Africa from offshore locations.

A further comment was that the United States economy and Banking system are exceptionally flexible, for example, there is less red tape around employment legislation, and this enables organisations to adapt to economic and market changes efficiently. A further illustration is that during the financial crisis homeowners could vacate their homes and post the keys to the Bank; this allowed Banks regain control over assets rapidly and reduced losses.

The Financial Sector Charter requires companies across the Financial Services sector to develop strategies to sell business to Living Standards Measure (LSM) 1 to 5. An Insurance Industry Body commented that currently the Short-term Insurance sub-sector only sells to LSM 8 to 10, not even to LSM 6 and 7. LSM 1 to 5 are low-income earners, hence it is very difficult to sell Short-term Insurance in this area. Low-income earners prioritise opening a Bank account and acquiring a funeral policy; insuring a motor vehicle or household contents are low on their list of priorities. Planned Microinsurance legislation should make it easier to offer low cost products to these categories. National Treasury is investigating issuing Microinsurance licenses that have different regulatory and compliance requirements for small, capped sums assured, as the risk involved is lower.

8.2.2. Growth

Growth areas

SAIA commented that Short-term Insurers are not increasing market penetration – only one third of all cars on the road in South Africa are insured. The way to increase penetration in this area is to offer more affordable Motor Vehicle Insurance; however, this is currently not possible for a number of reasons. (Further comments are included under 8.2.2. Growth - Risks to Growth).

Expansion into the rest of Africa and other Emerging Markets

The consensus amongst Industry Bodies is that the partnership model used by most Financial Services companies when doing business in the rest of Africa is the least risky and most effective mechanism for expansion.

A certain Industry Body mentioned that it is a common mistake to consider South Africa as the gateway to business in Africa, as other countries on the continent are making the same claim. The strength of South Africa's position going forward is highly dependent on the nature of the relationships, foundations and opportunities forged through the BRICS alliance. A different Industry Body mentioned that South African Banks set up two projects to investigate possible opportunities relating to this supposition and neither of the results proved to be optimistic.

Costs

An Industry Body commented that technological innovation continues to have an increasing impact across the Financial Services sector. The demand for good financial returns is forcing organisations to reduce costs through automation of business processes, especially in light of slowed economic growth.

The general view is that increased regulatory and compliance requirements have led to an escalation in operating costs as Financial Services sector companies have to employ additional staff and enhance systems to meet changing requirements. If cost increases affect shareholder returns, then this could affect the potential future capital base of organisations, as shareholders will be reluctant to provide additional funding. Executives are spending a disproportionate amount of time on compliance issues and less time on core functions like business strategy, which could in turn affect organisational growth, innovation and development.

South Africa is a member of the G20 and as such is subject to Financial Services Assessment by the World Bank. This means that South African companies have to comply with the global regulatory environment. In all likelihood, South Africa will implement Solvency II (scheduled for January 2016) ahead of Europe, who have delayed implementation indefinitely. Europe has also postponed the implementation of Basel II, already implemented in South Africa. The planned implementation of Twin Peaks will end the separation of non-Banking and Banking regulation in South Africa and all areas of the Financial Services sector will be subject to both Prudential and Market Conduct regulation. While acknowledging the benefits to the sector and South Africa, regulation increases the cost of doing business; the actual cost of Solvency II and Twin Peaks to companies is unknown at this stage.

A Banking Industry Body stated that the largest overhead for companies in the Banking sub-sector is staff, at around 50% of costs, and then Information Technology, at approximately 15% of costs. During unprofitable periods, cost reduction is a key strategy and reducing the number of employees through natural attrition and sometimes retrenchments is inevitable. Currently, job creation in the sub-sector is at odds with the economy as efficiencies are at risk.

SAIA stated that the manner in which the premium rand gets broken up drives the financial model in the Short-term Insurance sub-sector. This applies across the spectrum even though there are different players – niche, direct and speciality Short-term Insurers. 20 years ago, the allocation per R100 premium for a Broker driven company was R70 to claims payments, R15 for commission, R10 for costs and R5 to profits. Commission has a cap of 12,5% for Motor Vehicle Insurance and 20% for all other types of Short-term Insurance.

The profit margin has always been low across the Short-term Insurance sub-sector; however, over the last 6 or 7 years, the premium breakdown has changed. The cost and commission portion increased to R32 per R100 of premium, while commission structures have not changed. Increasing operating costs are only partially due to regulation and compliance requirements – the information technology environment has become increasingly sophisticated, customer expectations have changed and administration costs have escalated. Increases in Reinsurance premiums also drive up costs. Reinsurance is global; therefore, a catastrophe in another part of the world will affect Insurance premiums in South Africa. Overwhelmingly, premium increases in the sub-sector are due to claims inflation. Short-term Insurers are struggling to maintain existing business and are operating defensively.

Outsourcing

Short-term Insurers are constantly looking for ways to reduce costs; as a result, some companies have moved their Call Centres and IT development offshore. There were no further comments made by Industry Bodies regarding outsourcing across the Financial Services sector.

Risks to growth

A Banking Industry Body commented that the Banking sub-sector struggles to balance international Banking methods and the unique needs of the South African Banking environment, for example, financial inclusion of previously excluded individuals. This requires innovative solutions like the use of mobile technology; often such methods contravene conservative international best practice standards.

SAIA stated that the increasing costs of claims are threatening certain areas of the Short-term Insurance sub-sector. 15 years ago, 80% of motor claims were due to theft and 20% due to accident damage. Theft has now been contained at approximately 15% of claims, and currently the balance of claims are due to accident damage. Certain key factors have driven up the cost of claims; one of these is the weakness of the rand, as foreign currency is used to purchase spare parts for an increasing number of imported vehicles. Another factor is the sophistication of vehicles, for example, a car worth R100 000 can have up to 8 airbags and a simple accident may require that all airbags be replaced at a cost of up to R60 000. A minor accident could cause a Short-term Insurer to write off a car as the cost of repairs and replacement airbags could easily exceed 70% of the value of the vehicle. Another example is that tinted windscreens can cost up to R10 000, whereas 10 years ago, a windscreen cost around R1 000 to replace. A further factor is warranties; many vehicles have 5-year warranties where the manufacturer stipulates vehicles repair service providers, otherwise the warranty becomes null. These service providers are often more expensive than those that Short-term Insurers would normally use.

In 2012, a single hailstorm on the East Rand cost the Short-term Insurance sub-sector R1 billion. A fire in a Cape St. Francis housing development destroyed 70 units at a cost of R670 million rand as the local fire station had closed down and it took over an hour for the closest fire brigade to reach the scene.

A wide range of factors contribute to the high cost of Short-term Insurance claims and these ultimately inhibit growth in the sub-sector. Some of these factors are; a lack of emergency services, general poor driver behaviour, corruption in Driver's License issuing departments, Traffic Officers taking bribes, poor conditions on many roads, a high percentage of unroadworthy vehicles and a lack of compulsory Third Party Insurance in South Africa.

Government intervention could reduce the impact of these factors. South Africa has never ratified the SADEC agreement it signed to institute compulsory Third Party Insurance over 20 years ago, although other countries like Zimbabwe, Malawi, Kenya and Mozambique have implemented this requirement. The road death toll in South Africa is 10 times higher per motor vehicle than in Europe and Australia. Road accidents cost South Africa around R15 billion per annum in terms of bodily injury, excluding Motor Vehicle Insurance claims and the Road Accident Fund currently has a deficit of around R32 billion. In the United Kingdom, all vehicles older than 3 years must pass an annual roadworthy test, whereas in South Africa, vehicles only have to pass a roadworthy test on change of ownership. A further contributing factor is that Provincial Governments in South Africa rejected the Driver's License points deduction system for road traffic offenses proposed at national level.

8.2.3. Education

Training and development

Most Banks have developed in-house training programmes to varying degrees. The cost of running training internally is exorbitant, and an unsubstantiated estimate is that it costs approximately R150 000 per person to train staff members, whereas tertiary institutions could provide the same skills at around a third of the cost. The high cost of running in-house training has resulted in a proliferation of training service providers offering a number of services over and above actual training, like training infrastructure and administration services, development and

maintenance of training material, etc. This reduces the cost to the company and minimises the inconvenience involved in running internal programmes, however, this is an expensive option.

An Industry Body commented that companies across the Financial Services sector used to be reluctant to collaborate on skills development. This attitude has shifted dramatically in the last 3 years as companies now realise that they gain no competitive advantage from developing skills in isolation as skills move between companies across the sector. There is a need for a large pool of skills that all companies can benefit from; it is in the best interests of the entire Financial Services sector to drive skills development.

Industry qualifications

INSETA and BANKSETA commented that they ensure the alignment of education programmes with industry needs by consulting extensively with companies in the Insurance and Banking sub-sector before developing programmes.

INSETA and BANKSETA collect information annually relating to skills supply, critical skills and skills shortages through consultation with companies in their relevant sub-sectors. This information forms the basis of the Insurance Sector Skills Plan and the Banking Sector Skills Plan. The SETAs focus predominantly on addressing the scarce and critical skills in their sub-sectors as this has the most impact.

ASISA Academy's purpose is to fulfil specific industry training requirements over a limited period. BANKSETA and INSETA recognise the Academy and they are in the process of building partnerships with universities in order to professionalise course offerings. Many employees across the Financial Services sector lack exposure to structured professional qualifications and there is a need to offer formally accredited industry education programmes.

ASISA Academy courses lack formal accreditation, as this is a massive administrative exercise; it may take at least 9 months to complete the registration process and close to 2 years to achieve full accreditation. Furthermore, it is concerned about skills development rather than accreditation.

The Academy collaborates closely with industry when developing courses. The industry identifies needs, the Academy then conducts research, develops the curriculum and runs the courses. Industry experts deliver the majority of lectures.

ASISA Academy currently runs a Life Insurance Underwriters Programme at the request of the Life Insurance sub-sector due to the critical shortage of Life Underwriters in South Africa (there are only 250 active Underwriters in the country). The programme produces 20 Underwriters per year and ASISA is collaborating with INSETA to get National Qualifications Framework (NQF) accreditation for the programme. They also run an Investment Management Boot Camp for Information Technology employees, as there is a strong need for these staff to have background financial and investment knowledge when building and maintaining systems.

An Industry Body commented that many formerly UK-governed countries have Insurance Institutes; professional bodies with training academies that run three levels of part-time professional Insurance exams. These qualifications are internationally accredited and recognised in the Insurance sub-sector in any country with an Insurance Institute. The Insurance Institute of South Africa (IISA) closed down its Insurance College a number of years ago and the programmes offered in collaboration with UNISA and Milpark Business School. There is a real need for specialised Insurance training across the sub-sector rather than the general programmes now offered. The Minister of Education is encouraging the SETAs to provide education at lower levels in order to drive job creation. However, the real skills needs and role shortages in the Financial Services sector are at middle and higher levels in organisations. Currently the SETAs fund mainly Internships and Learnerships.

Tertiary education

There is a critical shortage of Leadership skills in the Banking sub-sector. Banking Industry Bodies believe that universities are key to alleviating this shortage, and have repeatedly made proposals to universities to address this, but feel frustrated by the limited progress on this issue.

The general view is that there is a need for university qualifications to align with the needs of the Financial Services sector, specifically in terms of work-integrated learning. One element of this would be to implement work-readiness into existing university programmes. Companies, Industry Bodies and Universities should collaborate to find ways to enable students to transition into the work environment more easily, both at postgraduate and undergraduate level.

Further to the comment above, an Industry Body suggested that most university graduates are completely ill-equipped for the work place. 20 years ago, graduates were able to start working straight away with much less supervision. Graduates from many universities lack basic interview skills. In addition to workplace behavioural skills, often graduates do not have basic technical skills; for example, some graduates are unable to use Microsoft Excel, which is an entry-level requirement for candidates with 4-year Finance degrees, and some 3-year Accounting graduates are unable to manage a set of books. In a number of cases, the Industry Body extended Internships to 2 years due the inadequate levels of skills after 1 year.

INSETA, BANKSETA and ASISA Academy are collaborating with various universities and companies across the Financial Services sector to develop programmes that address critical skills needs, as it is part of their role to facilitate the establishment and maintenance of relationships between tertiary education institutions and industry.

Significant changes to the regulatory framework of the Financial Services sector has created the need for graduates with strong core technical skills and a foundation of industry knowledge. Most Industry Bodies believe that the majority of university degrees currently meet the requirements for technical knowledge. They cited the Masters of Commerce – Financial Management offered by the University of Cape Town (UCT) and the Chartered Financial Analyst (CFA) qualification as examples.

Industry Bodes suggested that a range of Postgraduate Diplomas focusing on specific roles, skills and knowledge of the Financial Services sub-sectors could be a solution to meeting industry specific needs, and mentioned the Advanced Diploma in Management – Financial Planning offered by University of the Western Cape (UWC) as an example. Certain needs may not require a tertiary qualification and training courses could suffice, for example, Retirement Fund Trustee education.

A certain Industry Body mentioned that there are only two or three strong universities in the country and suggested that there could be a way for these universities to assist weaker universities to improve their programmes. They suggested investigation the "twinning" of universities in a partnership that would benefit both the Financial Services sector and the universities.

8.2.4. Skills deficits

The following roles are in high demand across the Financial Services sector – Actuaries, Accounting graduates, Claims Assessors, Business Analysts and Underwriters. In addition, there are critical skills shortages in certain areas, particularly Regulation and Compliance, Leadership and Information Technology. SAIA mentioned that the Short-term Insurance sub-sector previously did not have a need for Statutory Actuaries specifically qualified in Short-term Insurance. With the introduction of Solvency II, each company will require a Statutory Actuary.

There are exceptionally few qualified black Actuaries in South Africa, and there is a critical need to transform Senior Management across the Financial Services sector.

An Industry Body mentioned that they have been involved in many initiatives to raise the skills level of employees and potential employees in the Banking sub-sector, including in-service training in Mathematics and Accounting. It is essential to provide bridging programmes until the current education problems are resolved. Bridging programmes are an interim solution; producing school leavers with adequate numeracy skills that can comfortably enter the Financial Services sector remains the responsibility of the education system.

8.2.5. Recruitment

Since the Financial Crisis, Banks are operating in an environment with a high level of uncertainty. The strategic thinking skills required to negotiate this period are not sufficiently available in the industry. This has a significant impact on the ability of companies to correctly identify or anticipate the skills needs and capacities required in the medium to long-term.

9. Regulatory Authorities

9.1. Description of the South African Regulatory Authorities

In South Africa, the Financial Services sector is highly regulated under the supervision of the South African Reserve Bank (SARB), the Financial Services Board (FSB), the National Treasury and the National Credit Regulator (NCR). Brief descriptions of these regulatory authorities follow.

9.1.1. South African Reserve Bank (SARB)

The SARB is the privately owned Central Bank of South Africa, established in 1921 after Parliament passed an act, the "Currency and Bank Act of 10 August 1920," as a direct result of the abnormal monetary and financial conditions brought on by World War I. The SARB was the fourth Central Bank established outside the United Kingdom and Europe, the others being the USA, Japan and Java. The responsibilities and functions of the SARB may be summarised as follows:

- Formulating and implementing Monetary Policy;
- Issuing Banknotes and Coins;
- Supervising the Banking system;
- Ensuring the effective functioning of the National Payment System (NPS);
- Managing official Gold and Foreign Exchange reserves;
- Acting as Banker to the government;
- Administering the country's remaining Exchange Controls; and
- Acting as the lender of last resort in exceptional circumstances.

9.1.2. Financial Services Board (FSB)

The FSB is the South African government's independent financial regulatory agency responsible for the non-Banking Financial Services industry in South Africa. The FSB supervises and regulates the Financial Services industry in the public interest. Non-bank financial intermediaries include Capital Markets, Collective Investment Schemes, Financial Services Providers, Insurers, Re-Insurers and Retirement Funds.

The responsibilities and functions of the FSB may be summarised as follows:

- To ensure regulated entities comply with relevant legislation;
- To ensure regulated entities comply with capital adequacy requirements;
- To deal with breaches of regulation and other legislation via the enforcement committee[10];
- To deal with customer complaints and adjudicate on appropriate resolutions; and
- To deal with appeals against decisions and resolutions undertaken by the FSB.

9.1.3. National Treasury

The National Treasury is responsible for managing South Africa's national government finances. Supporting efficient and sustainable public financial management is fundamental to the promotion of economic development, good governance, social progress and a rising standard of living for all South Africans. The Constitution of the Republic (Chapter 13) mandates the National Treasury to ensure transparency, accountability and sound financial controls in the management of public finances.

The Public Finance Management Act (Chapter 2) also describes the National Treasury's legislative mandate. The mandate of the National Treasury is to promote government's fiscal policy framework; to coordinate macroeconomic policy and intergovernmental financial relations; to manage the budget preparation process; to facilitate the Division of Revenue Act, which provides for an equitable distribution of nationally raised revenue between national, provincial and local governments; and to monitor the implementation of provincial budgets.

As mandated by the Executive and Parliament, the National Treasury continues to support the optimal allocation and utilisation of financial resources in all spheres of government to reduce poverty and vulnerability among South Africa's most marginalised.

Over the next 10 years National Treasury priorities include increasing investment in infrastructure and industrial capital; improving education and skills development to raise productivity; improving the regulation of markets and public entities; and fighting poverty and inequality through efficient public service delivery, expanded employment levels, income support and empowerment.

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10 The Committee may impose unlimited penalties, compensation orders and cost orders. Such orders are enforceable as if it were a judgment of the Supreme Court of South Africa.

Tax, Financial Sector and International Economics

This division is comprised of the following units:

The Tax Policy unit is responsible for advising the Minister of Finance on tax policy issues that arise in all three spheres of government.

The Financial Sector Policy unit is responsible for the design of the legislative framework for the financial sector as a whole and works closely with regulatory agencies such as the Financial Services Board, Banking Supervision and Exchange Control (now to be called Financial Surveillance) departments of the Reserve Bank, and the Financial Intelligence Centre. The unit is responsible for liaison between the National Treasury and the Reserve Bank on matters related to bank supervision, financial stability and the national payments system.

The International Economics unit comprises two chief directorates, International Finance and Development and Africa Economic Integration. South Africa aims to promote reform of the IMF and the World Bank. Policy focusses on exploring ways to reduce global financial market volatility and promote balanced global growth and development, through government's participation in the G20, which South Africa chaired in 2008. South Africa also plays an important role in encouraging these institutions to seek innovative solutions for poverty alleviation, and to promote regional and African growth and development with strategic alliances on the continent and with other emerging economies.

9.1.4. National Credit Regulator (NCR)

The National Credit Act 34 of 2005 established the NCR as the regulator of the South African credit industry. The NCR's tasks include carrying out education, research, policy development, registration of industry participants, investigation of complaints, and ensuring the enforcement of the Act. The Act requires the Regulator to promote the development of an accessible credit market, and particularly to address the needs of historically disadvantaged people, low-income people, and remote, isolated or low-density communities. The NCR registers Credit Providers, Credit Bureaux and Debt Counsellors and enforces compliance with the Act. The responsibilities and functions of the NCR may be summarised as follows:

- To promote a fair and non-discriminatory marketplace for access to consumer credit and for that purpose to provide for the general regulation of consumer credit and improved standards of consumer information;
- To promote black economic empowerment and ownership within the consumer credit industry;
- To prohibit certain unfair credit and credit-marketing practices;
- To promote responsible credit granting and use, and for that purpose to prohibit reckless credit granting;
- To provide for debt re-organisation in cases of over-indebtedness;
- To regulate credit information;
- To register credit bureaux, credit providers and debt counselling services;
- To establish national norms and standards relating to consumer credit;
- To promote a consistent enforcement framework relating to consumer credit;
- To establish the National Credit Regulator and the National Consumer Tribunal;
- To repeal the Usury Act, 1968, and the Credit Agreements Act, 1980; and
- To provide for related incidental matters.

Accordingly, the SARB and the NCR plays the largest roles in regulating the conventional Banking components of the sector, while the FSB also plays a major role in regulating universal Banks. The SARB follows the international standards set forth by the Basel Capital Accords, and therefore the regulatory capital framework currently follows those rules encapsulated in Basel III. The implementation of Basel III in South Africa follows the phased approach proposed by the Basel Committee, commencing in January 2013 and continuing to 2018. Other pieces of legislation that are relevant to the Banking sector include the following:

- Banks Act;
- National Payments System Act;
- Financial Intelligence Centre Act (FICA);
- Financial Advisory and Intermediary Services Act (FAIS);

- National Credit Act;
- Consumer Protection Act;
- Treating Customers Fairly Act;
- Protection of Personal Information Bill;
- Home Loan and Mortgage Disclosure Act;
- Competition Act; and
- King Code on Corporate Governance.

Several Ombudsmen in the South African Banking sector assist the FSB and the NCR, particularly regarding the fair and confidential treatment of disputes between customers and Banks. In addition to the aforementioned pieces of legislation, the local industry is also aware of impending changes in the form of:

- South Africa's equivalent of the American Fair and Accurate Credit Transactions Act (FACTA); and
- National Treasury's Twin Peaks regulatory framework, proposed in 2011, with the first legislative steps toward implementing the framework in 2013.

National Treasury's Twin Peaks regulatory framework should provide greater protection for depositors, creditors and investors involved in the local Banking sector by distinctly splitting the responsibility of prudential regulation and market conduct regulation. The SARB will be solely responsible for all prudential regulations relating to the Banking industry, while the FSB will be solely responsible for all market conduct related regulation.

9.2. Banking regulation

The interconnectedness of the large Banks with other Banks, as well as all facets of the economy, implies that the failure or bankruptcy of such institutions could cripple the entire economic system; commonly referred to as systemic failure. Accordingly, considering the importance of the Banking system to the functioning of the economy, it became imperative that governments standardise the practices of Banking institutions, while maintaining vigilant supervision thereof.

Banking regulations are a set of rules, guidelines, restrictions and requirements stipulated by government and drafted into Banking legislature, to ensure that Banks act transparently, ethically and prudently. Broadly, there are two categories of regulation, viz. Prudential and Market Conduct. In almost all jurisdictions, governments delegate the implementation of regulations and the continual supervision and monitoring of compliance to these regulations to specific central institutions – most commonly referred to as a Central Bank, Reserve Bank or monetary authority.

As a brief overview, the key objectives of Banking regulation may be summarised as follows:

- To mitigate the risk faced by depositors (or rather creditors of the Bank);
- To mitigate the risk of systemic failure - this may result from inappropriate risk management, irresponsible risky trading or general excessive risk taking;
- To mitigate the fraudulent use of Banks for criminal purposes – the laundering of the proceeds of criminal activities;
- To ensure appropriate risk management and the prudent allocation of credit across the economy; and
- To ensure fair treatment of customers, and that their information is protected and treated confidentially.

In the same manner, the general principles governing Banking regulation may be summarised as follows:

- **Supervision** – Banks are required to obtain a Banking license from the relevant regulatory authorities in order to partake in Banking activities. The Regulator ensures that the Bank adheres to and complies with the set of regulations on a continual basis, and has the right to obtain undertakings, give directions and directives, impose penalties or revoke the Bank's license, upon breach of any of the regulatory requirements.
- **Minimum Requirements** – These requirements usually take the form of capital reserves, the quantum of which are linked to risk exposures, thereby converting intangible, non-monetary risk exposures into tangible monetary reserve requirements.
- **Market Discipline** – As a further requirement, Regulators also require Banking institutions to publicly disclose financial as well as other regulatory capital and reserve information. This enables depositors, other creditors, as

well as investors to assess the level of risk in these institutions and make investment decisions, by analysing the information. Consequently, the Regulator has a further source of information to assess the health of a Banking institution and the sector as a whole.

Given the key objectives and general principles of Banking regulation, the following are the primary instruments and mechanisms for implementing Banking regulation:

- **Capital Requirement** – A framework that stipulates how Banks should handle their capital in relation to their assets. Regulatory capital serves to mitigate the risk of a Bank going insolvent, by acting as an internal insurance fund for risks that cannot be hedged in the external market. The Bank for International Settlements' (BIS) Basel Committee on Banking Supervision sets forth the capital regulatory framework for Banking, internationally. The Basel Capital Accords refer to the capital measurement system set forth by the aforementioned committee, with Basel III being the latest version of the framework.
- **Reserve Requirement** – This refers to the minimum reserves that a Bank should hold to meet the demand of deposit holders. The primary purpose of such a requirement is to ensure that Banks possess the necessary level of liquidity. Required physical reserves alternate between gold, banknotes, deposits and foreign currency.
- **Corporate Governance** – Regulations based on robust corporate governance ensure that a Bank is well managed, thereby achieving a host of objectives in an indirect manner. Further, given that most Banking institutions are large diversified Financial Services companies, the need for robust corporate governance is a minimum requirement to ensure that senior management has clear oversight of all divisions and aspects of their respective institutions.
- **Financial and Other Disclosure** – Regulators require Banking institutions to disclose all audited financial information on a periodic basis, in accordance with international reporting standards. In addition, in most jurisdictions, senior management are individually required to certify the accuracy of financial information. The United States' Sarbanes-Oxley Act of 2002 provides an international standard for the set of criteria that should be satisfied for companies disclosing financial data to the public.
- **Credit Rating Requirement** – Some Regulators require Banking institutions to obtain and maintain a certain or minimum credit rating from an approved credit rating agency. These publically disclosed ratings therefore provide depositors, creditors and investors with more insight into the level of risk undertaken by each Banking institution. The ratings reflect the tendencies of the Bank to take on high risk endeavours, in addition to the likelihood of succeeding in such deals or initiatives. The external credit rating agencies that are most commonly utilised by Regulators are the Fitch Group, Moody's, and Standard and Poor's.
- **Large Exposure Restrictions** – Regulators often limit Banks from having excessively large exposures to individual counterparties or specific groups of counterparties. This ensures that the institution does not expose its shareholders' to any unnecessary large idiosyncratic risks – rather, this type of limit/restriction promotes the idea of diversification of a Banks investments and general activities. These limits are a proportion of the Bank's assets or equity, and different limits may apply depending on the security held and/or the credit rating of the counterparty.
- **Activity and Affiliation Restrictions** – In certain instances a Regulator may restrict the activities or associations of a Banking institution. For example, the United States' Glass-Steagall Act of 1933 restricted the association of Retail Banks and Investment Banks. In general, Banking institutions require approval by the respective regulating and other government bodies before undertaking all new activities, affiliations or associations.

9.3. Insurance regulation

As with other components of the financial system, the Insurance sub-sector is evolving continuously in response to changing technological, social, political and global economic developments. With the Insurance sub-sector covering risks across all facets of the economy – ranging from the public to the private sectors (financial companies, other corporates and households) - there is no differentiation between the interconnectedness of the sub-sector with other financial sectors as well as the broader economy. Naturally then, it is vital that Insurance supervisory and regulatory frameworks are robust, yet agile enough to cope with a continually evolving financial climate. Furthermore, at a fundamental level, a sound Insurance regulatory system is pivotal for an unbiased, safe and stable sub-sector, which protects the interests of policyholders and contributes to the stability of the economic system.

Insurance products are vastly different to other Financial Services products, from the perspective of being characterised by the reversal of the production cycle; in other words, premium payments are periodic during the life of the contract. However, value to the policyholder only materialises upon the realisation of the insured event.

Insurers directly facilitate the transfer of risks and manage these exposures via risk pooling, diversification and a range of other sophisticated techniques. Accordingly, it is critical that all Financial Services sector Regulators understand the mechanics of the Insurance sub-sector, and closely consider the interaction of the sub-sector with other financial agents and the broader economy in order to sustain systemic stability.

Apart from the intermediation of a variety of business and other household-related risks, Insurers generate and accumulate a substantial amount of risk on the liability side of the balance sheet. These are commonly referred to as technical risks and are directly related to the Actuarial methodologies that are utilised to value liabilities, along with their associated risk exposures. Insurers also incur all the risk exposures that are synonymous with the Banking and Asset Management sub-sectors, viz. market, liquidity, credit and operational risks, including asset-liability mismatching risks, which emanate from their general financial operations as well as investment activities. Apart from pure Insurance products, Insurers also offer pure Savings products and Pension products, as well as products with embedded savings features. It is therefore imperative that regulatory and supervisory systems are cognisant and provide for the aforementioned features and nuances.

Financial convergence or globalisation, the current socio-economic dynamic that has been brought about by an ever growing number of international financial groups, partnerships and conglomerates, also needs to be considered by supervisory committees when drafting appropriate regulations. The growing importance of the Insurance sub-sector for global financial stability, as evidenced during the recent global credit and debt crises, is testament to the need for Regulators to fashion regulations that accommodate for a broader set of global risks. It is therefore essential that Regulators at the international and local levels collaborate closely to ensure efficacy and consistency of appropriate regulations and eliminate supervisory oversights, in order to protect policyholders, stabilise financial markets and minimise the possibility of global risk contagion.

Insurance regulatory law is the body of statutory law, administrative regulations and jurisprudence that governs and regulates the Insurance industry and those engaged in the business of Insurance. State Insurance departments primarily enforce Insurance regulatory law through regulations, rules and directives as authorised and directed by statutory law enacted by the state legislatures. However, federal law, court decisions and administrative adjudications also play an important role. Insurance is characterised as a business vested in, or affected by, the public interest. Thus, the business of Insurance, although primarily a matter of private contract, is nevertheless of such concern to the public as a whole, that it is subject to Governmental regulation to protect the public's interests.

Therefore, the fundamental purpose of Insurance regulatory law is to protect the public as Insurance consumers and policyholders. Functionally, this involves:

- Licensing and regulating Insurance companies and others involved in the Insurance industry;
- Monitoring and preserving the financial solvency of Insurance companies;
- Regulating and standardising Insurance policies and products;
- Controlling market conduct and preventing unfair trade practices; and
- Regulating other aspects of the Insurance industry.

The International Association of Insurance Supervisors (IAIS) is a voluntary membership organisation of Insurance Supervisors and Regulators from more than 200 jurisdictions in nearly 140 countries. Established in 1994, the IAIS is the international standard setting body responsible for developing and assisting in the implementation of principles, standards and other supporting material for the supervision of the Insurance sub-sector. The mission of the IAIS is to promote effective and globally consistent supervision of the Insurance industry in order to develop and maintain fair, safe and stable Insurance markets for the benefit and protection of policyholders and to contribute to global financial stability.

Insurance Core Principles as set forth by the International Association of Insurance Supervisors are:

- **Objectives, Powers and Responsibilities of the Supervisor** - The authority (or authorities) responsible for Insurance supervision and the objectives of Insurance supervision are clearly defined.
- **Supervisor** - The supervisor, in the exercise of its functions and powers, is operationally independent, accountable and transparent; protects confidential information; has appropriate legal protection; has adequate resources and meets high professional standards.
- **Information Exchange and Confidentiality Requirements** - The supervisor exchanges information with other relevant supervisors and authorities subject to confidentiality, purpose and use requirements.

- **Licensing** - A legal entity intending to engage in Insurance activities must obtain a license before it can operate within a jurisdiction. The requirements and procedures for licensing must be consistently applied, and be clear, objective and public.
- **Suitability of Personnel** - The supervisor requires Board Members, Senior Management, Key Personnel in Control Functions and Significant Owners of an Insurer to be and remain suitable to fulfil their respective roles.
- **Changes in Control and Portfolio Transfers** - Supervisory approval is required for proposals to acquire significant ownership or an interest in an Insurer that results in that person (legal or natural), directly or indirectly, alone or with an associate, exercising control over the Insurer. The same applies to portfolio transfers or mergers of Insurers.
- **Corporate Governance** - The supervisor requires insurers to establish and implement a corporate governance framework that provides for sound and prudent management and oversight of the Insurer's business and adequately recognises and protects the interests of policyholders.
- **Risk Management and Internal Controls** - The supervisor requires an Insurer to have, as part of its overall corporate governance framework, effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters and internal audit.
- **Supervisory Review and Reporting** - The supervisor takes a risk-based approach to supervision that uses both off-site monitoring and on-site inspections to examine the business of each Insurer, evaluate its condition, risk profile and conduct, the quality and effectiveness of its corporate governance and its compliance with relevant legislation and supervisory requirements. The supervisor acquires the necessary information to conduct effective supervision of Insurers and evaluate the Insurance market.
- **Preventative and Corrective Measures** - The supervisor takes preventative and corrective measures that are timely, suitable and necessary to achieve the objectives of Insurance supervision.
- **Enforcement** - The supervisor enforces corrective action and, where needed, imposes sanctions based on publically disclosed clear and objective criteria.
- **Winding-up and Exit from the Market** - The legislation defines a range of options for the exit of Insurance legal entities from the market. It defines insolvency and establishes the criteria and procedure for dealing with insolvency of Insurance legal entities. In the event of winding-up proceedings of Insurance legal entities, the legal framework gives priority to the protection of policyholders and aims at minimising disruption to the timely provision of benefits to policyholders.
- **Reinsurance and Other Forms of Risk Transfer** - The supervisor sets standards for the use of Reinsurance and other forms of risk transfer, ensuring that Insurers adequately control and transparently report their risk transfer programmes. The supervisor takes into account the nature of Reinsurance business when supervising Reinsurers based in its jurisdiction.
- **Valuation** - The supervisor establishes requirements for the valuation of assets and liabilities for solvency purposes.
- **Investment** - The supervisor establishes requirements for solvency purposes on the investment activities of Insurers in order to address the risks faced by insurers.
- **Enterprise Risk Management for Solvency Purposes** - The supervisor establishes requirements for enterprise risk management for solvency purposes that require Insurers to address all relevant and material risks.
- **Capital Adequacy** - The supervisor establishes capital adequacy requirements for solvency purposes so that insurers can absorb significant unforeseen losses and to provide for degrees of supervisory intervention.
- **Intermediaries** - The supervisor sets and enforces requirements for the conduct of Insurance Intermediaries, to ensure that they conduct business in a professional and transparent manner.
- **Conduct of Business** - The supervisor sets requirements for the conduct of the business of Insurance to ensure customers are treated fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied.
- **Public Disclosure** - The supervisor requires Insurers to disclose relevant, comprehensive and adequate information on a timely basis in order to give policyholders and market participants a clear view of their business activities, performance and financial position. This is expected to enhance market discipline and understanding of the risks to which an Insurer is exposed and the manner in which those risks are managed.
- **Countering Fraud in Insurance** - The supervisor requires that Insurers and Intermediaries take effective measures to deter, prevent, detect, report and remedy fraud in Insurance.

- **Anti-Money Laundering and Combating the Financing of Terrorism** - The supervisor requires Insurers and Intermediaries to take effective measures to combat money laundering and the financing of terrorism. In addition, the supervisor takes effective measures to combat money laundering and the financing of terrorism.
- **Group-wide Supervision** - The supervisor supervises insurers on a legal entity and group-wide basis.
- **Macro-prudential Surveillance and Insurance Supervision** - The supervisor identifies, monitors and analyses market and financial developments and other environmental factors that may affect Insurers and Insurance markets and uses this information in the supervision of individual Insurers. Where appropriate, such tasks should utilise information from, and insights gained by, other national authorities.
- **Supervisory Cooperation and Coordination** - The supervisor cooperates and coordinates with other relevant supervisors and authorities subject to confidentiality requirements.
- **Cross-border Cooperation and Coordination on Crisis Management** - The supervisor cooperates and coordinates with other relevant supervisors and authorities such that a cross-border crisis involving a specific Insurer can be managed effectively.

South African Context

The South African Insurance Regulator, the Financial Services Board (FSB), deals with the regulatory, supervisory and operational matters of the South African Insurance Sector. More precisely, the FSB is responsible for the supervision and enforcement of the Long-term Insurance Act (Act 52 of 1998), and the Short-term Insurance Act (Act 53 of 1998). The primary role of the FSB from a supervisory perspective may be summarised in terms of risk-based supervision.

"Risk-based supervision evaluates the risk profile of a regulated institution, taking into account the institution's financial condition, future strategy, governance, management processes and its compliance with applicable laws and regulations. It is a tool to assess, monitor and prioritise supervisory focus and to allocate supervisory resources." *(FSB Annual Report 2012)*

The FSB is also a member of the International Association of Insurance Supervisors (IAIS). As such, South Africa keeps up with and borrows from most of the developed world's regulatory developments. Implementation of Solvency II proposals in Europe by 2015 are a good example. South African Regulators are implementing similar proposals, adapted to local conditions, called Solvency Assessment and Management (SAM). South Africa is also a member of the 15-nation Southern African Development Community (SADC), whose Regulators have agreed to adopt common minimum Insurance supervision standards. The Financial Crisis has also increased the dialogue between the US, EU and emerging market Regulators to harmonise global Insurance regulations. These developments may lead to greater standardisation of products and policies, and possibly promote more globalisation of the Insurance value chain.

In addition to the global trends, South Africa has its own social reform agenda, which should significantly change the way insurers conduct their business over the next few years. Some of the regulatory and social reform changes are:

- Microinsurance regulation, to be implemented by 2014, to increase access to Insurance;
- National Health Insurance (NHI) proposals, aimed at increasing access to Health Insurance to include all South Africans;
- Treating Customers Fairly (TCF) proposals, aimed at regulating the market conduct of Financial Services providers;
- Pension Fund and National Social Security reform proposals which are still in development; and
- Twin Peaks model of Financial Services regulation, to separate the regulation of Prudential and Market Conduct activities of Financial Services providers.

More information on pending regulation changes and new supervisory projects undertaken by the FSB may be summarised as follows:

- **Solvency Assessment and Management (SAM)** - The FSB is developing a new, risk-based solvency regime for the South African Long- and Short-term Insurance industries. The SAM regime is based on the principles of the Solvency II Directive adopted by the European Parliament, but adapted to South African circumstances where necessary. The design of the regime is to meet the requirements of a third country equivalence assessment under Solvency II, which will enhance the participation of South African Insurers in the global Insurance market.

The SAM regime will become effective for all Insurers as from 1 January 2015. Implementation of transitional measures took place from January 2012, addressing concerns related to technical provisioning and capital requirements in the Short-term Insurance sub-sector. Expected further transitional measures in 2013 are to address particular concerns related to governance, internal controls and risk management in the Long-term and Short-term Insurance sectors, as well the introduction of Insurance group regulation.

- **Consumer Credit Insurance** - The National Treasury (NT) established a joint Consumer Credit Insurance (CCI) Task Team, comprising the FSB, the NCR and the Competition Commission to review consumer credit Insurance practices in the market and to formulate a joint response to any concerns.
- **Reinsurance Regulatory Framework** - As part of the development of the new, risk-based solvency regime for the South African Long- and Short-term Insurance industries (which includes Reinsurance), the FSB initiated a review of the regulatory framework applied to the conduct of the Reinsurance business in South Africa. Undertaking this review of aspects of the Reinsurance regulatory framework will match the work of the various SAM Task Groups, developing proposals on a solvency regime for both Insurers and Reinsurers in South Africa.
- **Microinsurance** - In response to the need to enhance financial inclusion as well as consumer protection, the government of South Africa has taken a robust policy position to regulate and license the Microinsurance industry. For this reason, the NT released the Microinsurance policy document in July 2011. Following the release of the policy document, the NT, in conjunction with the FSB, established a steering committee and various work groups to oversee the drafting of the Microinsurance legislation, intended for tabling in Parliament in 2013.
- **Intermediary services and related remuneration** - A letter sent to industry associations on 11 November 2011 for input by 30 March 2012, called for contributions on the subject of Intermediary services and related remuneration in the Insurance sub-sector. The FSB has undertaken the solicitation of remuneration data from the intermediary services component of the Insurance sub-sector. The FSB hopes to gather contributions from industry associations for possible refinements to the definition of Intermediary services in the current Insurance laws, and reforms to related remuneration structures in order to: (i) promote appropriate, affordable and fair advice and services to potential and existing policyholders; and (ii) support a sustainable business model for financial advice. This followed concerns that, despite recent reforms in the FAIS regulatory space, which has raised the standards of professionalism and the management of conflicts of interest in the intermediary sector, the potential for mis-selling and poor outcomes for policyholders persists, and may require structural change. This is consistent with the current introduction of the TCF initiative by the FSB for the Financial Services industry as a whole.

The aim of most of these regulatory changes is to increase access to Financial Services to the previously excluded majority, while at the same time improving consumer protection activities. The resultant or emergent environment may force South African Insurers to rethink and re-devise their business models and associated strategies.

9.4. Asset Management regulation

Unique to the Investment Management industry is the separation of operating companies and assets (externally supervised and held), which means that clients are offered a very substantial degree of protection. The failure of an individual Asset Management company or fund operator should have no impact upon the ability of the end investors to reclaim their assets.

Regulation in the Asset Management industry serves to promote and sustain financial stability, ensure investor protection and support the ethical and prudential development of capital markets. Historically, regulation focussed on the Retail market, providing a framework for companies to provide investment products to individual clients. Mutual funds in the United States and Undertakings for Collective Investment in Transferable Securities (UCITS) funds in Europe are collective investment schemes, which are pioneering examples of regulated retail products. The design of the regulation framework supporting these investment products is to promote participation in capital markets by protecting investors' savings. This regulatory protection does not constitute the mitigation of market risks – movements in financial variables. Their impact on rates and prices and the associated financial gain or loss is entirely borne by the investor. Rather, the regulatory protection ensures that the funds the retail investor has access to are well diversified, managed and governed, as well as being sufficiently transparent to enable the investor to fully comprehend the inherent risks and potential profitability. In summary, creation of the traditional retail focused legislation and regulations was to govern the following aspects of retail investment management: (1) product structuring; (2) risk management; (3) business conduct; and (4) disclosure criteria. This framework was predominantly product focused, and therefore commonly termed "Product-Based Regulation".

In the wake of the 2007/2008 Financial Crisis, it became apparent that regulation focused on Retail Investment Management, and devised at a product level was insufficient and deficient. Two important regulatory goals had emerged, which had previously been over-looked – to maintain financial stability and the protection of professional investors. While research undertaken by Regulators to understand the causes of the Financial Crisis had revealed that the Asset Management industry was peripheral to the source of the primary issues, the prevailing regulatory framework was found to be partially deficient (see Turner, 2009; de Larosière, 2009 and FSB, 2011). Firstly, regulations did not address the issue of financial stability directly and secondly, prevailing regulations were inconsistent and incongruent across different jurisdictions, sectors, and subsectors. Moreover, certain sectors of the industry were largely unregulated, while the application of regulations across different jurisdictions appeared to differ, despite continuing convergence in operations, products and services. In particular though, the Turner (2009) and de Larosière (2009) reports did reveal that poorly managed micro-risks could eventually spill over and pose risks to overall financial stability.

Internationally, in response to the regulatory deficiencies, the European Union adopted the Alternative Investment Fund Managers Directive (AIFMD) while the United States signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into Federal Law. The UCITS legislation is product-based, while the new AIFMD legislation is manager-based and applies horizontally across all Asset Managers (apart from those operating under the UCITS rules). The AIFMD rules have introduced a variety of minimum operating requirements and a plethora of new reporting requirements to enable the Regulator to monitor financial stability. The United States' Dodd-Frank Act is similar in terms of financial legislation, mandating a variety of operational and reporting requirements for effective systemic risk oversight of the Asset Management industry.

Post Financial Crisis regulatory research also revealed the need for legislation to protect professional and institutional investors, yet another oversight of traditional Asset Management regulations. Providing protection to institutional investors from a regulatory perspective is somewhat different to the level of protection afforded to retail investors. The regulatory protective role afforded to professional and institutional investors basically ensures that Asset Managers: (1) offer a level of transparency and disclosure which enables clients to perform adequate due diligence processes; and (2) abide by their fiduciary duties by incorporating best practice business conduct principles into the legislation. This institutional investor based regulation is Prudential in nature and therefore complements other manager-directed regulation.

New manager-based or, more generally, Prudential regulations incorporate the majority of the rules from the product-based regulation regime. The question therefore arises whether application of product-based regulations should be to all segments of the Asset Management industry, in conjunction with the newly formulated prudential regulations. It appears to be widely accepted that product-based regulations make sense for the Retail market, but will prove to be counterproductive if applied to the Institutional market. It is broadly accepted that the application of product-based regulation to the Institutional Asset Management market would reduce the incentive for client-driven due diligence processes, generally reduce the range of available products, while at the same time create a fairly simple avenue for the Asset Management industry to transition into more complex and opaque sectors of financial markets. It is therefore clear that the Prudential aspects of management-based regulations are imperative to ensure catering for broad ranges of macro-systemic risks.

One should also take note of the fact that Asset Management regulation may address economic objectives other than financial stability, investor protection and the prudential development of capital markets. Some other economic policy orientated goals include promoting long-term savings and socially responsible investing. Achievement of these objectives is by including regulatory criteria, which addresses issues regarding the quality and liquidity of investments, as well as their associated environmental, social and governance considerations. There is also scope for regulations to promote activity in not-for-profit activities and other social entrepreneurship ventures.

South African context

In South Africa, policies for the regulation of the Investment Management industry are the responsibility of the National Treasury, headed by the Minister of Finance. The institutions that are responsible for the administration and the supervision of this regulatory legislation are the Financial Services Board (FSB) and the South African Reserve Bank (SARB). The SARB's role in the Asset Management space is somewhat less onerous when compared to the role of the FSB, However, when matters of exchange controls are in question, the SARB features prominently. The FSB administers various pieces of legislation, with there being specific pieces of legislation for each segment of the Financial Services sector (Exchanges, Insurers, Pension Funds, Collective Investment Schemes, Friendly Societies and Financial Services providers). All Financial Services providers in South Africa are subject to the Financial Advisory and Intermediary Services (FAIS) Act, except for those specifically regulated under other legislation

(for e.g. Stockbrokers and Collective Investment Schemes Managers). For Pension Fund Managers, Section 13B of the Pension Funds Act is the critical piece of legislation, while the Collective Investment Schemes Control Act is relevant for Collective Investment Schemes Managers.

Currently, there are three categories of licenses issued under the FAIS Act, and these are:

- **Category I** – for non-discretionary Financial Intermediary and Advisory Service providers;
- **Category II** – for Financial Services providers that provide discretionary fund management; and
- **Category III** – for administrative Financial Services providers who aggregate client funds or securities.

Furthermore, the FSB has recently instated the requirement for employees of license holders under the FAIS Act to be compliant with designated rules and regulations via successful completion of examinations prescribed, set forth and administered by the FSB. As mentioned in previous sections, the pending implementation of the Twin Peaks regulatory governance framework would result in the SARB supervising Prudential regulations, while the FSB shall focus solely on Market Conduct of financial agents.

As with the global Asset Management environment, regulation in the local industry is undergoing continual change and refinement. According to The Asset Management Review (2012), over recent years, the Regulators of the South African Asset Management industry have focused on a number of issues: (1) The competence of individuals who are overseeing Financial Services; (2) The Prudential investment limits applicable to Pension Funds; (3) The criteria for Pension Funds to invest in private equity funds and engage in security lending transactions; and (4) The removal of key credit ratings requirements from certain prudential investment requirements. Furthermore, key changes to existing regulation have been as follows:

- **Credit Ratings** – The departure from a credit ratings-based regime has resulted in the removal of credit ratings requirements from Prudential investment regulations for both Collective Investment Schemes and Pension Funds. The relevant regulatory authorities are also considering new legislation for the conduct and statutory functioning of credit rating agencies.
- **Derivative Regulation** – The proposed Financial Markets Bill, amongst other initiatives, will enhance derivative market regulation, raising South African legislature to match international standards and best practices. Expectations are that the new legislation will also to influence the Pension Fund industry, as the new regulation is set to specify clear parameters with regard to derivative holdings.
- **Unregulated Participants and Investments** – The FSB has made substantial progress in addressing gaps in regulation, in particular regulating certain segments and operations within the industry, which had been overlooked previously. In particular, the FSB has recently prescribed criteria for Pension Funds to hold private equity investments, and wil be prescribing similar conditions for hedge fund holdings in the near future.
- **Regulatory Measures** – The local Regulators are considering increasingly sophisticated methodologies to assess and measure risk. One example of such sophistication is the development of the Solvency Assessment and Management framework as a risk-based supervisory regime for the prudential regulation of insurers, which mirrors the Solvency II framework implemented in Europe.

Pension Fund assets constitute the majority of institutional assets under management in the South African investment industry; therefore it is worthwhile to take note of the Pension Fund regulatory framework. Registered under the Pension Funds Act, regulation of Pension Funds in South Africa is under the FSB within the criteria and conditions prescribed by the Act. Another key piece of legislation for Pension Funds in South Africa is "Regulation 28", which provides prudential investment limits for Pension Fund investments.

Key aspects of "Regulation 28" may be summarised as follows:

- **Trustees** – The Board of Trustees of a Pension Fund have fiduciary responsibilities to act in the best interest of the members of the fund, ensuring the responsible investment of the Pension Fund's assets. There is a common belief amongst the local Regulators that South African Trustees generally lack investment expertise. As a result, legislation like "Regulation 28" is largely rules-based, and permits the Board of Trustees to enlist the help of specialist advisors to assist with investment decisions.
- **Asset Limits** – "Regulation 28" also specifies the allowable types of asset classes for Pension Fund investment, along with associated issuer and aggregate exposure limits per permissible asset class. For example, a Pension Fund may not have more than 75% exposure to listed equity securities, or more than 35% exposure to unlisted securities, which includes debt, equity, property, hedge funds, private equity, etc.

- **Look-Through Principle** – The Look-Through Principle, related to the classification of asset classes also applies to "Regulation 28". A Pension Fund has to apply the Look-Through Principle when determining the classification of an investment, i.e. one has to consider the underlying exposure of an investment and not classify investments based on the respective investment vehicle or conduit. This prevents circumvention of the "Regulation 28" asset class and limit restrictions.
- **Borrowing Restrictions** – A Pension Fund can only borrow to maintain sufficient liquidity for its operational functions and for hedging purposes.
- **Securities Lending** – A Pension Fund may engage in securities lending, if the fund subscribes to the terms and conditions set out by the Securities Lending Notice. Any securities that are subject to security lending agreements are still seen as assets of the Pension Fund, are subject to "Regulation 28" limit restrictions, and must still be disclosed in the fund's financial statements.
- **Derivatives** – "Regulation 28" permits Pension Funds to invest in derivative securities. However, there are still outstanding conditions that are yet to be finalised.

Another key player in the South African investment management industry is the Public Investment Corporation (PIC, including the Government Employees Pension Fund). Wholly owned by the government, the PIC is South Africa's principal public sector Asset Manager. The PIC has its own regulatory statute, the Public Investment Corporation Act. Being a public entity, the PIC is bound to comply with the South African Public Finance Management Act. Apart from its core Asset Management responsibilities, the PIC has the additional responsibility of contributing to economic development. In addition, the PIC is also responsible for promoting social, environmental and governance initiatives in the South African industry, and played a key role in the drafting of the Code for Responsible Investing in South Africa.

9.5. Interviews – Regulatory Authorities

9.5.1. Financial Advisory and Intermediary Services Act (FAIS)

The Financial Advisory and Intermediary Services Act (FAIS), passed in September 2004 requires all individuals providing financial advice to pass a regulatory examination. The introduction of a mandatory exam came 5 years after the introduction of FAIS, as many of the approximately 130 000 individuals affected by the FAIS Act did not have a clear understanding of their rights and obligations in terms of the Act. The examination requirement has consumer interests in mind; for example, before selling Insurance products to an individual, an Intermediary is required to complete a Financial Needs Analysis to ascertain the financial situation of the consumer. This enables an Intermediary to make appropriate recommendations that meet the clients' actual financial needs.

9.5.2. Financial Services Board (FSB) Levies

The FSB is a Non-Profit Organisation registered under the Public Finance and Management Act as a Schedule 2 Organisation. The FSB does not receive any government funding and subsidises itself exclusively through FSB Levies. The four divisions of the FSB (Investments, Pensions, Insurance and FAIS) do not cross-subsidise one another; the money collected annually by way of levies (equivalent to a tax), is utilised to fund the cost of regulation of the particular area for which the Division is responsible. The FSB is very conscious of the cost of doing business, especially for small players and as a result, they attempt to keep the FSB levy increases to a minimum.

9.5.3. Twin Peaks

The two primary Financial Services Regulators (FSB and SARB) belong to three international standard setting bodies:

- **BIS** – Banking of International Settlements
- **IAIS** – International Association of Insurance Supervisors
- **IOSCO** – International Organisation of Securities Commissions

If Financial Services companies want external recognition that enables them to operate outside South Africa, it is essential that they meet the minimum requirements of international regulatory bodies.

Australian Regulatory bodies originated the Twin Peaks regulatory framework. Regulation in Australia is not institutional; rather regulation is activity-based using the logical divisions of Prudential and Market Conduct.

The Financial Crisis highlighted the need for stricter regulation of the Financial Services sector worldwide. The G20, the three international standard setting bodies and the Financial Stability Board came up with a number of principles and as South Africa is part of the G20, the Minister of Finance endorsed those principles. These include regulation that is more inclusive, a review of the existing regulatory structure and the recognition of Market Conduct as a focus of regulation. In the annual Budget Speech in 2011, the Minister of Finance announced that South Africa would adopt the Twin Peaks model for financial regulation.

The SARB will assume the role of Prudential regulator, with the objective of maintaining and enhancing the safety and soundness of regulated financial institutions. This implies the continued financial health of regulated institutions. The FSB will assume the role of the Market Conduct Regulator with the objectives of protecting consumers of financial services and promoting confidence in the South African financial system. *(Source: National Treasury, Media Statement - 1 February 2013: Implementing Twin Peaks regulation in South Africa)*.

The main impact of Twin Peaks is the end of the division of Financial Services regulation into Banking and non-Banking regulation. All Financial Services companies will report to both Regulators with respect to their areas of responsibility – either Prudential or Market Conduct.

On different occasions, the World Bank and the Financial Stability Board recommended that South Africa merge the NCR into the Market Conduct Regulator. The final decision regarding the NCR is still pending a decision by the two relevant ministries. A further outstanding issue around Twin Peaks implementation is the fate of the various industry bodies that investigate client recourse complaints across the Financial Services sector – the Banking, Long-term Insurance, Short-term Insurance, Credit and FAIS Ombud's, and the Pensions Funds Adjudicator. The UK has named their Market Conduct Regulator the Financial Consumer Agency (FCS); the names of the new Regulators in South Africa are undecided.

During 2013, it is expected that the legislation to create the architecture of Twin Peaks and the mandate of Prudential and Market Conduct Regulators will be tabled in Parliament and the existing Acts adapted accordingly.

It is very difficult to predict whether the implementation of Twin Peaks will add to the regulatory burden of Financial Services companies. One of the high-level principles of Twin Peaks is to ensure that the application of regulation across the Financial Services sector is at the same level; whether this adjustment for consistency has an impact on certain areas of the sector remains to be seen.

9.5.4. General comments made by Regulators

Financial Services regulation aims to address four key issues – Financial Stability, Consumer Protection, Financial Inclusion and Financial Crime. Financial Stability risks include solvency, credit, operational, market and liquidity risks; these risks do not occur in isolation, they are interrelated, as was evident during the Financial Crisis. Non-compliance to international regulation would have an exceptionally negative impact on the South African economy, and would result in loss of credibility of the Financial Services sector and the view of South Africa as risky for foreign investment and transactions.

There are conflicting opinions regarding the role of the Financial Services sector in the wider economy. One view is that core function of the sector is Intermediation and the purpose is to service the real economy. The opposing view is that the Financial Services sector is an independent area of the economy, with aggressive pursuit of growth as the main function. Regulators believe that one cannot take for granted that even though the Financial Crisis did not have significant implications for South Africa, that a Financial Crisis will not affect South Africa in the future. Consequently, higher capital requirements and the reduction of maturity mismatches are beneficial and essential as a preventative measure in the long-term. In the short-term, companies across the Financial Services sector view increased regulation as an additional tax. Furthermore, there are various other concerns for companies, for example, that stricter regulation may restrain lending.

Globally, Regulators believe that the Financial Services sector needs to shrink. The sector reached massive proportions prior to the Financial Crisis, particularly in the Banking sub-sector. In South Africa, four major Banks are comprehensively interlinked and the Financial Crisis made South African Regulators consider about how they would be able to resolve the situation if one of the four major Banks failed. If any one Bank reached the point of bankruptcy, there is an exceptionally high probability that the entire Banking sub-sector would collapse in South Africa.

Banks have an implicit assurance of protection by the government in the case of Bank failure and regulation is in place to ensure that this doesn't occur. When Saambou Bank failed, it took 8 years for the National Treasury to settle the resultant liabilities, ultimately from taxpayers' money. If a major Bank in South Africa failed, a bailout

would cost 25% to 30% of South Africa's Gross Domestic Product (GDP). In a scenario like this, it would also be highly unlikely that any Bank would fail individually; the fallout would be huge.

The challenge for any Regulator is to be as efficient and cost-effective as possible. Regulators realise that regulations have a cost implication for Financial Services companies, but commented that costs are not borne by the Shareholders, but passed on to clients. Overwhelmingly, Regulators are of the opinion that the benefits of increased regulation outweigh the costs. A certain Regulator commented that they suspect that Financial Services companies overstate the cost implications of regulatory compliance and mentioned that Banks are particularly adept at passing on costs. South African Banking costs are among the highest in the world; this is a historical fact and has not changed recently because of increased regulation.

Another Regulator stated that pricing of Banking products is wholly a business decision on the part of Banks. On the question of whether Banks are pricing appropriately, the Regulator stated that they were not in a position to comment. They further remarked that it is not possible to compare Banking costs in South Africa with Banking costs in other jurisdictions, like the United States. South African Banks operate in a different environment and use a dissimilar model and structure; a number of studies conducted regarding this issue all have reached this conclusion.

Regulators are acutely aware of industry concerns around Financial Services regulation. The establishment of relationships between Regulators and various Industry Bodies across the sector is for the benefit Financial Services companies; Regulators maintain a close connection with Industry Bodies and meet to discuss issues frequently.

Overall, most Financial Services legislation does not restrict the entry of newcomers to the Financial Services sector. Provided companies meet the minimum requirements, Regulators issue a licence to conduct business; this applies to both Banks and Insurance companies and this encourages healthy competition. For example, Regulators are currently investigating the feasibility of reducing the entry requirements for Microinsurers into the Insurance sub-sector.

Regulators stated that they consult with Financial Services companies on a regular basis and are more than willing to discuss any difficulties companies are experience related to regulation.

Overall, Financial Services regulation is a globally adopted framework of best practices for Risk Management and Risk Measurement – whether this is Basel III for Banks or Solvency II for non-Banking Financial Services. Increased regulation is a reality when operating in modern financial markets.

9.5.5. Expansion of Financial Services companies outside South Africa

Various structures like the Customs Union, the SADC Secretariat etc., hold periodic multi-lateral discussions. The National Treasury attempts to influence other African countries to create a more conducive regulatory environment for South African Financial Services companies. However, it is important to remember that every country has an equal voice and the discussions are not an intimidation platform for South Africa. Countries come together to negotiate and these are strong, serious debates. The numerous stakes under consideration means that decision making happens extremely slowly; for example, Botswana has massive ambitions of becoming a financial centre. There are also substantial mistrust issues in the rest of Africa towards South Africa. Countries across the continent have serious concerns that South Africa is adopting a colonialism role and as a result, any negotiations have to be strategic and skilfully executed.

Many countries in the rest of Africa are resistant to the idea of listing on the Johannesburg Stock Exchange (JSE) as they would prefer to establish in-country stock exchanges. It is not viable for many of countries to implement stock exchanges, but the motivation is political. The drive to create additional stock exchanges is contrary to the international shift towards consolidation into massive global stock exchanges. Some of South Africa's biggest companies are no longer listed on the JSE, but are listed on the London Stock Exchange (LSE) instead, as it is a much larger capital market. Other companies have their primary listing on an external stock exchange and a secondary listing on the JSE. The National Treasury supports this trend as they have a long-term strategic view of how South Africa should develop. In fact, National Treasury envisions the JSE and South Africa as the financial hub of Africa; this is one of the reasons that the National Treasury allowed United States Dollar-based listings on the JSE.

The National Treasury attempts to facilitate the expansion of South African interests outside of South Africa in alternative ways that are more efficient and effective than through negotiations with other African countries. For example, Treasury adopts a macro-prudential approach and assisted institutions by increasing the allowable offshore portion of company balance sheets from 25% to 30%; this enables simpler transfer of capital in and out of the country. A provision was recently introduced that allows JSE listed companies to create an entity exempt

from Exchange Controls and South African domiciled Holdings Companies are permitted to transfer R750 million per annum to the entity.

The Exchange Control exempt entity acts as a Foreign Exchange current account enabling money to flow in and out of the country. Companies therefore do not need to report on tax and currency variations. Treasury wants to encourage companies to expand, but also monitors the inflow and outflow of capital to ensure that there is no introduction of systemic risk into the South African economy. For example, if a South African Bank had an operation in a country that ended up in a situation like Cyprus, the foreign operation could accrue massive liabilities requiring a guarantee by the South African Holdings Company. This would pose a risk not only to that particular Bank, but also to the entire Banking sub-sector, as Banks in South Africa are so closely interlinked. There is a very real possibility that such a situation would destabilise the entire financial system in the country; this is the National Treasury's greatest concern.

9.5.6. The changing regulatory landscape post-Financial Crisis

Regulators exist because of Financial Services companies. A Banking or Insurance license grants the recipient approval to act as an Intermediary and pool the national savings of the wider economy – this is a massive responsibility and mismanagement has the potential to destroy not only the wealth of individuals, but also the wealth of the entire country.

Before the Financial Crisis, Regulators introduced "light-touch" regulation in the United States, Europe etc., as Banks requested reduced regulatory oversight to enable them to optimise economic development, wealth creation and employment growth. In many jurisdictions, Regulators allowed Banks to operate with a minimum set of rules. Banks did not act responsibly, understated their risks and adopted unsecured lending practices; the outcome was the biggest Financial Crisis in 80 years.

Regulators developed a framework in which Banks could model risk. The proviso for allowing this was that certain checks and balances were in place. Now, for the first time there is alignment between internal management by Banks and external capital management. Regulators do not create regulation randomly; all Banking regulation is a reflection of how advanced the market is and how Banks are pricing risk. In the aftermath of the Financial Crisis, Regulators are simply making sure that Banks calibrate their models accurately. It is important to remember that the current Regulatory environment is a direct result of the Financial crisis.

The Financial Crisis did not significantly affect South Africa due to the following attributes of South African Banks: correct governance, strong capital adequacy, sound supervision and strong Boards of Directors and Senior Management. Additionally, Regulators in South Africa did not adopt "light touch" regulation.

In the Basel framework, Pillar I addresses the quantification of risk and Pillar II examines risk to determine whether a model is correctly estimating the risk and a capital add-on is then determined accordingly. Regulators examined the Basel II framework and concluded that, for South Africa, the model used in the framework underestimated the risk. Regulators imposed a systemic add-on, which is an over-the-top capital charge to compensate; as a result, Banks in South Africa were far better capitalised than international Banks.

Regulators have very close relationships with Boards of Directors of Banks in South Africa; they meet frequently, discuss risk positions, new markets that institutions are entering, new products, etc. Boards of Directors in South Africa are exceptionally competent. In many jurisdictions, this was not the case and a lack of understanding of the risk positions taken in Trading Rooms was a factor that contributed to the Financial Crisis.

A further aspect that benefitted South Africa is Exchange Controls; Banks were not allowed to sell Collateralised Debt Obligations (CDOs), Re-securitisation positions etc. in global markets. The capital restrictions of cross-border flow definitely played a part in avoiding the Financial Crisis. Risk Management in Banks in South Africa is advanced and institutions are honest and have integrity, however, this was not always true of Banks internationally.

Overall, Regulators believe that regulation is the glue that holds the Financial Services sector in South Africa together and the associated costs of regulation contribute to the stability of the system.

10. Appendices

10.1. Appendix 1

"Sub–Saharan Africa has grown impressively over the last 15 years: registering growth rates of over 5 percent in the past two years, the region continues to exceed the global average and to exhibit a favourable economic outlook.

Indeed, the region has bounced back rapidly from the global economic crisis, when GDP growth dropped to 2.8 percent in 2009. These developments highlight its simultaneous resilience and vulnerability to global economic developments, with regional variations. Although growth in sub–Saharan middle–income countries seems to have followed the global slowdown more closely (e.g., South Africa), lower–income and oil–exporting countries in the region have been largely unaffected. These regional variations are reflected in this year's rankings. While some African economies improve with respect to national competitiveness this year, South Africa and Mauritius, the two African countries in the top half of the rankings, remain stable. However, other countries that were previously striding ahead are registering significant declines. More generally, sub–Saharan Africa as a whole lags behind the rest of the world in competitiveness, requiring efforts across many areas to place the region on a firmly sustainable growth and development path going forward.

South Africa is ranked 52nd this year, remaining the highest–ranked country in sub–Saharan Africa and the third–placed among the BRICS economies. The country benefits from the large size of its economy, particularly by regional standards (it ranks 25th in the market size pillar). It also does well on measures of the quality of its institutions and on factor allocation, such as intellectual property protection (20th), property rights (26th), the accountability of its private institutions (2nd), and its goods market efficiency (32rd). Particularly impressive is the country's financial market development (3rd), indicating high confidence in South Africa's financial markets at a time when trust is returning only slowly in many other parts of the world. South Africa also does reasonably well in more complex areas such as business sophistication (38th) and innovation (42nd), benefitting from good scientific research institutions (34th) and strong collaboration between universities and the business sector in innovation (30th). These combined attributes make South Africa the most competitive economy in the region." *(Source: World Economic Forum, The Global Competitiveness Report 2012–2013, Sub–Saharan Africa, 37, 39)*

10.2. Appendix 2

"The baseline outlook is subject to major uncertainties and risks, mostly on the downside. First, the economic crisis in the euro area could continue to worsen and become more disruptive. The on-going perilous dynamics between sovereign debt distress and Banking sector fragility are deteriorating the balance sheets of both Governments and Commercial Banks. The fiscal austerity responses are exacerbating the economic downturn, inspiring self–defeating efforts at fiscal consolidation and pushing up debt ratios, thereby triggering further budget cuts. The situation could worsen significantly with delayed implementation of the Outright Monetary Transactions programme and other supports for those members in need. In such a scenario, as simulated through the United Nations World Economic Forecasting Model, the euro area could suffer an additional cumulative output loss of more than 3 per cent during 2013–2015 and the world as a whole of more than 1 per cent.

Second, the United States could fail to avert the so–called fiscal cliff. A political gridlock preventing Congress from reaching a new budget agreement would put automatic fiscal cuts in place, including a drop in government spending by about $98 billion and tax increases of $450 billion in 2013; taken over 2013–2015, the automatic fiscal austerity would amount to about 4 per cent of GDP. In the fiscal cliff scenario, world economic growth would be halved to 1.2 per cent in 2013 and by 2015 global output would be 2.5 per cent lower than in the baseline projection. The output loss for developing countries would be about 1 per cent.

A third downside risk is the possibility of a hard landing of the economies of one or more of the large developing countries, including China. Growth slowed noticeably during 2012 in a number of large developing economies, such as Brazil, China and India, that had enjoyed a long period of rapid growth prior to the global financial crisis and managed to recover quickly at a robust pace in 2010 after the Great Recession. Given the uncertainties about their external demand and various domestic growth challenges, risks of further and larger–than–expected declines in the growth of these economies are not trivial. In the case of China, for instance, exports continued to slow during 2012, owing to weak demand in major developed economies. Meanwhile, growth in investment, which contributed to more than 50 per cent of GDP growth in the past decade, has been decelerating. The reasons for this are tighter housing market policies, greater caution regarding fiscal stimulus measures, and financing constraints faced by local Governments in implementing new projects. Because of these factors, there are substantial risks for much lower GDP growth in China. If economic growth in China would slow to about 5 per cent per year (caused by a further deceleration in investment growth, continued tightening of the housing market and absence of new fiscal stimulus), developing countries as a group could suffer a cumulative output loss of about 3 per cent during 2013–2015 and the world as a whole of about 1.5 per cent." *(Source: United Nations, 2013 World Economic Situation and Prospects, Executive Summary: Uncertainties and risks, ix – x)*

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