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The Southern Africa Financial Services Journal

Sharing insights on key industry issues

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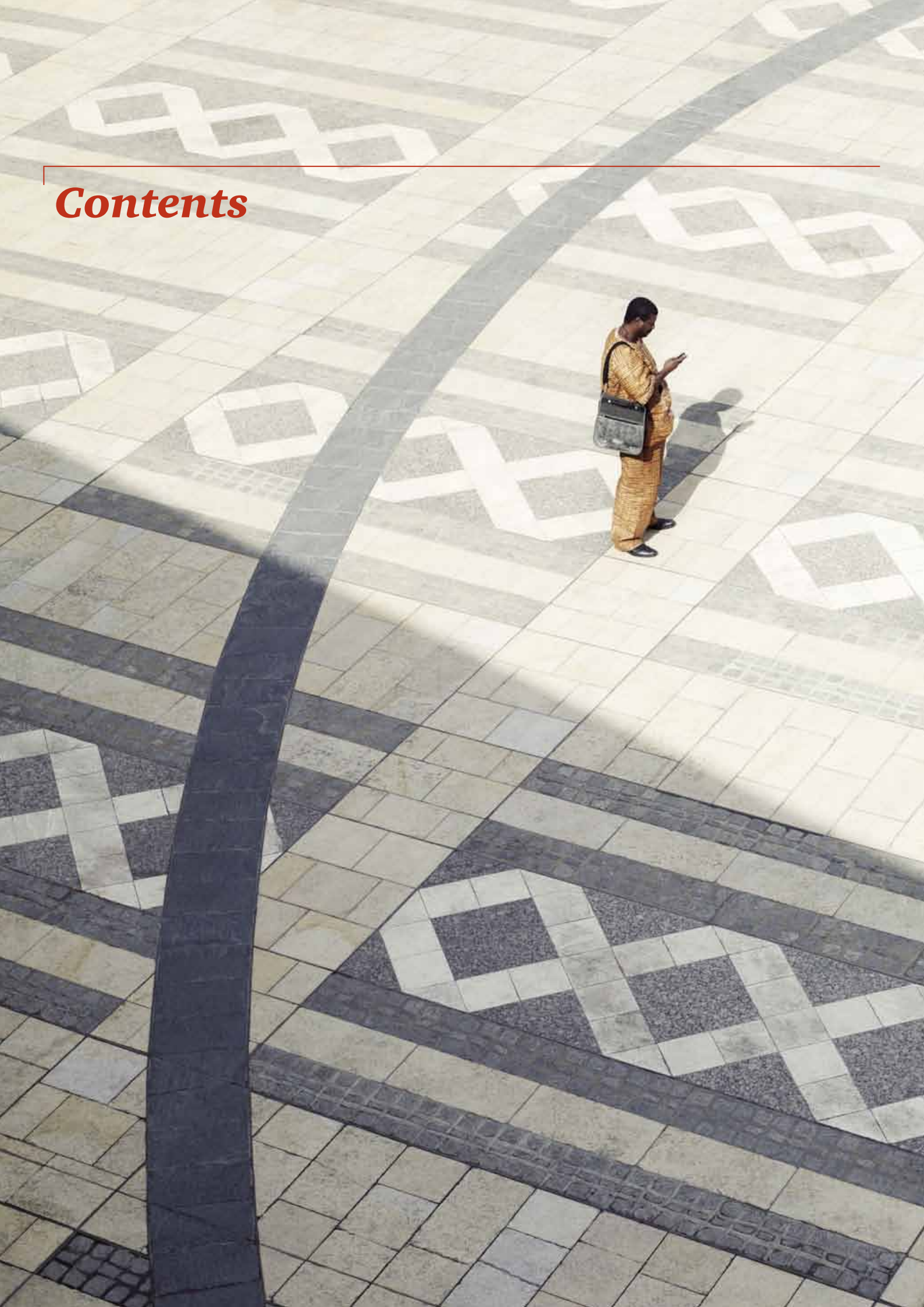
Contents



Editor's comments

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We are pleased to release the annual edition of the PwC Southern African Financial Services Journal – dedicated to addressing strategic, operational and technical issues and their impact on the financial services sector.

At the start of 2012, the debt crisis in Europe has been dominating world financial headlines and observers predict that the global economy will struggle in 2012. The rest of the world is starting to brace itself for the ripple effects on economic growth and volatility in financial markets. South African Finance Minister Pravin Gordhan said towards the end of 2011 that there were "considerable risks" to the domestic economy and at that point there was no need for additional policy changes, but that South African leaders will need to continue closely monitoring global developments in preparation for the 2012 budget to assess the impact on our economy.

With all the negative headlines circulating in the press regarding the Euro debt crisis and its impact on the South African economy, it is important to also remember our own accomplishments. The South African financial services sector is among the best in the world and the World Economic Forum Global Competitiveness Report 2011/12 ranked South Africa in 50th position among 142 countries. It is from this position that our financial services industry can look forward to current and coming developments and challenges.

The financial services industry has already experienced dramatic changes and we can expect these to continue, and even accelerate. Looking forward to 2012, we can expect that the global economic developments will have an impact on the domestic economic developments. Uncertainties and challenges faced by the financial services industry include the European sovereign debt crisis; finding ways to grow profit and containing costs in a weak economy; coping and adapting to a new era of regulatory evolution; renewed focus on consumer protection, health and social security reforms; and tax transparency to name a few. The banking sector braces itself for Basel III and scrutiny of bankers' pay, while insurers can expect changes such as Solvency Assessment and Management (Solvency II); and finalising the insurance accounting proposals. Although these challenges may be tough we believe that financial services players who can anticipate and plan for change can create their future.

We welcome your comments and suggestions on this and our other publications.

Tom Winterboer
10 February 2012

PwC 15th Annual Global CEO Survey – Financial Services sector summary

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PwC's 15th Annual Global CEO Survey, released at Davos in January 2012, assesses CEO confidence about future prospects and explores how they are building local capabilities and realising opportunities in new markets.

While 1 258 CEOs from 60 countries took part in the survey this feature provides a summary of findings on issues specifically affecting the **financial services** sector. It is based on interviews with 368 financial services CEOs (121 from insurance, 125 from asset management and 122 from banking and capital markets) in 52 countries.

Download the global report, access the results and explore the CEO interviews from our 15th Annual Global CEO Survey online at www.pwc.com/ceosurvey

Banking and capital markets

While the agendas of CEOs in the banking and capital markets (BCM) sector is dominated by changing regulation, the European sovereign debt crisis and wider economic concerns, BCM CEOs also recognise the importance of continuing to focus on talent, technology and cost control as they strive to generate viable investor returns and create sustainable long-term growth.

Despite the turmoil of 2011, BCM CEOs are remarkably upbeat about their growth prospects, with more than 80% being confident about improving revenues in the next 12 months and over the next three years.

Changes in regulation was cited as the main factor for BCM CEOs anticipating some change in their business strategy over the next 12 months. More than half of the BCM CEOs believe that the global economy will get worse over the next 12 months, compared to 20% who believe it will improve.

Our latest CEO survey underlines the extent to which regulatory upheaval and economic uncertainty are weighing down on banks and capital market businesses. Capital and liquidity demands are putting further pressure on balance sheets, while uncertainty over the final rules is making it difficult to plan ahead. Regulation is becoming increasingly intrusive and intense, with supervisors demanding more information, more quickly than ever before. But as difficult as these challenges are, sector leaders still need to look over the horizon at how the rapid shifts in the global economy, technology and customer demand are going to reshape their marketplace and their ability to compete. The immediate priority is how to develop the scenario analysis and range of options needed to deal with the current uncertainty. Looking ahead, the key priorities are determining whether your business and operating models will still be viable in this evolving landscape and identifying the strengths within the business that would allow it to establish a leading position. The findings from this year's CEO survey provide some useful markers that will help industry leaders in these vital deliberations.

Robert Sullivan, Global Banking and Capital Markets Leader

The development of the emerging economies of South America, Asia, Africa and the Middle East (SAAAME) is leading to a radical shake-up in growth opportunities and competition facing BCM organisations. South America, Asia and Africa were identified as regions where key operations are expected to grow in the next 12 months.

Many BCM businesses are facing a growing gulf between their growth objectives and the availability of talent to meet them. More than 40% of respondents believe it's getting harder to recruit and retain good people, with high-potential middle managers, who will be crucial in taking the business forward, in particularly short supply.

Key highlights

- 87% are concerned about uncertain or volatile economic growth affecting their business growth prospects.
- 74% anticipate that changes in regulation will be one of the main factors that will influence their need to change strategy.
- Nearly three-quarters anticipate at least some modification in their talent strategy, with nearly 20% planning major changes.
- 62% believe that high-potential business managers that are capable of taking the business forward are in short supply.

Insurance

Insurance CEOs are encouragingly optimistic about their future prospects: 90% are confident about improving their company's revenues over the next 12 months and 95% about doing so over the next three years. This makes them among the most upbeat business leaders in the CEO entire survey.

However, insurance CEOs are clear about the immediate challenges they face and recognise economic uncertainty as the greatest threat to growth in the short term. Around 60% believe that the crisis has had a significant impact on their finances and say it has triggered changes to their strategy, risk management or operational planning as a result. While the Eurozone states have been at the centre of the storm, the survey confirms that the impact on insurers' strategies and finances is being felt around the globe.

Nearly half of insurance CEOs believe that the economy will continue to get worse over the next 12 months. Only 12% expect it to improve – one of the most pessimistic outlooks in the survey.

Insurance CEOs see the second-biggest threat to growth as over-regulation. Clearly, many insurers are facing a huge workload in the lead up to Solvency II. The changing capital demands are also going to be a key factor in determining business plans for the future and providing further impetus to the continuing overhaul of risk and capital management.

About three-quarters of insurance CEOs anticipate at least some further change in the way they manage risk over the next 12 months and nearly 40% are planning to modify their capital structure.

Nearly half of insurance CEOs see emerging markets as more important than developed markets to their company's future. More than 80% of insurance CEOs expect to build up their operations in East Asia, South-East Asia, Africa and Latin America over the next 12 months, compared to less than 40% in Western Europe.

Insurance CEOs recognise the risk of standing still: 70% plan to change their strategy over the next 12 months, some quite significantly. Yet, most are responding to the immediate challenges of regulation, economic instability and pressure on consumer spending as a priority before looking at how to prepare their businesses for the medium and longer term developments ahead.

A significant problem insurers face is a growing gulf between their business objectives and the availability of talent to meet them. Nearly 60% of insurance CEOs see shortages of skills as a significant threat to growth, much higher than other financial sectors. Some 30% have been unable to pursue a market opportunity or have had to cancel or delay a key strategic initiative as a result of these talent constraints.

Many participants recognise the need to explore less-expensive and more sustainable ways to manage talent. More than 80% of insurance CEOs anticipate at least some modification in their talent strategy, with nearly 20% planning major changes. Yet most participants accept that they lack sufficient information in key areas such as cost, productivity and talent mapping, analysis that will be crucial in developing and implementing a durable and proactive strategic workforce plan.

Key highlights

- 75% anticipate further change in the way they manage risk
- 70% plan to change their strategy over the next 12 months
- 60% believe that the Eurozone crisis has had a significant impact on their finances and say it has triggered changes to their strategy, risk management or operational planning
- 40% are planning to modify their capital structure

The insurance industry should be proud of the way it has dealt with the financial crisis and responded to a number of major recent catastrophes around the world. Yet, few insurers have been able to demonstrate the value they can bring to a changing world in areas ranging from providing effective support for an ageing population to understanding and managing the implications of a more volatile climate. So in addition to grappling with the current economic turmoil, it's vital that CEOs develop and communicate a clear vision of the future of insurance and the value their businesses will deliver to customers and stakeholders.

David Law,
Global Insurance Leader

Asset management

With financial markets in crisis once again, asset management (AM) CEOs are searching for growth in an extremely challenging environment. They are therefore executing growth plans cautiously, keeping costs down, and concentrating on execution and closely monitoring risk. They are exploring opportunities in both developed markets and the fast-growing Asian region.

AM CEOs' confidence about their business prospects contrasts with their anxiety about the economic outlook. Eighty percent express confidence about their companies' prospects for revenue growth over the next 12 months – and more than 90% do over three years.

As the Eurozone crisis unfolds, asset managers are clearly worried that market volatility will deter investors from buying their products. Fifty percent of AM CEOs said that they thought the global economy will decline over the next 12 months, while 44% voiced 'extreme concern' about economic uncertainty.

With austerity stalking developed markets, and financial market returns likely to be anaemic, asset management CEOs are tailoring their strategies to today's austere conditions, but see no need for radical change. Fifty-one percent said that their strategies would change 'somewhat', suggesting that they would adjust their strategies rather than reengineering them. Almost three-quarters of asset management CEOs, 73%, attributed the need for change to the economy.

Asset management CEOs have cautious business development strategies, with almost a third, 32%, viewing increasing market share in their existing markets as the best route to growth in the next 12 months. To do so, 22% of asset management CEOs aim to launch new products or services. But at the same time, 18% say they will target growth by entering new markets, suggesting that asset management companies will continue to expand into emerging markets such as Asia, where the potential for growth is much higher than in the developed world.

Just as volatile markets have concentrated asset managers' minds on cutting costs, so they are turning CEOs towards identifying and mitigating all risks across their organisations.

Seventy-five percent of asset management CEOs say they will change the way they manage risks in the next 12 months. Regulatory risk is also becoming a key risk, as asset managers face complying with a series of new investor protection and market regulations over the next few years. Sixty-seven percent of AM CEOs say they are concerned about over-regulation.

Like sports teams, the value in asset management companies lies in their people and CEOs are taking an increasingly long-term approach to developing talent. Sixty-two percent of asset management CEOs say they plan to develop and promote most talent from within the company, with just 25% looking to recruit from outside. CEOs personally view this as important; 65% of them say they would like to spend more time developing leadership and talent.

The full spectrum of asset management companies has become far more ready to outsource key processes in recent years. Mounting cost pressures are causing asset managers to look once again at outsourcing as a way of cutting their overheads with 42% outsourcing a business process in the last 12 months and 40% planning to do so in the next.

Key highlights

- 79% of AM CEOs said they were concerned about a lack of stability. Because the outcome of the European sovereign debt crisis is expected to have such a significant effect on financial markets in 2012, political events are likely to have a greater impact than ever on financial market returns.
- 72% of AM CEOs report that the ongoing European sovereign debt crisis has directly affected their companies financially.
- 24% of CEOs view China as most important for their growth prospects in the next 12 months. China ranks second only to the US, the world's largest asset management market, which 26% of CEOs think is most important for growth over the coming year.
- 57% of CEOs identify high-potential middle managers as their priority, against 38% who see the senior management team as the area where talent is most in demand.

In the past year governments have come under enormous pressure to deal with the continued fallout from the financial crisis. People have been universally frustrated by their inability to agree to long-term plans. As a result, financial markets remain volatile and unstable. Asset managers have continued to plan for growth and product innovation — but with a cautious eye towards government regulation and markets. The path seems clear, but there are many potential road blocks and detours ahead. Even so, people across the globe desperately need professional advice, financial planning acumen and products that reflect the full range of risk tolerances and income needs. While these needs are not new, it is clear people do not universally trust governments to adequately address or fix these issues. So there has never been a better time for asset managers to exhibit leadership.

Barry Benjamin, Global Asset Management Leader

Talent

Worldwide, the financial services (FS) industry is facing a severe shortage of talent. Nearly half of the industry leaders taking part in the survey believe that the limited availability of key skills poses a serious threat to their growth prospects. This level of concern is on a par with the downturn in consumer spending and the challenges of financing growth.

Nevertheless, more than 80% are planning to build up their businesses in Asia, Africa and Latin America over the coming year. More than half of these see emerging markets as more important than developed markets to their future.

CEOs also report that pay costs have risen more than expected, and in the insurance industry, this was especially high at 53%.

Overall, the recruitment challenge is most marked in the insurance industry, where some 50% of CEOs are concerned about their ability to attract the people they need.

Regulatory developments including Basel III, EU Solvency II and the US Dodd-Frank Act are heightening the pressure to attract people with particular experience and professional qualifications in specialist areas such as risk.

Many businesses believe that they can hire or relocate the staff they need. Yet, as businesses chase openings, competition for good people is soaring and leading to rapidly rising pay costs within many businesses. CEOs report that pay costs have risen more than expected (in insurance this was especially high at 53%)

Key highlights

- 50% of FS CEOs are looking to increase their headcount over the next 12 months, with half of these anticipating staff increases of more than 5% over the coming year. Less than 20% are planning to reduce staff overall.
- Only a third of FS CEOs are certain that they will have access to the talent they need to execute their company's strategy over the next three years.
- 59% of FS CEOs believe that high-potential middle managers capable of taking the business forward, are in short supply .
- More than 40% of FS CEOs are planning to move experienced employees from their home market to newer markets to circumvent skills shortages.

Basel III

New regulations and regulatory developments

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As the European Union grapples with the sovereign debt crisis and stumbles to protect its banks and currency from collapse, the rest of the world contemplates how recent developments in Basel III and over-the-counter (OTC) derivatives legislation will shape the future of OTC derivative markets.

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Background

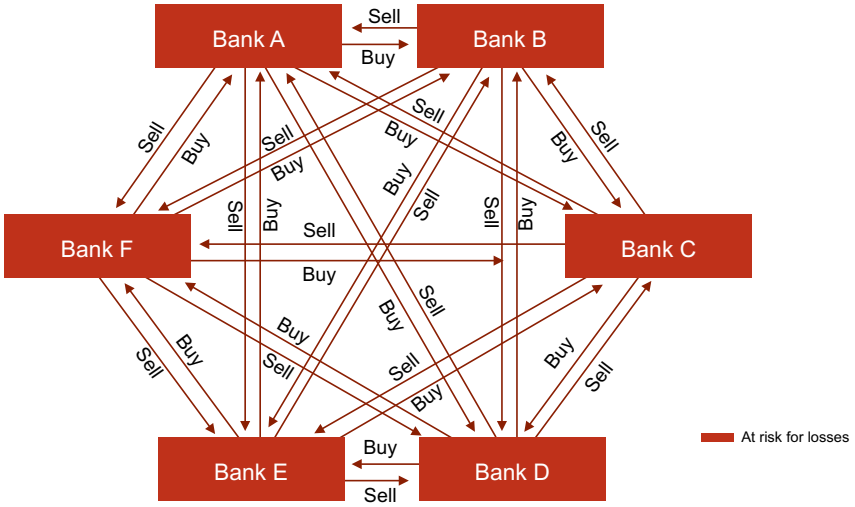
The impact of Basel III has been well publicised. In terms of capital requirements, South African banks will be affected mostly by the trading book elements of Basel III such as credit valuation adjustments and stressed value at risk (VAR). The 6% scalar, which is being implemented in South Africa for the first time, will also have a significant impact. From a liquidity perspective, our challenges are even bigger, with some analysts estimating that the South African banking industry will fail to meet the requirements of Basel III, if those are left unchanged. However, an area of Basel III that has not enjoyed widespread exposure in the South African market is the potential requirement for a Central Counterparty (CCP) to clear OTC derivatives.

In September 2009, the G20 committed to improve the functioning, transparency and regulatory oversight of OTC derivative markets. It called for standardised OTC derivatives to trade through an electronic exchange and, where possible, to clear through a central clearing counterparty by 2012. Those not centrally cleared would be subject to higher capital charges.

In response to this call, regulators around the world are working to implement this objective. In the US and Europe, the Dodd-Frank Act and European Market Infrastructure Regulations (EMIR) are pushing for OTC derivatives to clear centrally. Recently in South Africa, the Financial Markets Bill, issued on 4 August 2011, proposes two types of clearing houses, namely an 'independent clearing house' and an 'associated clearing house' to facilitate the clearing of OTC derivatives, in line with the G20 and the International Organization of Securities Commission's (IOSCO) recommendations.

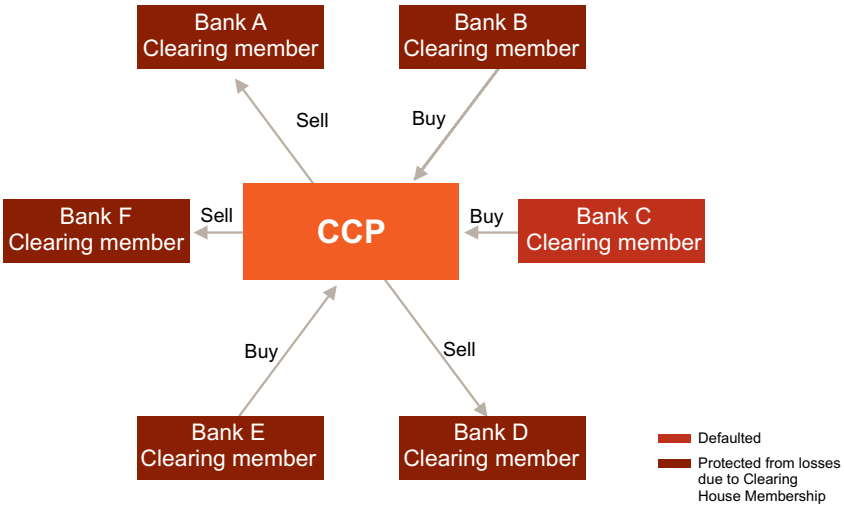
This article analyses the challenges and complexities that lie ahead for the South African banking industry with regards to the central clearing of OTC derivatives through a CCP.

Counterparty risk – Bilateral settlement



OTC Derivatives: The default of firm A in an OTC derivative transaction has a possible contagion effect. It does not only affect firm F, it leaves all connected trading counterparties from firm A to F potentially at risk.

Counterparty risk – Central clearing



In the example above the CCP stands in between firms A to F in the transactions. If firm C defaults, positions are closed out or transferred to other members. The effect of default is contained, there is no contagion.

***Source**: World Federation of Exchanges, an article entitled "The role of central counterparties in financial crisis recovery" by Marcus Zickwolff, Executive Director and Head of Trading & Clearing System Design, Eurex Group*

Analysis

Basel III rules

The aim of using a CCP to clear OTC derivatives is to reduce systemic risk by mitigating counterparty credit risk between derivative users. Without central clearing, counterparty risk builds up through a web of bilateral exposures that create systemic risk. In the event of one of the users failing, the risk of other users being affected through their interconnectedness is very real, as was witnessed during the global financial crisis. The introduction of a CCP reduces systemic risk as the web of bilateral exposures is replaced with a set of potentially much smaller net exposures of each clearing member to a CCP, as illustrated in the diagrams on the left.

The Basel III framework provides a number of incentives to clear trades through a CCP. For example, all trades that clear through a qualifying CCP[1] attract a risk weight of only 2%. By contrast, those not clearing through a CCP will not only incur capital charges at the counterparty's risk weight (usually higher than 20%), but also require additional capital in the form of credit valuation adjustment[2] and asset value correlation[3] charges.

1 Qualifying CCP refers to a CCP that is compliant with CPSS-IOSCO standards and is able to assist clearing member banks in properly capitalising for CCP exposures (by either undertaking the calculations and/or making available sufficient information to its clearing members, or others, to enable the completion of capital calculations.'

2 Credit valuation adjustment is an additional capital charge proposed by Basel III to capitalise banks against potential mark-to-market losses associated with a deterioration in the credit worthiness of a counterparty.

3 Asset value correlation is an upward adjustment proposed to risk weighted assets for exposures to financial institutions that were found to be more closely correlated than had been anticipated in the original Basel II accord.

In December 2010, the Basel Committee issued initial proposals to capitalise clearing members' exposures to a CCP. Updated proposals were issued in November 2011. The latest proposals still require the CCP to determine its 'hypothetical capital' requirements, which it then compares with a 'default fund' set up by its members. Clearing member banks are required to carry capital on their contribution to the default fund and on any excess of the hypothetical capital over this default fund.

To the extent that the pre-funded default fund established by the CCP and the clearing members is equal to the hypothetical capital requirement, the portion contributed by the clearing members would be capitalised at 100%, based on a 1250% risk weight (assuming a capital ratio of 8%). To the extent that the pre-funded default fund exceeds the hypothetical capital, the clearing members' contribution would be capitalised at between 0.16% to 1.6% (at just 1.6% in the original proposal). The exact percentage within this range, termed the 'decay factor', will be dependent on the extent of such surplus. On the other hand, any shortfall (hypothetical capital exceeding the pre-funded default fund) would require the clearing member to make additional contributions, which would then be capitalised at 120% to reflect the fact that some clearing members may not be able to honour additional contributions.

The methodology described here has been criticised particularly because of the way the hypothetical capital is calculated. The method uses the current exposure method (CEM), which is premised on the fact that derivative exposures consist of two parts, namely:

- An exposure based on current market values; and
- A potential future exposure that reflects the fact that derivative values are volatile and exposure could increase in the future.

Critics have argued that this method overstates the capital requirement as it does not adequately reflect the multilateral netting benefits introduced by each member's portfolio at the CCP. The November 2011, revisions made some concessions by increasing netting benefits provided.

Another criticism has been levelled against the time horizon inherent in the CEM. Critics are of the opinion that since transactions with the CCP are margined daily, a shorter time horizon is warranted than the one-year horizon assumed in the CEM. This does not seem to have been directly addressed although other concessions have been made. For example, the introduction of a decay factor to reflect the diminishing risk associated with larger amount of the default fund.

At the time of writing, it is uncertain what the final rules will be, though we would expect recent revisions to be very close. Nevertheless, the proposals as they stand, require clearing member banks to hold additional capital on their commitment to participate in the losses of other clearing members through their default fund contribution and any loss beyond the default fund (loss mutualisation). This would impact banks' clearing businesses, where banks act in an intermediary capacity, as they will be required to hold additional capital, which was not previously required.

In contrast, the use of a CCP should result in greater netting efficiency through 'multilateral' netting. Multilateral netting refers to a situation in which a party's purchases and sales in the same asset with multiple trading parties are offset and reduced into one net amount. The net amount is delivered to or received from a CCP. Multilateral netting can significantly reduce the value and number of obligations that require settlement, reduce operational risks and, combined with legal novation, reduce capital requirements.

In addition, banks should be able to take advantage of the incentives that Basel III rules provide to move clearing to a qualifying CCP, as already discussed.

In the final analysis, the capital impact of central clearing is a balancing act between higher capital charges for default fund contributions and capital benefit through multilateral netting and benefitting from incentives provided by Basel III. This is arguably the one area of Basel III that is likely to affect banks significantly, but is perhaps the least understood at this stage. Further analysis is required to fully understand the total impact on individual banks and the industry.

Other issues

With regulations pushing for OTC derivatives to clear through a CCP, it is critical that the risk management function at the CCP itself be robust to ensure that the objective of systemic risk reduction materialises. The risk of losses at a CCP can be managed in two ways:

- Through robust daily margining requirements; or
- Through a default fund mechanism funded by members' contributions. This default fund would then act as an 'insurance pot' from which losses arising from a clearing member's default could be funded.

Internationally, most CCPs adopt a combination of robust margin and default fund protection. In South Africa, SAFCOM, a JSE subsidiary that clears exchange traded derivatives, does not have a default fund. On the assumption that SAFCOM becomes the associated clearing house, the first challenge it will have is to decide if a default fund should be set up and, if so, how much is required and how it will be funded.

It must be emphasised that the Basel III rules do not require the establishment of a default fund. They merely provide guidance on capital rules where such fund exists. The decision to establish a default fund is one of risk management rather than Basel III compliance.

Internationally, the rationale for a default fund is that it provides protection against losses in stress conditions, while margins protect the clearing members against losses under normal conditions. In deciding whether to set up a default fund, it is also critical to evaluate if the margining requirements are sufficiently robust for the markets being cleared. If margin levels are deemed not to provide sufficient protection, they could be complemented with a default fund. However, it has to be borne in mind that a default fund could play a perverse role in creating moral hazard in that clearing members who underwrite poor credit risk could share their losses with other clearing members via the default fund.

Key challenges ahead

In countries such as Canada and Australia, the debate around the optimal configuration of clearing arrangements is raging on. The industry has to decide which instruments are sufficiently standardised or can be standardised to enable central clearing. In most markets, single currency interest rate swaps are the obvious candidates. But there are many other OTC derivative instruments that require further investigation.

There is also the question of whether an international player or a local player is best suited to serve the South African market. International clearing houses have the advantage of experience, global reach and a proven risk management track record. In addition, since an international player operates in many jurisdictions, international dealers enjoy the netting benefits that accompany larger pools of trades.

However, the best course of action is not clear cut as a local player would have the advantage of being locally based and the local regulator would have better control and oversight of the CCP that serves local banks. In addition, the operational challenges of netting across various jurisdictions for an international CCP and the question of jurisdictional oversight are not to be underestimated.

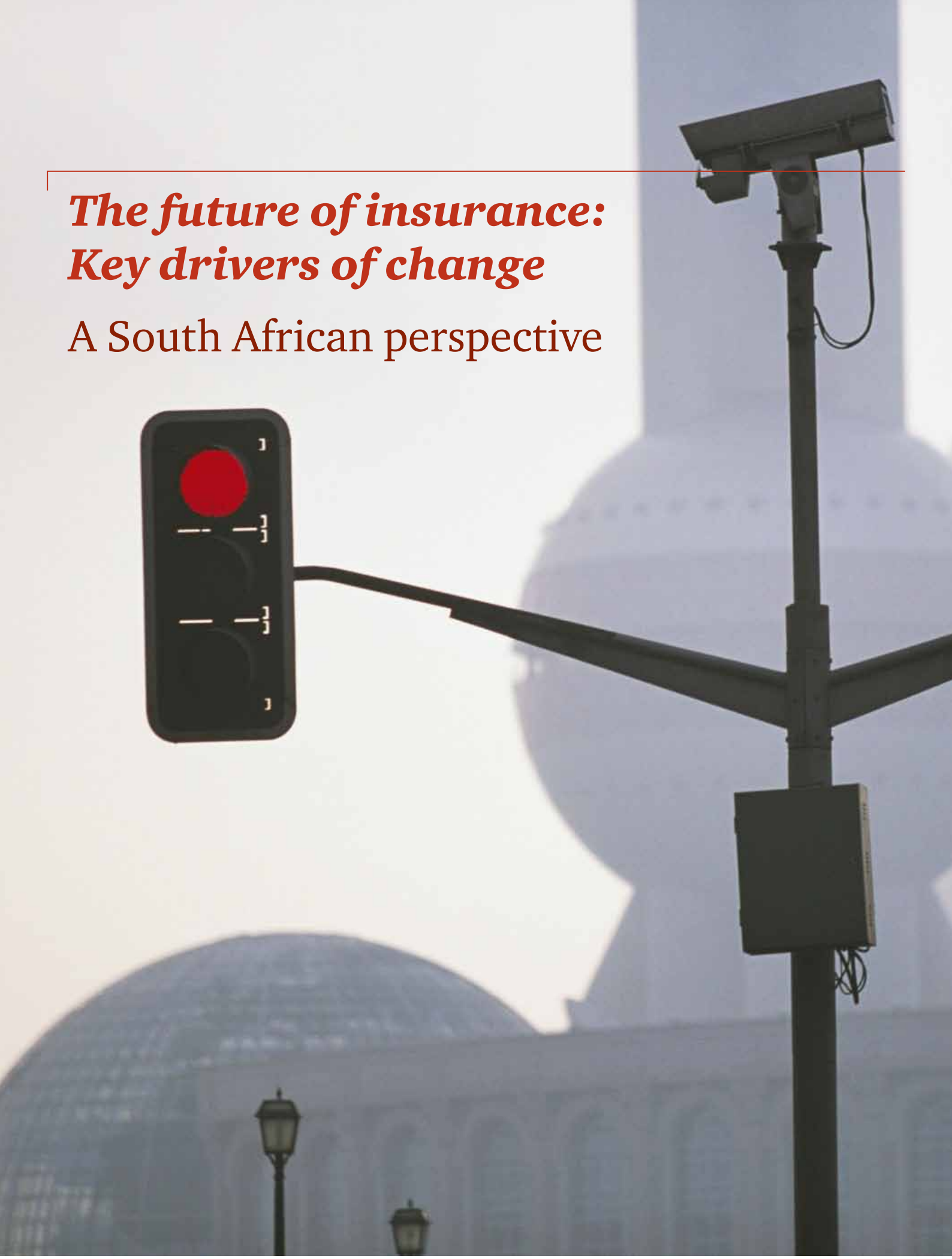
Australia is looking at various ways in which to bridge the gap between the different approaches. One of them is that international dealers clear their trades through the international CCP, while the local counterparty clears its trades through the local CCP. The two CCPs would then post margin between themselves for this trade – a concept known as 'interoperability'. This could work well in the South African context, where two types of CCPs are being set up. As with everything else, however, this would come with its own set of challenges, not least being the question of the transmission of risks from one CCP to another, which requires further study.

Conclusion

Clearing trades though a CCP is in theory a good idea to reduce systemic risk, which should find favour with regulators. Banks are also likely to benefit in reducing the capital consumption of on-balance-sheet OTC derivatives, but clearing businesses are likely to be negatively affected due to potentially increased capital requirements. However, the operational challenges of setting up a CCP should not be underestimated. Clearing members, regulators and the appointed CCPs will need to work together to mitigate potential negative impacts that could arise.

The future of insurance: Key drivers of change

A South African perspective



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Introduction

Before to the financial crisis, the global economy was growing, with booming stock and labour markets. The sudden crash in 2007 surprised global markets, and brought with it the most severe global economic downturn in 75 years. Unlike previous cycles, emerging economies quickly recovered, while developing economies have continued to struggle. The unfolding crisis in Eurozone countries, which has already led to dramatic changes in government in Italy and Greece, is a clear indication of the desperate situation developing there. Despite all this, the 57 insurance CEOs who took part in our latest PwC 14th Global CEO survey revealed a surprising level of confidence regarding growth prospects, driven by targeted investments in emerging markets.

In our PwC 2010 *Strategic and Emerging Issues in South African Insurance survey*, most South African insurance company CEOs expressed the view that the local insurance industry had escaped the worst effects of the 2008 global financial crisis. Although investment performance continues to be affected by global events, CEOs were unanimously confident about future growth prospects. However, given the negative impact of the continuing Eurozone debt crisis on global economic growth prospects, underperforming investment markets, rising unemployment levels (above 25% in South Africa) and low economic growth accompanied by rising prices(stagflation), generating profitable growth will remain a significant challenge for most insurers. Tight margins and the mounting costs of unrelenting regulation in a fragile global and local economic environment also add to the challenges.

Overcoming these challenges will require a major shift by most South African insurers.

South Africa's challenges

For historical reasons, South Africa has a large percentage of unskilled people, and unemployment levels in excess of 25% to this day. Although annual economic growth rates since 1994 have averaged around 3%, this has not been enough to absorb the 10 million or so unemployed South Africans. High interest rates, volatile exchange rates and high inflation rates relative to Europe have all left their mark on the South African economy and meaningful growth remains elusive. South Africa needs a major shift in economic growth if we are to reduce unemployment levels from 25% to 6% by 2030. Despite all the negatives, when compared to the rest of the economy, South African insurers enjoyed steady annual growth in earnings, boosted by bullish investment markets and modest growth since 1994. Then it all came crashing down with the global financial crisis.

Global events since the financial crisis have had a profound impact on the confidence, psychology and expectations of people in general, as well as insurers across all sub-sectors; including personal lines, commercial lines, individual life, annuities and retirement and group benefits. Reinsurers have also been affected. The current unfavourable megatrends and dramatic changes in the global insurance environment are set to continue into the next decade, and will continue to negatively impact South African insurers. Insurance CEOs who can anticipate these changes early, plan ahead and make fundamental changes to their strategies and business models will create competitive advantage for their companies.

In order to create a vision of the future, insurers in South Africa need to realise and accept that the environment in which they have spent most, if not all of their careers has changed. The future may not be like the past. Diversification into other African markets is also not going to be easy. Smart insurers in the more developed but struggling developed markets will also start looking to places like Africa for growth opportunities, increasing competition there.

To help South African CEOs to judge the impact of the changing business environment, PwC research has grouped the megatrends that are likely to shape the future of insurance in South Africa and resulting strategic implications into a series of social, technological, environmental, economic and political megatrends (STEEP) scenarios.

Social changes shifting the balance of power to customers

So what is changing in South Africa? Demographic shifts, including urbanisation, increasing literacy levels and economic empowerment of the previously excluded majority black groups have given birth to a new black middle class, creating new opportunities for growth as the new entrants start buying houses, cars, assets, and insurance protection. Government is in turn creating an enabling environment to increase access to insurance, through emerging legislation to formalise the micro-insurance sector and other consumer protection initiatives such as 'Treating Customers fairly' (TCF).

At the same time, the younger and better educated middle class are also becoming more aware of their choices and are more demanding about how they buy insurance products, how much they pay for them and from whom they buy - which presents new challenges for traditional insurance distribution models.

Customer behaviours, including their expectations for simplicity, transparency and speed of fulfilment have also changed significantly in the past decade. Increasing familiarity with online channels and the ease of using them for education, research, advice and purchase of complex products has grown exponentially over the past decade.

As consumers get more comfortable with social networks, exchange more personal information, and build new networks of trusted friends, family, and acquaintances, we may start to see the trust balance shifting from the traditional agent and broker channels to online communities. Could these online networks or virtual communities grow into pooling arrangements for self insurance? Would insurance carriers then be reduced from insurance product manufacturers to insurance administration service providers?

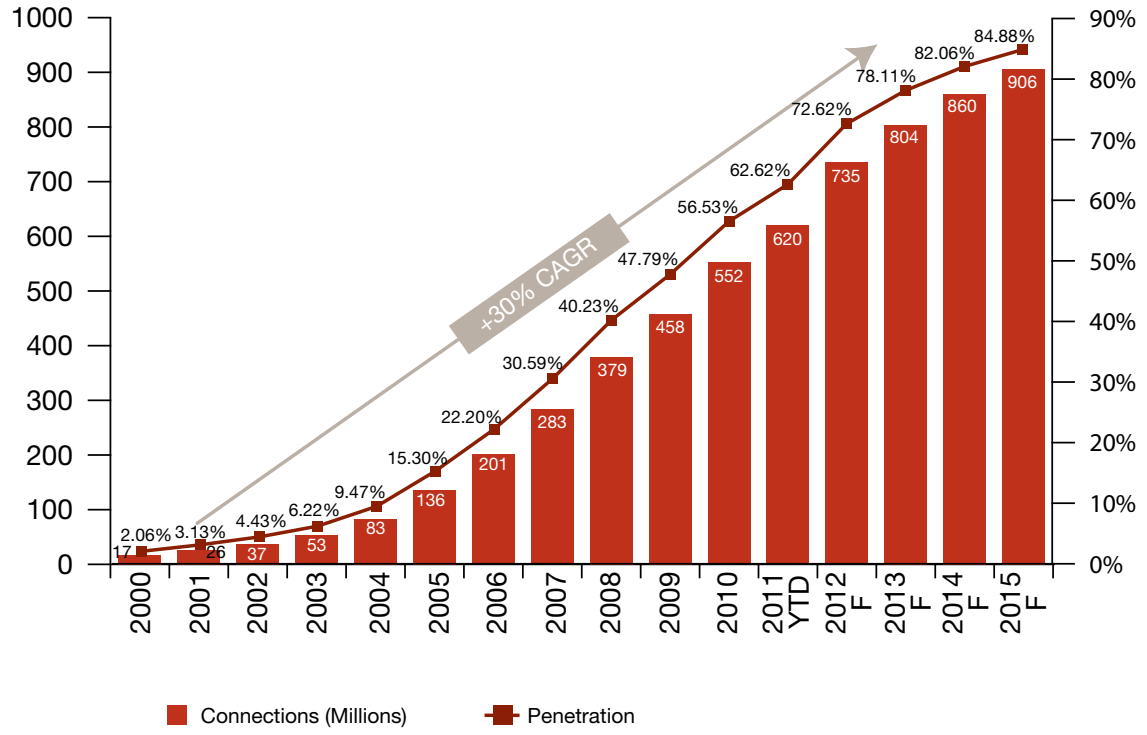
The future role of intermediaries also remains unclear. It is also unclear whether new entrants to the market can trust them. Is the balance of power shifting from intermediaries to customers?

The rise of direct carriers in South Africa over the past decade would suggest a growing preference for direct distribution channels by a growing number of South Africans.

Technological changes

Figure 1 shows the exponential growth in the penetration of mobile connections in Africa over the past decade, as well as projections for the future. Cellphones, smartphones and tablet technology, are increasing 'go anywhere anytime' access to the internet. Could these advances present new distribution opportunities for insurers in Africa, where populations are largely rural and inaccessible by traditional bricks-and-mortar based channels?

Figure 1: Total African mobile connections and penetration rate (million, % penetration)[1]



Source: GSM World – Mobile Observatory Series

The lower insurance penetration rates as shown in Figure 5 would suggest that the African continent presents growth opportunities for South African insurers to expand their offerings there. Relatively higher GDP growth rates in countries like Ghana (6.6%)[1], Nigeria (7.9%)[1] and Kenya (5.3%)[1], for example, also make the business case more appealing.

Secondly, emerging new technologies built into mobile monitoring devices can also significantly increase the operational efficiencies of insurers in their existing businesses in South Africa, while also enhancing the customer service experience. Connected devices and sensors built into emerging mobile technologies can provide real-time 'big data'. Advances in analytical techniques to translate their big data into actionable insights, including the identification and prediction of trends, could have a significant impact on the property and casualty (P&C) and life and annuities sectors. This could help insurers to proactively reduce losses and to better manage risks. On the P&C side, we have started to see the innovative use of telematics to price for and underwrite motor insurance risks on a pay-as-you go basis by some South African insurers.

On the down side, could health monitoring devices that significantly extend life expectancies, and the number of years of active retirement, also introduce longevity risks for annuity and retirement income providers?

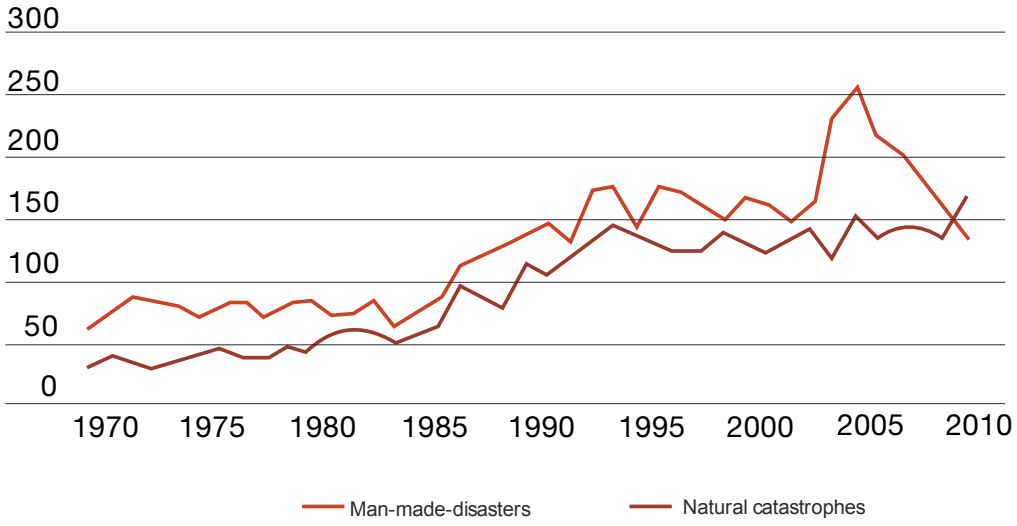
1 GDP growth rates source: The World Bank

Environmental drivers: Rise of more sophisticated risk models and risk transfer/sharing

In our 2011 PwC Global Insurance Banana Skins survey, natural catastrophes ranked fifth out of the top 20 insurance risks, rising from 22nd position in 2009.

We have subsequently seen the increasing severity and frequency of catastrophes, including earthquakes in Japan and New Zealand, as well as storms and hurricanes in the US. As the global climate continues to change, the rate and intensity of these disasters is expected to increase. In South Africa, we have also experienced our own share of flooding over the past few rainy seasons.

Figure 2: Number of global catastrophe events 1970 – 2010



Source: Swiss Re Economic Research & Consulting

The 2011 Banana Skins survey raised concerns about under pricing for catastrophe risk cover in the past, as well as insufficient reserving due to the low rates. Could the increase in catastrophes present growth opportunities for insurers, where such business is renewable annually and can be re-priced? The changing environmental patterns would, however, require insurers to be more sophisticated in their risk modelling and to be innovative in structuring risk transfer deals. Those who fail to do so could be forced to exit certain coverage markets.

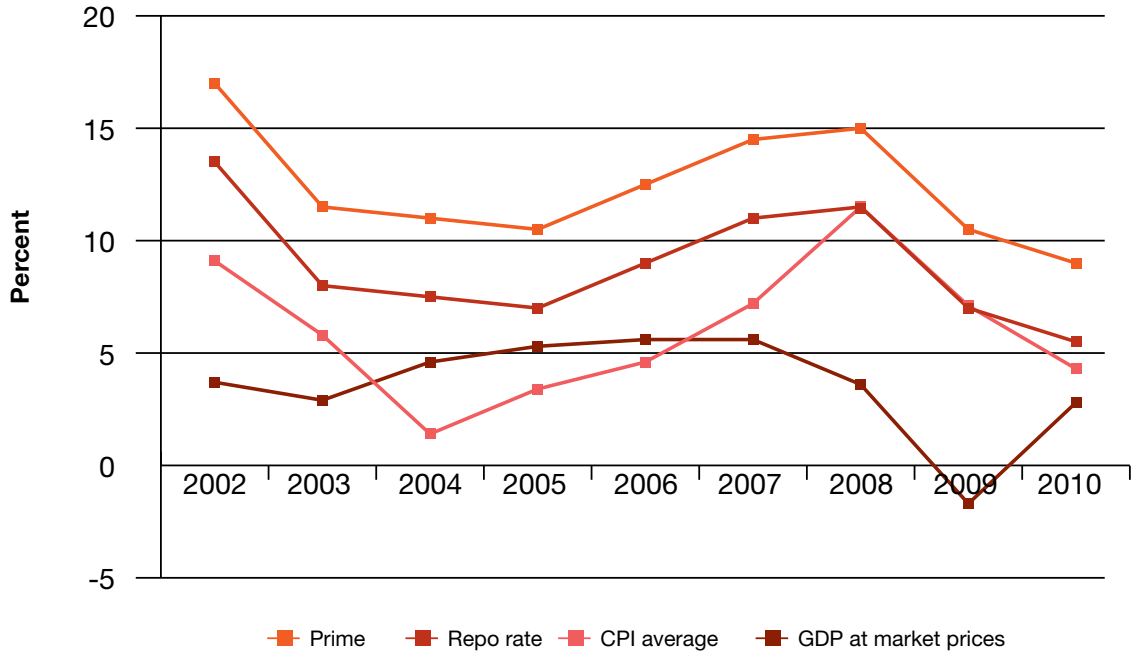
Could the shortage of specialist talent in these underwriting areas in South Africa, also highlighted in the global Banana Skins survey, certain growth in this area?

Economic uncertainty: Rising economic and political power of emerging markets

Our latest global Insurance Banana Skins survey, ranked the 'weakening macro-economic trends' third out of the top 20 insurance risks, with the loudest concerns coming from Europe. Concerns about resurgent inflation, persistently weak economic conditions and the increasing instability arising from debt and political stresses in the Eurozone, the Middle East and North Africa could spring nasty surprises such as possible defaults, major market disruption and long-term structural changes. The course of inflation in particular, accompanied by low interest rates and poor investment performance could be very damaging for insurers.

In South Africa, there are growing concerns about the impact of the interconnected risks arising out of the unsolved Eurozone problems. We have started to see significant Rand exchange rate volatility and uncertainty in equity markets in the past year. Stagflation, a combination of slow economic growth and rising prices may force the Reserve Bank to increase the repo rate from 5.5%, following a progressive reduction from highs of 11% in 2009. It would be difficult for insurers anywhere in the world to plan for growth with any certainty under these conditions. Investment products with guaranteed long-term investment returns would especially at risk.

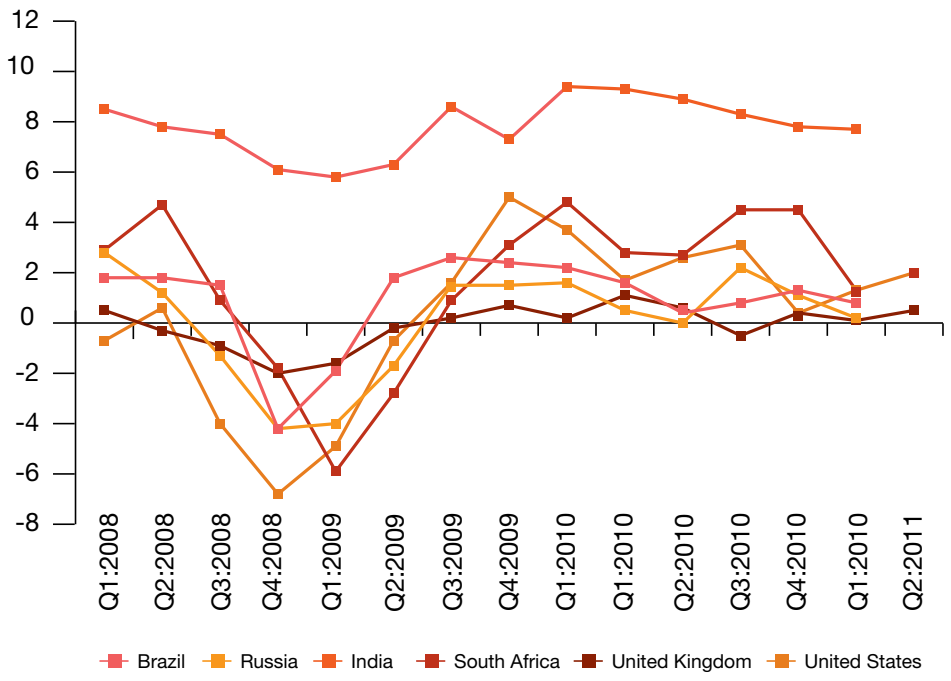
Figure 3: South African economic indicators



Source: South African Reserve Bank and Statistics South Africa

While most of the developed world continues to experience negative or zero GDP growth rates, emerging market economies, including Brazil, Russia, India, China and South Africa have been enjoying varying levels of positive growth.

Figure 4: GDP growth rate adjusted by inflation



Source: TradingEconomics.com

Figure 4 highlights the relative strengthening of GDP economic growth rates of emerging economies, compared to Europe and the US. The BRIC countries' proportion of global GDP has been increasing over the past twenty years. This is increasing the attractiveness of emerging markets as investment targets.

Figure 5 shows that insurance penetration rates are relatively lower in the emerging markets, with a lot of room for growth before they get to the same levels as South Africa and Europe/US. Economic uncertainty and the search for growth may well drive developed market insurers to emerging markets.

Figure 5: Insurance penetration: premiums as % of GDP in 2010

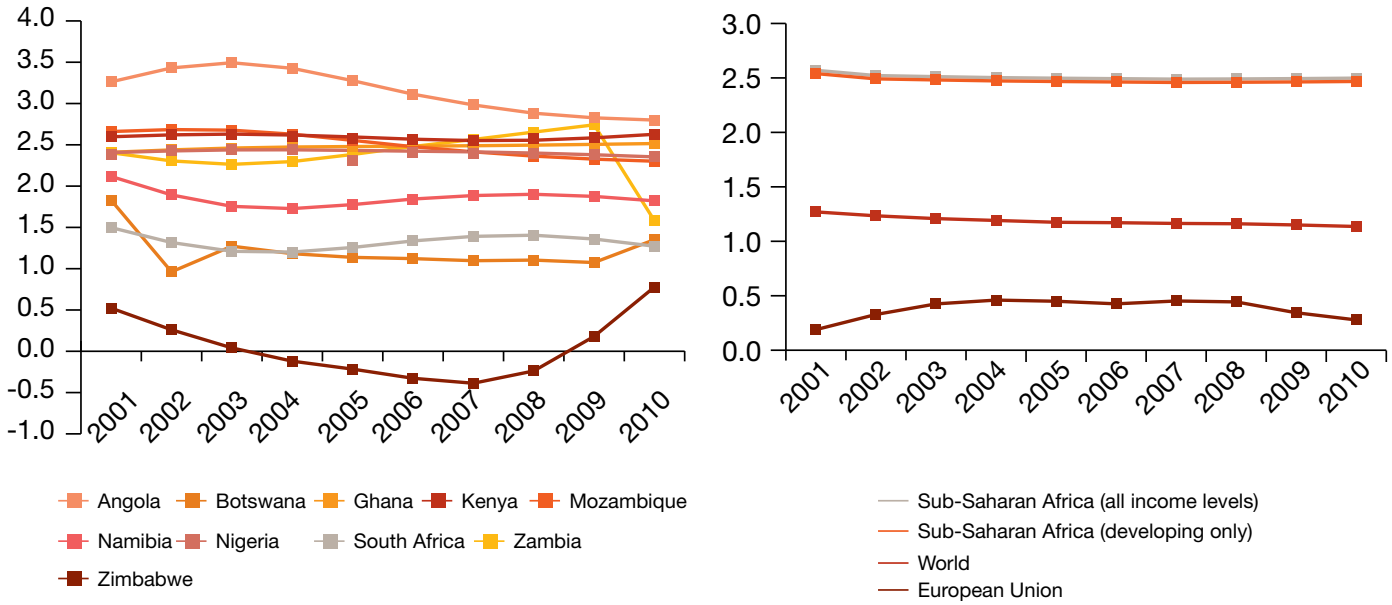
	Country	Ranking	Total business	Life business	Non-life business
North America			7.9	3.5	4.5
	United States	18	8.0	3.5	4.5
Latin America and Caribbean			2.6	1.1	1.5
	Brazil	47	3.0	1.6	1.5
Europe			7.4	4.4	3.0
	Netherlands	3	13.1	3.7	9.5
	United Kingdom	4	11.7	8.9	3.0
Asia			6.1	4.5	1.6
	Taiwan	1	18.5	15.5	3.0
	Hong Kong	5	11.3	10.0	1.4
	India	33	4.7	4.0	0.7
	PR China	41	3.8	2.5	1.2
Africa			3.6	2.5	1.1
	South Africa	2	13.4	10.7	2.7
	Namibia	19	8.0	5.5	2.5
	Mauritius	29	5.2	3.4	1.9
	Kenya	44	3.2	1.1	2.1
	Morocco	50	2.8	1.0	1.9
	Tunisia	66	1.8	0.3	1.5
	Angola	79	1.0	0.1	0.9
	Egypt	83	0.7	0.3	0.4
	Algeria	85	0.7	0.1	0.6
	Nigeria	88	0.5	0.1	0.4
Oceania			5.9	2.8	3.0
World			6.9	4.0	2.9

Source: Swiss Re Sigma No. 2/2011, Statistical appendix, January 2011

Given the relatively high insurance penetration rates in South Africa at 13.4%, South African insurers are also looking elsewhere for this growth. We have already started to see some bold moves to expand into Africa and other emerging markets. Most of the big South African insurers already have operations in other African countries, either through new acquisitions, joint venture or bancassurance arrangements with major South African banks with branch networks and in some cases start-ups. Other interesting developments include cell captive and joint venture arrangements with mobile cellphone, communications and data network operators who already have rapidly expanding markets in Africa.

Other factors influencing the shift to emerging markets include relative population growth rates. Eurozone countries are starting to experience declining population growth rates, relative to emerging markets. At the same time, populations in the developed world are ageing, with average longevity improvement factors of 4% per annum compared to South Africa (and emerging markets) at 1-1.5%. As these longevity improvement factors start to have a negative impact on annuity books in the developed world, the relatively younger and growing populations in the emerging markets present new territories for growth. Would South African insurers be able to compete?

Figure 6 & 7: Population growth (annual %)



Source: The World Bank

Political and regulatory changes: Harmonisation, standardisation and globalisation of insurance market

The South African insurance regulator, the Financial Services Board (FSB), is a member of the International Association of Insurance Supervisors. As such, South Africa keeps up with and borrows from most of the developed world's regulatory developments. The Solvency II proposals to be implemented 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 14th 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.

Could these developments could 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 listed below :

- 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.

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.

Could the resulting environment force South African insurers to reconsider their business models and strategies?

Making sense of the trends: So what is the future for South African insurance?

Having looked at the trends described above, a range of scenarios could emerge, raising questions on two main dimensions, being socio-technological and politico-economic. Could the socio-technological trends result in a shift in the balance of power, with virtual social networks acting as trusted networks for insurance purchase or self-insurance? Could we see a shift in power from the powerful intermediaries to customers. Could the emergence of direct carriers eventually overtake the traditional intermediated channels? What changes will we see as a result of technological advancements which produce 'big data' for actionable insights?

On the other hand, could the emerging politico-economic environment result in an emerging market-led global recovery from a developed world-led global downturn? Will South African insurers rise up to the challenge and lead this recovery in Africa at least?

Impact on traditional South African insurance business models?

Under the traditional business model, South African insurers made money from identifying risk, pricing for it at a margin and then trying to be more operationally efficient than their competition. Could the traditional model be overturned through the use of socio-technological advances to provide internal and external information to underwrite and price for risk and to proactively reduce losses and manage risk? This would create competitive advantages for those insurers who shift from the reactive claims payment models.

In South African personal lines businesses, the clever use of telematics has now made it possible for innovative migrations to 'pay-as-you go' auto insurance, away from the traditional fixed premium models. On commercial lines, 'value sharing' models that balance premiums with loss-control incentives could be further innovations. On the health and life side, there are already companies in South Africa which offer lifestyle-based premiums and incentive payouts for lifestyle-based behavioural changes such as exercise and diet awareness among others.

Impact on the South African insurance value chain?

If CEOs choose not to change their business models, then greater investment may be required to improve the existing insurance value chain. If the investments in the socio-technological advances are not made, greater use may be required of external data to improve customer segmentation, targeting, needs analysis and pricing and margins. This would still require ongoing investments in IT, to improve and make more economical products and service customisation.

Talent management

Talent shortages ranked sixth out of the top 20 risks in the Insurance Banana Skins survey. The increasing regulatory demands arising from Solvency II and its equivalent in South Africa, SAM, are seen as distracting the best people away from the real business issues. Shortages of actuaries and specialist underwriting skills were also identified by global and South African survey participants. The ability to acquire and develop talent is a global issue and global talent mobility to potential growth markets makes cultural diversity and the ability to function in multiple cultures a key senior management requirement.

Is the South African insurance industry attractive enough to attract talent from different cultural backgrounds and can it compete for talent on a global stage?

What should be on a South African insurance company CEO's agenda

Creating the future through innovation

Those insurers who want to reshape their future through innovation, regardless of whether they are in emerging or developed markets, may wish to focus on R&D, analytical decision making and new product innovation. Innovations into new areas such as micro-insurance and proactive loss control activities may be good examples for South Africa insurers. Could the proposals around the National Health Insurance and National Social Security proposals also present administration and other opportunities to early innovators?

Creating the future through geographic expansion

Those insurers who want to reshape their future through expansion into emerging and other markets may wish to focus on exporting their existing core competencies. These would be growth seekers, and not necessarily innovators in products and services.

The expansion into Africa by most of the major South African insurers has been in this area; by exporting their existing core competencies and product portfolios into the continent. Could countries to the north, like Ghana and Nigeria, with their oil and resources wealth, growing GDP per capita incomes, growing populations, increasing urbanisation rates and low insurance penetration rates present expansion opportunities for brave South African insurers looking for growth through geographic diversification?

Regardless of where different insurers sit, we all need to prepare early for an uncertain future and take advantage of emerging opportunities.

Medical benefits for all: At no cost?

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Could NHI be the knight in shining armour for medical schemes in South Africa?

National Health Insurance (NHI)

Medical schemes currently offer medical insurance cover to 16.2% of the population, mainly the private sector. The increase in private healthcare costs has resulted in many schemes increasing premiums, often higher than CPI. Schemes have even resorted to decreasing member benefits, which has led to many members exhausting their benefits by mid-year.

It is therefore not surprising that many members are paying for their own healthcare costs out of pocket. Schemes are experiencing sustainability with the number of medical schemes declining from 180 in 2001, to less than 100 in 2011.

The flip side of the coin is that the fiscus funds 84% of public sector patients, whose healthcare facilities have fewer human resources than the private sector.

Motivation for change

South Africa has a very high burden of disease, mortality and crime, which includes the following:

- HIV/AIDS and TB
- Maternal, infant and child mortality
- Non-communicable diseases
- Injury from assault.

From the above list, HIV/AIDS and TB are most prominent. With just 0.7% of the world's population, South Africa is host to 17% of the HIV-infected people globally. Moreover, the TB and HIV/AIDS co-infection rate is one of the highest in the world at 73%. HIV/AIDS has also contributes significantly to high maternal and child mortality rates.

Change is needed but how should this be achieved?

There are a serious concerns with regard to the public sector as the question of overall healthcare services has either deteriorated or remains poor.

The perception is that public health sector has been underperforming and that this is attributable to poor management, underfunding, and deteriorating infrastructure.

There is currently a skewed distribution of financial and human resources in South African healthcare. Currently, 8.2 million people are on medical schemes and the annual per capita expenditure for this group is estimated at R11.150. For the remaining 42 million public sector-dependant on the public sector population, annual per capita health expenditure is estimated at R2.766.

The medical scheme industry has its own difficulties, one of them being the high increases in private hospital and specialist costs. The decline in the number of medical schemes has mainly been to over-pricing of healthcare, exorbitant administrator fees, an oversupply of brokers, disproportionate membership, and managed care costs.

The Government released its much anticipated Green Paper on National Health Insurance (NHI) in August 2011 to bring about change in the South African health system.

So what is NHI?

The NHI is a financing system that aims to ensure all citizens of South Africa (and legal long-term residents) are provided with essential healthcare; regardless of their employment status and ability to make a direct monetary contribution to the NHI fund.

Objectives of NHI

The objectives of NHI are to:

- Provide access to quality health services for all South Africans;
- Pool risks and funds so that equity and social solidarity is achieved;
- Procure services on behalf of the entire population and efficiently mobilise and control key financial resources; and
- Strengthen the under-resourced and strained public sector so as to improve health system performance.

In achieving these objectives, the NHI will be guided by the following seven principles:

- **The right of access** – to healthcare services as stated in Section 27 of the Bill of Rights of the Constitution;
- **Social solidarity** – this refers to the creation of financial risk protection for the entire population that ensures sufficient cross-subsidisation between the rich and the poor, the healthy and the sick;
- **Effectiveness** – the better performance of the healthcare system will contribute to positive health outcomes and overall improved life expectancy for the entire population;
- **Appropriateness** – this refers to the adoption of new and innovative healthcare service delivery models and tailoring of these into a South African context;
- **Equity** – the health system should provide those with the greatest health need with timely access to health services;
- **Affordability** – this means that services will be procured at reasonable costs that recognise health not just as an ordinary commodity of trade but as a public good; and
- **Efficiency** – will be ensured through creating administrative structures that minimise or eliminate duplication.

Benefits of NHI

The current two-tiered system – private and public – will be eliminated and the entire population will be indemnified against health-related financial risks.

The NHI will ensure that all citizens have access to a defined comprehensive package of healthcare.

This package will include primary healthcare which is defined as follows: 'the provision of health promotion, preventative, curative and rehabilitative care as close to household and community as is possible'.

Health affects social development and economic productivity in four ways:

- Increased output as a healthy person works more effectively and efficiently and devotes more time to productive activities;
- A broader knowledge base in the economy as the gains to education increase as life expectancy increases;
- Increased 'work life' and savings as a result of increased life expectancy may result in greater earning and saving for retirement; and
- Increased labour force activity.

These benefits include having a healthier population, which in turn translates into a productive and effective workforce that grows local business, attracts foreign investors and expands the domestic economy.

Each extra year of life expectancy raises a country's GDP per person by around 4% in the long run win contract, the lack of health insurance in a country like India means that over 37 million citizens fall below the poverty line each year, because of colossal health spending.

When Canada's provinces introduced national health insurance, across eight industries in 10 provinces, employment rose and wages increased whilst average working hours remained unchanged. In addition, provinces with high initial levels of private insurance coverage had lower rates of employment and slower wage growth.

From the above it is possible that the NHI benefits will enhance and improve the current two-tiered healthcare system in place.

'It is not the government's intention to abolish private medical schemes if individuals wish to keep them.'

Dr Aaron Motsoaledi (National Minister of Health)

'Even with a fully-developed NHI, there will still be supplementary health insurance products that will have to be regulated.'

Dr Monwabisi Gantsho (Registrar of Council for Medical Schemes)

How will primary healthcare be delivered?

NHI is based on the three dimensions of universal coverage:

- Expand population coverage – ultimately cover all South Africans;
- Expand service coverage – the initial focus will be on the re-engineering of primary healthcare costs; and
- Financial risk protection – sharing the burden of cost.

Primary healthcare is focussed on community outreach and will be delivered through to the following streams:

- **District-based clinical specialist support teams supporting the delivery of priority healthcare programmes to districts**. This measure will address the high levels of maternal and child mortality. To improve health outcomes, an integrated team of specialists will be based in the districts. The specialities will include: a principal obstetrician and gynaecologist; a principal paediatrician; a principal family physician; a principal anaesthetist; a principal midwife and a principal primary healthcare professional nurse.
- **School-based primary healthcare services**. School health is an integral part of the comprehensive package of healthcare services. This programme will ensure the general state of physical/mental health and wellbeing of schoolchildren. Services will be delivered by a team headed by a professional nurse and will include health promotion, prevention and curative health services.
- **Municipal ward-based primary healthcare agents**. These agents will collectively facilitate community involvement and participation in identifying health problems (and behaviours that place individuals at risk of disease or injury), vulnerable individuals and groups. The healthcare agents will implement appropriate interventions from the service package to address the behaviours or health problems.
- **Hospital-based benefits**. As part of the overhaul of the health system and improvement of its management, hospitals in South Africa will be redesignated as follows: District, Regional, Tertiary, Central and Specialised hospitals. District hospitals will be considered the 'gatekeepers' to lower costs before a patient can be referred to a regional hospital or other hospital.

What are the benefits?

The comprehensive primary healthcare package will be 'fair and rational' while demonstrating how well the system is performing and ensuring timely referral.

Improved district health services with a focus on public health and clinical intervention delivered via primary healthcare. This will also address convenience and will respect privacy while meeting quality standards.

Primary healthcare services will additionally be provided by accredited and contracted private healthcare providers especially where these are needed to support primary healthcare.

NHI will provide hospital benefits that will be supplied and aligned with the hospital designation and managed via a referral system. All hospitals will be designated and managed via a referral system.

The Office of Health Standards Compliance (OHSC) will be established through an Act of Parliament. All health establishments (public and private) that wish to be considered for rendering health services to the population will have to meet set standards of quality.

How will NHI be funded?

A combination of sources will be used, which will include fiscus, employers and individuals.

The revenue base should be as broad as possible in order to achieve the lowest contribution rates and still generate sufficient funds to supplement the general tax allocation to the NHI.

Is NHI the knight in shining armour?

The rising cost of the private healthcare sector as well as the ageing of member profiles of medical schemes were amongst the factors that resulted in 80 medical schemes ceasing to exist in a 10-year period. Under NHI, medical schemes will continue to co-exist with the NHI.

The introduction of NHI offers schemes the opportunity to further develop and explore service and product delivery to their members as some of the benefits that will be excluded from the comprehensive primary healthcare package include:

- Cosmetic surgery that is not necessary or medically indicated but is done as a matter of choice;
- Expensive dental procedures performed for aesthetic purposes;
- Expensive eyecare devices like trendy spectacle frames;
- Medicines not included in the National Essential Drug List; except in circumstances where the complementary list has been approved by the Minister of Health; and
- Diagnostic procedures outside the approved guidelines and protocols as advised by expert groups.

We are conducting an NHI Survey to understand what level of primary healthcare is currently delivered by medical schemes and what non-primary healthcare services and products are delivered. This will provide an understanding of the potential gains to the schemes if they can refocus and re-align their benefit options as a top-up cover for those products not covered by NHI.

These are exciting times for medical schemes with a number of opportunities available to them in these changing times.

*(**Sources**: Policy Paper on National Health Insurance in South Africa and the Presentation on National Health Insurance Policy for the Portfolio Committee of Health)*

"The NHI package of services and the Prescribe Minimum Benfits (PMBs) will be very much aligned and this will help members to make a seamless transition from medical schemes to NHI."

Humphrey Zokufa (Board of Healthcare Funders of South Africa)

Change is coming. Is your tax function ready?

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The days when a tax professional is only responsible for tax technical and tax compliance responsibilities are numbered. There are a number of significant trends emerging in the world of tax. Each of these has a major impact on the way in which organisations govern their tax obligations and the role of the tax professional.

Transparency beyond numbers

In the recent past we have seen a widespread and legitimate interest growing among various stakeholders in how much tax companies pay, and a definite trend towards greater tax transparency by leading global organisations. In a recent publication by PwC[1] it is reported that many companies see the benefits of more transparent reporting and disclosing different aspects of their tax affairs. They are talking about their tax strategies and policies, their tax governance framework, their tax numbers and total tax contribution. This is known as the tax transparency framework. Leaders in tax transparency believe that such practices have many potential benefits, including an increased awareness of the tax and economic contribution of business, a demonstration of board involvement in tax governance and long-term reputational benefits, to name but a few.

Worldwide, there are examples of participation by non-governmental organisation (NGO's), the press and the public voicing their protest against large companies that are perceived not to pay their fair share of taxes, and these groups are putting pressure on politicians and regulators alike to enforce change.

[1] Tax transparency. Communicating the tax companies pay. November 2010.

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Adapting revenue collection practices

Revenue authorities are becoming more serious about monitoring and identifying risk in the large business sector and are adapting their administration practices to enable greater and more focussed revenue collection, as this is the lifeblood of a country's quest for financial recovery and growth. Their modus operandi is to tackle aggressive tax planning through improved transparency and disclosure on a real-time basis.

It would appear that revenue authorities globally are looking for evidence to confirm that tax is on the board's agenda and that the board has active involvement in setting the risk appetite in relation to managing tax. This includes appropriate oversight, sound systems, clear accountabilities, strong controls, ethical behaviours, highly skilled people supported by robust processes and procedures, and the capacity to identify, assess and mitigate tax risks. There is an expectation to see both strong corporate governance structures, and effective accounting and control mechanisms meet day-to-day compliance and reporting obligations. In some jurisdictions chief executives may now be held personally accountable for failures in the tax risk management of their companies.

Closer to home our governments looking at ways to increase the tax base and clamp down on corporate taxpayers from a tax morality perspective. SARS Commissioner, Mr Oupa Magashula, has emphasised this and made it clear that tax morality is here to stay and that taxpayers should pay the right amount of tax and be tax compliant.

The SARS banking accord signed with the Banking Association in 2009 was one such initiative to promote the concept of being a good corporate citizen and not to employ aggressive tax structures that will erode the tax base.

Tax professionals who are seeing the bigger picture

The message is quite clear: in the wake of the financial crisis and with the loss of public trust in business, companies have to become more sophisticated in their approach, allocating greater resources to the governance and management of tax and one has to wonder if this is the start of a new breed of tax professional in commerce and industry.

This new landscape for tax professionals requires operating in business environments in which improved governance, adequate risk management practices, improved transparency and disclosure to the board, audit committee and stakeholders are expected. These needs and responsibilities have been fulfilled by specialists in risk, compliance and governance; and since tax is not part of their expertise, it is understandable that the impact of tax is not always assessed and taken into account. That being said, tax professionals' expertise are tax technically focussed and they don't generally have any risk and compliance or governance proficiencies. The gap created the management of tax risk between the responsibilities or focus of the tax functions and the specialists in risk, compliance and governance might leave organisations exposed, as tax risk is not adequately managed and mitigated in order for boards and audit committees to discharge themselves of their duties and responsibilities.

Recent results published by PwC's in the Non-executive Directors report[2] indicated a 7% decline from 2010 in the number of non-executive directors available to serve boards and committees. This was as a result of the increased personal risk exposure and reduced fees earned in relation to the risks that the directors accept. This places further emphasis on risk management and the need for internal assurance, as boards and audit committee members will start raising questions and looking to management teams across the organisation to provide comfort.

Tax risk, which includes all tax types and tax liabilities, is considered to be one of the top ten risks in any organisation. With increased awareness and tax risk maturity in the market place, management will be under increased pressure over the next three to five years to provide assurance in response to the concerns of the board, audit committee and external stakeholders, like SARS on tax risk, and the tax control environment.

[2] PwC Non-executive directors. Practises and fees trends report 2011

Governance, enterprise risk management and the concepts of risks, controls and combined assurance frameworks will soon form part of a tax professional's lexicon. In order to meet the demands and requirements of stakeholders, various functions across an organisation will look to the company's tax professionals in order to assist with the integration of tax risk into the organisations' risk frameworks and governance structures with a view to satisfying its stakeholders and demonstrate that its a good corporate citizen, that risk management requirements are met and an adequate and effective tax control environment exists.

This increased need for risk information and internal assurance on tax risk, which is an area of specialism, will require the market to respond to a need for skills and expertise from tax professionals that will satisfy enterprise risk management, governance and assurance needs and responsibilities.

Having an effective tax function alone will not deliver the value required by stakeholders. Integration and synergies with co-assurance providers will not only be an enabler for the tax function, but will ensure that the board, audit committee and stakeholders can rely on the tax risk control environment.

The US Foreign Account Tax Compliant Act (FATCA)

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How the new rules will affect institutions, and why early action is the best policy

Introduction

In March 2010, the Foreign Account Tax Compliance Act (FATCA) became law in the United States (US). The law seeks to impose additional reporting requirements on financial institutions (FI) globally. In particular, it requires FI to employ enhanced due diligence procedures to identify US persons who have invested in either non-US financial accounts or non-US entities. Although a substantial portion of the law is yet to be written, the statutory definitions are very broad and classify a number of financial services industries in the scope of FATCA.

FATCA has far reaching consequences for financial institutions, including non-US FI. This article explains the general requirements of FATCA, its impact on financial entities as well as which are the qualifying financial entities and why it is important to starting preparing for compliance now.

The penalty for non-compliance is significant. Failure by a non-US financial institution, referred to as 'Foreign Financial Institution' (FFI), to comply with FATCA's requirements will subject such an institution to a 30% withholding tax on any payment routed via a US payer. In turn, any US financial institution that fails to obtain the proper documentation and withhold from an account holder on a 'withholdable payment' to a non-US entity will be subject to a penalty of 30% on any such payment.

Under the statute, the definition of a 'withholdable payment' is broad and includes not only interest, dividends, rents, and other US source passive income; but also the gross proceeds on sale or disposition of property that could produce US source interest or dividend income.

For example, a non-compliant FFI receiving gross proceeds of $1 million on the sale of a US Treasury bond from the FFI's proprietary trading account (even if held for a just day), could be subject to a $300.000 withholding tax. In addition, at the transaction level, all companies (both US and foreign) will need to review payments to non-US entities to determine if the payment is subject to FATCA withholding tax and whether the payee has provided the appropriate FATCA documentation or it could be liable for the 30% withholding tax on that payment and any associated interest and penalties.

As such, based on current guidance, FATCA will generally require:

- Non-US financial institutions to identify their US clients and report payments made to them to US tax authorities on a number of different products as part of their agreement with the Internal Revenues Services (IRS) to be FATCA complaint;
- Non-financial foreign entities (NFFEs) to either provide the identity of any substantial US owners or certify that there are none;
- US financial companies to enhance their current analysis of certain entity clients for either FATCA compliance (in the case of an FFI) or US ownership (in the case of an NFFE); and
- All companies, US and non-US, will be required to do an analysis of any foreign company before they make a payment to determine if the payee is required to comply in some form with FATCA rules and that it has in fact done so, or withhold tax on that payment.

Although the provisions of FATCA are effective for payment made after 31 December 2012, recent transition rules provided by the US Treasury and the IRS have provided that FATCA withholding tax be phased in with no obligation to begin any FATCA withholding until 1 January 2014. Although these provisions delay the withholding, the due diligence process for certain types of financial products (e.g. private placements and life insurance) should begin by 1 July 2013. As such, many believe the extended due date only provides those who start planning now with enough time to enhance their due diligence procedures to be able to request, collect, review and store the additional account holder information required under FATCA.

Impact on financial companies

To avoid FATCA withholding tax, all non-US financial companies will be required to enter an FFI agreement with the IRS, and obtain an identification number to certify that they entered into an FFI agreement with the IRS.

An entity that enters into an FFI agreement will need to implement a prescribed process to identify individual clients who are US citizens or residents, and in the case of an FFI that is a client, verify FATCA compliance.

For payments made to non financial foreign entities (NFFEs), the financial company will need to obtain the name, address and tax identification number of each US owner certification from the NFFE that there are or no such US owners.

US financial companies are already subject to a number of US information reporting requirements on substantial US owners' payments (e.g. Form 1099, RMisc) and have been feeling the pressure of the IRS stepping up its enforcement in this area.

FATCA now requires US financial companies to also enhance their due diligence process to determine whether the FFIs and NFFEs are FATCA compliant or withhold 30% on certain payments under certain conditions.

In addition, US financial companies also need to review the types of payments made to non-US counterparties and whether the counterparty is FATCA complaint; otherwise the US financial company becomes liable for the withholding tax.

With the combination of cross-border withholding tax being a top three priority audit issue and these requirements under FATCA, many US financial companies are finding that their existing compliance efforts may be insufficient.

Financial entities subject to FATCA

Unfortunately, while the guidance issued to date clearly includes insurance companies in its broad grasp, there is not clarity about which entities and products are within the scope of FATCA. What is clear is that financial companies, foreign and domestic, will need to re-evaluate the types of information collected from clients to determine whether the client or counterparty is compliant.

Fortunately, the statute grants the Secretary of the Treasury regulatory authority to exclude or include financial companies and certain products based on the probability of being used for US tax evasion.

The IRS has already announced its intentions to exclude certain insurance companies, such as those that solely issue property and casualty insurance, from FATCA and potentially narrow the focus of FATCA to insurance products with just a cash value (investment) component, such as whole and variable life and annuity products.

Scope of a Foreign Financial Institution

Activity	Examples
Accepts deposits in the ordinary course of a banking or similar business	• Savings bank • Commercial bank • Loan association • Thrift • Credit union • Co-operative banking institution
Holds financial assets for the account of others as a substantial portion of its business	• Broker dealers • Clearing Organisation • Trust company • Custodial bank • Custodian of employee benefit plan
Is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities, or any interest in such assets (including derivatives such as forwards, futures or options)	• US fund • Non-US fund • Funds of fund • Exchange traded fund • Hedge fund • Private equity fund • Venture capital fund • Sovereign Wealth fund • Commodity pools • Managed fund • Collective investment schemes

Enterprise - wide impact

As opposed to banking or brokerage, insurance is generally a 'low touch' business - meaning insurers frequently do not have contact with their policyholders except at the initial purchase of the product and then when a payment is made related to the product.

Bankers and brokers on the other hand, frequently make payments throughout the year (interest, dividends etc.) and consequently have several opportunities within a year to communicate with customers.

FATCA therefore, poses specific challenges to the insurance industry. Often the only contact an insurer has with a policyholder is when a policy is purchased or when there are policy changes and transactions are undertaken during the lifetime of the policy.

Companies may need to change how and how often they interact with their policyholders. Opening new accounts may require more documentation, and companies may have to follow up with customers to ensure that all required forms (e.g. W-8 forms) are kept up-to-date. In addition, information captured for; onboarding, AML/KYC, tax withholding and reporting, and credit risk information, as well as any information captured for any regulatory purpose, will need to be reviewed for indicia of US status and inconsistencies.

Because FATCA impacts processes and systems throughout the organisation, and requires new information collection and reporting systems and procedures, addressing it will require a multidisciplinary effort.

FATCA is not just a tax initiative but an operational requirement. To achieve and maintain compliance with the new regulation, companies will have to develop multidisciplinary support teams that include not only a tax specialist but specialists from service and operations, information technology (IT) and compliance.

The need for early action

Despite the fact that regulations have yet to be issued, companies should begin planning their FATCA compliance efforts today. The window of time available to prepare for these rules is relatively narrow, and implementation will require a substantial amount of work, especially for large multinational companies.

For such large organisations, it could take two months or more just to identify and mobilise a multidisciplinary global programme team that can focus on the multiple impact points across the enterprise. In addition, FATCA may require significant resources and budgets throughout 2012.

By taking steps today to address FATCA, companies can gain a better sense of time, staffing and budget, and maintain compliance. Starting too late will leave less time to carry out essential prioritisation of operational changes, IT enhancements and compliance-related activities.

A three-step approach to compliance

FATCA compliance activities can be divided broadly into three steps:

- Current state analysis;
- Future state and roadmap development; and
- Implementation.

Companies can start working on FATCA by completing the first two steps without the necessity to have the regulations published. Even small steps towards implementation can be taken.

Each compliance activity should be viewed in terms of the six factors that could be affected by FATCA:

- people;
- process;
- technology;
- governance;
- standards; and
- data.

Many financial institutions focus too narrowly on one or two of these six factors and minimise the others. For instance, a company might focus on data requirements and building new technology to address FATCA, but fail to adequately address the governance processes that are essential to achieving and maintaining compliance. All six dimensions must be kept in mind as the organisation proceeds through the three-step compliance process.

In addition, an organisation should consider the following functions in the compliance process:

- operations;
- tax operations;
- technology;
- legal;
- compliance (AML/KYC);
- onboarding;
- new product development; and
- distribution.

FATCA will impact each of these functions in some way.

A comprehensive, multidisciplinary approach that considers the six factors and eight functions at every step of the way will help to ensure that no detail that could jeopardise future compliance is overlooked.

Conclusion

The US government continues to solicit input from stakeholders about FATCA. Proposed regulations are not expected until the first quarter 2012, and it could be almost a year or more before final regulations are issued. The scope of FATCA is enormous, the 30% withholding tax is punitive, and the time left for to prepare for compliance is short – all of which reinforces the importance of taking action now. Many financial services firms have begun to do so: of 685 firms responding to a PwC survey in March 2011, more than half (55%) were planning to perform a current state assessment and 17% had completed one already. Of the latter group, 85% believe their FATCA compliance effort will be significant. By planning the work needed for compliance, and completing as many preliminary steps as possible today, companies can minimise the disruption to their business operations as the FATCA deadline approaches.

The three-step process to FATCA compliance

Step 1

Current state analysis

The first step in achieving FATCA compliance is to assess the current state of the organisation and determine what current processes and technology can be used and which must be modified in order to be compliant. Among other activities, this step requires companies carry out the following:

- Entity analysis: Review the company's existing organisational structure and entity data to identify potential US FIs, FFIs and NFFEs;
- Production analysis: Identify and review the company's portfolio of clients that may be subject to FATCA;
- Business unit analysis: Review the documentation collection and management process for onboarding, tax withholding, and AML/KYC to see where indicia of US ownership or entity compliance can be found. Each business unit needs to also be assigned to the appropriate legal entities;
- Customer account analysis: Establish the number of US and non-US accounts/policy holders by legal entity. Identify the information collected from clients and gaps to remediate; and
- Review of client agreements and services level agreements to determine FATCA data and process responsibilities.

In conducting these activities, the organisation should consider the implications for people, process, technology, governance, standards and data; and determine which of the eight functional areas will be affected and thus should be involved. Given the enormity of the tasks highlighted above, many organisations have conducted pilots to evaluate the impact of FATCA on specific business units or geographic areas affected.

Step 2

Future state and roadmap development

The next step is to develop a target operations model – a view of the future state of the organisation under FATCA – and create a preliminary implementation roadmap. Key activities during this step include:

- Defining target state regulatory, business, and functional requirements;
- Defining future state operating models and technical architectures;
- Conducting a gap analysis (current vs desired future state);
- Creating a plan to remediate existing accounts and develop new 'business-as-usual' processes;
- Prioritising the roadmap and implementation plan by business unit; and
- Developing a business case and funding request.

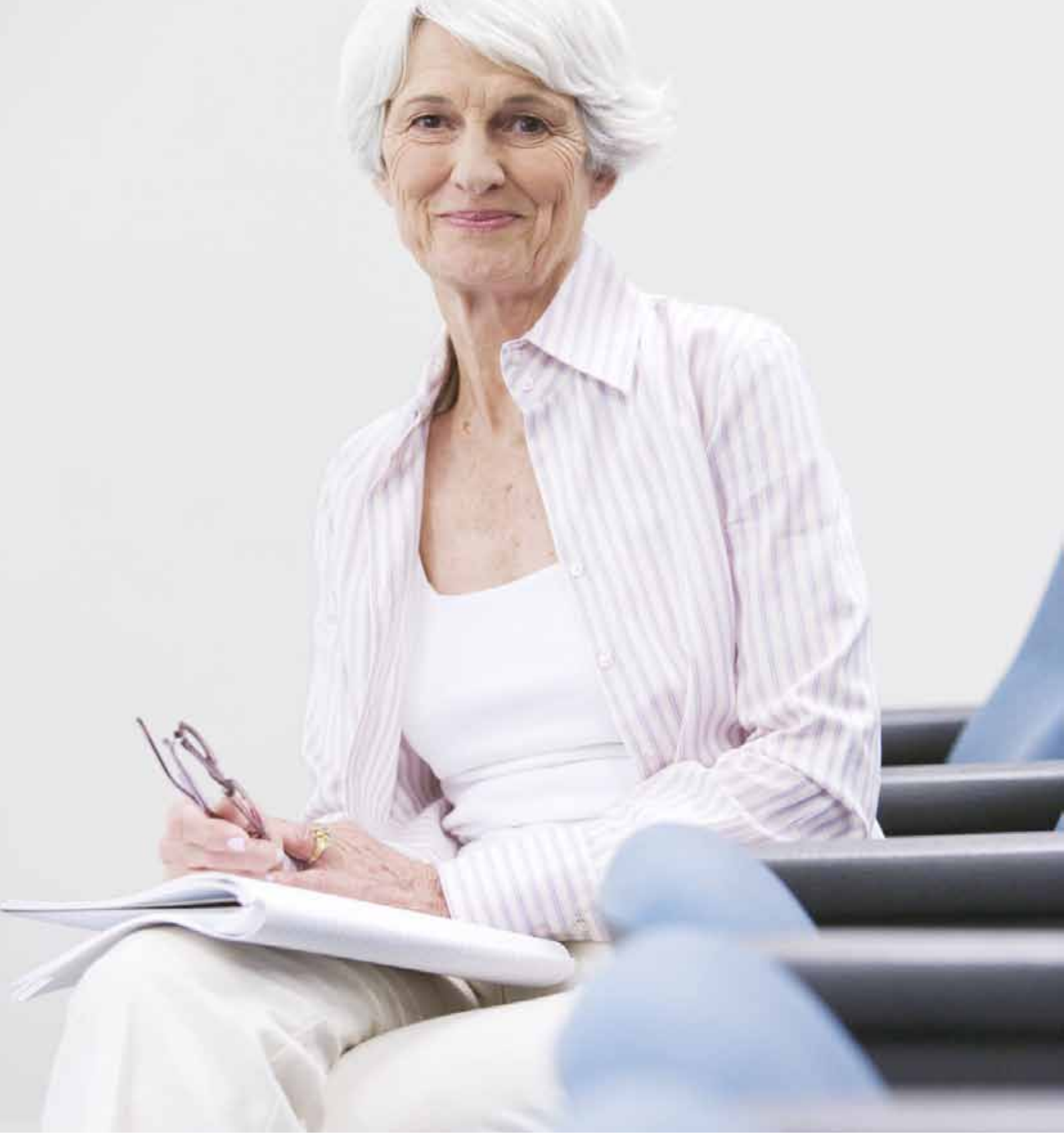
As with the current state analysis, for each activity in Step 2, the organisation should consider the implications for people, process, technology, governance, standards and data as well as the eight functional areas that could be impacted by FATCA.

Step 3

Implementation

Until final FATCA regulations are issued, organisations will not be able to execute fully on the implementation roadmap. That said; the IRS has issued enough guidance at this point to enable companies to identify gaps between current and future states and implement many needed improvements to systems, processes and procedures to comply with the new regulations. This includes gathering required customer data and ensuring communications across systems that will be affected by FATCA. In addition, firms can begin to educate customers and affected business units about the new data collection and reporting requirements. Doing so now will help to avoid potential problems later when FATCA is effective.

Pension fund governance and IT



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The principles for governance of retirement funds are mainly set out in Section 7 of the Pension Funds Act (Act 24 of 1956 as amended), as well as in Pension Fund Circular PF130.

IT governance arrangements define the decisions, the involvement by various stakeholders, and the structures, processes, responsibilities and other mechanisms required to make decisions. This involves building the right capacity, processes and structures in order to make the right decisions to achieve alignment, manage risks, enable change, deliver quality IT services and manage service costs. In the end, IT governance is about setting the rules and building the capabilities to run IT in order to create stakeholder value.

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Introduction

Section 7D of the Pension Fund Act (Act 24 of 1956 as amended) requires the board of trustees to ensure that proper control systems are employed. In various instances, this duty is outsourced to a retirement fund administrator. PwC have recently assessed the maturity of operational and IT controls at various self-administered retirement funds and retirement fund administrators. These benchmarking assessments included a significant portion of the current retirement fund market.

The following rating criteria to assess the maturity of the operational and IT controls was prepared, which are shown on the following pages.

Criteria	Summary of criteria used
Level of automation	This involved the assessment of automation related to key controls and was based on the extent of manual intervention required in order to execute the control. The rating of maturity included elements such as the use of spreadsheets, back-end system interventions, front-end overrides through system approvals and validations, the level of record keeping and the embedding of calculations and validations into the systems.
Level of management oversight	We assessed the level of management oversight over key controls based on the seniority of the reviewer, for example, having a review performed by a peer as opposed to line management. Other elements involved rating the level of overall oversight by the audit committee or board of trustees, if applicable.
Detective and/or preventative nature of controls	We assessed the preventative and/or detective nature of the key controls based on whether the controls in place prevented and/or detected control failures.
Frequency of controls	We assessed the frequency with which controls were executed in respect of key activities. The frequency of execution could be, for example, on a daily, monthly, quarterly, bi-annual or annual basis.
Depth of the control	The depth of key controls was assessed on the basis of the level of robustness of the control activities. The assessment included elements such as whether any reasonability checks or reconciliations were performed, availability of exception reports, validation of source information and independent review and approval.

Based on these above rating criteria, the following represents a summary of typical controls at a specific level of maturity:

Level of controls maturity	Summary of controls
0%-20% **Immature control environment**	Processes were mostly manual, or key calculation and record keeping was performed on spreadsheets with a low level of management review. Controls were primarily detective, with the frequency of review falling between annual and quarterly. Reasonability checks and limited reconciliations were performed by management.
20%-40% **Predominantly a manual control environment**	Processes were mostly manual, or key calculations, validations and record keeping were performed on systems with a high level of system override from the back-end. Independent reviews were performed by peers with a low level of management review. Controls were detective in nature with the frequency of review falling between quarterly and monthly. Reasonability checks, reconciliations performed and exceptions identified were reviewed by management.
40%-60% **Predominantly an automated control environment with a high level of override**	Processes were mostly automated or key calculations, validations and record keeping were performed on systems with some level of system override from the back-end. Independent reviews were performed by peers with some level of management review. Controls were detective with the frequency of review falling between quarterly and monthly. Reasonability checks, reconciliations performed and exceptions identified were reviewed by management. Key transactions and processes required management authorisation.
60%-80% **Predominantly an automated control environment with limited override**	Processes were significantly automated and key calculations, validations and record keeping were performed on systems with limited system override from the back-end. A high level of independent review was performed by management. Controls were both detective and preventative with the frequency of review falling between quarterly and monthly. Reasonability checks, reconciliations performed and exceptions identified were reviewed by management. Key transactions and processes required management authorisation and source information was validated prior to approval.
80%-100% **Mature control environment**	Processes were significantly automated and key calculations, validations and record keeping were performed on systems with no system override from the back-end. A high level of independent review was performed by management. Controls were preventative with the frequency of review either being between monthly and daily. Reasonability checks, reconciliations performed and exceptions identified were reviewed by management. Key transactions and processes required management authorisation and source information was validated prior to approval.

Results of our assessments

Figure 1 and 2 benchmark the industry against PwC best practice in respect of operational controls and IT general controls for the period ended 31 December 2010.

Processes were found to be mostly automated with some key calculations, validations and record keeping performed on the systems, but with a high degree of system override from the back-end or outside of the systems.

Independent reviews were performed by peers and lower level management with a limited degree of senior management review.

Controls were mostly detective in nature with the frequency of review falling between quarterly and monthly.

Reasonability checks, reconciliations performed and exceptions identified were reviewed inconsistently by management.

Key transactions and processes that required management authorisation were not always reviewed in a timely manner resulting in unresolved discrepancies.

Figure 1: Operational Environment – Level of Control Maturity

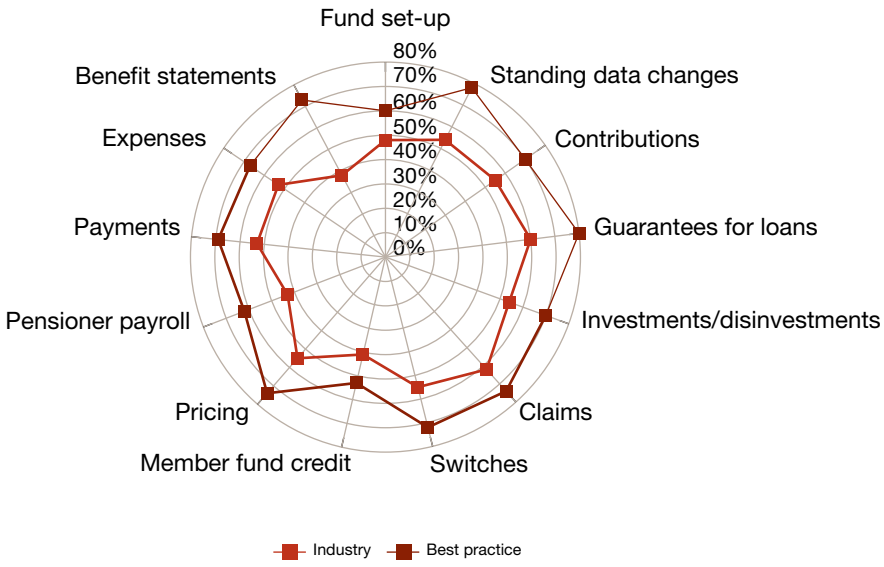
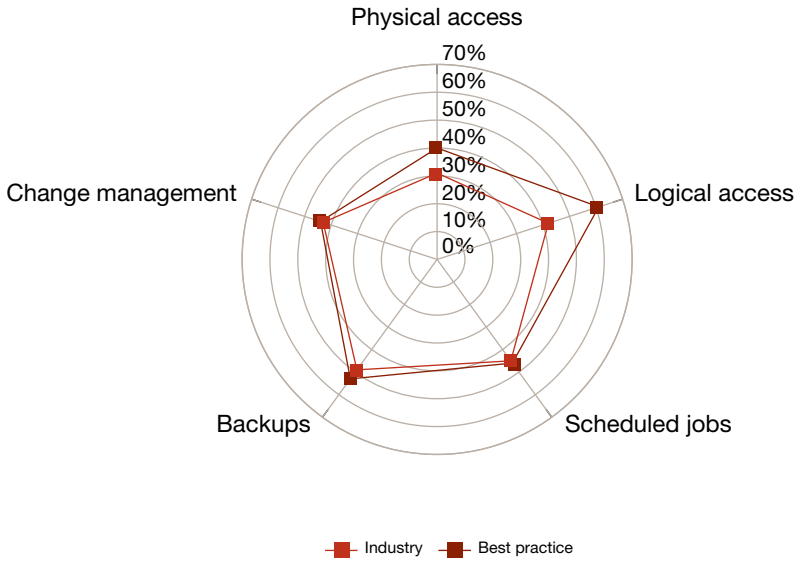


Figure 2: IT Environment – Level of Control Maturity



Comparison to PwC best practice

The results of the benchmarking assessments indicated the following alignment to PwC best practice standards and general working practices followed by the industry:

IT general controls

With the exception of logical access, the IT general controls were aligned to PwC best practice standards, tailored to meet the size and complexity of the specific retirement fund administrator. Physical access to, and environmental controls within and surrounding, the server rooms were strictly controlled.

Change management processes that focused on program changes (bug fixes, database changes, code changes and report changes) were well controlled and included control activities surrounding ownership, version control, release management and testing of changes.

Operations within the IT environment, for example, job scheduling and backups, were managed and monitored on an appropriate basis. Failed jobs were reported, escalated and resolved.

Reconciliations

Manual reconciliations performed over contributions, investments and/or disinvestments, loans and cash were suitably designed and were performed on a regular basis. Such reconciliations were usually accompanied by detailed checklists that evidenced review and sign-off.

A movement towards increasing the level of automation over such reconciliations was evident, in particular with regards to the electronic upload of information (as opposed to manual capture) and automated matching of criteria. This will increase the efficiency and accuracy with which the reconciliations are performed and decrease the level of human error and manual intervention.

Reporting

Standard system-generated reports were appropriately designed to address controls. Such reports were also reliable and were a true representation of both the source and objectives of the reports.

Typical control deficiencies and/or breakdowns within the industry

The results of the benchmarking assessments indicated the following typical control deficiencies and/or breakdowns within the industry:

Administration backlog

The receipt of take-on data from previous administrators or the funds themselves was often a lengthy process due to the reliability of data received from employers and/or previous administrators. Although, it was preferable to take on audited financial data, this was not always possible.

Data discrepancies often resulted in a backlog in the fund take-on process. This, in turn, resulted in long outstanding reconciling items between the static and financial data received from the previous administrator and/or funds themselves to that loaded on the systems.

The handover process between the fund take-on team and the administration team was often informal, which resulted in the long outstanding reconciling items remaining unresolved and consequently not being tracked to resolution.

Fund take-on occurs frequently and is fundamental to administrating the fund correctly. Consequently, standard operating procedures surrounding data quality and reconciliation over the fund take on and handover processes should be formalised and implemented effectively.

Lack of segregation of duties

A lack of segregation was prevalent in the certain areas of the business, for example:

- The recording and approval of static data changes, for example, fund rules;
- The recording and approval of prices and/or rates of return;
- The processing and review of investments and/or disinvestment instructions;
- The recording of new and/or terminated pensioners, changes to pensioners' banking details, the reinstatement of pensioners, the pensioner payroll run and reconciliation; and
- The flagging and/or de-flagging of guarantees for loans.

Often, the systems were not programmed to enforce segregation of incompatible functions and thus relied on incompatible functions being segregated using access profiles and/or manual processes dictated by standard operating procedures.

However, for reasons outlined later, access profiles were insufficiently controlled and although well designed, implementation of the standard operating procedures was found to be poor and inconsistent among branches and/or regions.

Often, system workflows did not exist or were insufficient and allowed incompatible functions to be performed by the same person resulting in a lack of segregation of duties. Retirement fund administrators relied on straight-through processing to increase efficiencies and reduce costs. However, the necessary in-built validations required to mitigate the risk of a lack of segregation of duties associated with straight-through processing were not considered.

Access levels should be restricted to authorised users commensurate with job responsibilities and appropriately segregated. Management should periodically review the appropriateness of such access levels.

Inadequate logical access controls

We found that inappropriate user access controls can be attributed to ineffective user administration, especially where users were promoted, transferred or were assigned to assist with special projects. Changes to access levels that were necessitated by a change in job responsibilities often resulted in users possessing access to incompatible functions, especially where the granting of new access levels was not accompanied by the revocation of the existing access levels.

While many of the users were unaware of the excessive and incompatible access levels they possessed, this still negated the effect of segregated access control and allowed users to perform incompatible and unauthorised functions that could lead to fraud or operational losses due to erroneous processing.

Access clean-up projects were in-progress, but often proved to be ineffective as the access levels assigned to the users were not profile-driven, which resulted in production delays due to the revoking of incompatible access levels. The access clean-up projects were both time-consuming and resource intensive.

Retirement fund administrators should consider the impact of the revocation of access levels configured to application users. An identity management architecture, where payroll and administration applications interface a lightweight directory access protocol (LDAP) solution on the operating system, could assist with timely and effective user administration.

Insufficient validation controls

Validation controls in respect of fund rules and investment restrictions were often bypassed or not embedded into the systems. Key manual validation and/or review and calculations were occurring outside of the system; for example, compliance with Regulation 28 of the Pension Fund Act or the calculation of late payment interest. We have identified manual intervention as the root cause of processing errors that resulted in non-compliance with regulations and fund rules. Legacy systems did not possess the necessary inherent built-in validation functionality to cope with the validation required, particularly with respect to the increased level of compliance and associated controls.

Manual interventions should be limited through embedding fund rules and investment restrictions into the systems. The compliance functions within the retirement fund administrators or the funds themselves should be involved in the change management process relating to such validations.

Insufficient management oversight and/or monitoring

An increasing trend towards implementing robust oversight and/or monitoring controls was evident, for example, dashboard reporting. However, the level of robustness in such oversight and/or monitoring controls required specific improvement surrounding the compilation of complete and accurate data from source systems for use by the reporting mechanisms. Representation of the information also needed to be more graphic and user-friendly, with areas of non-compliance that have standard operating procedures graded in terms of severity, cost implication and priority.

An increased trend towards implementing asset-liability matching as a 'catch all' control at month-end was also evident. While this initiative proved valuable, the escalation procedures related to non-compliance issues arising from such a control were insufficient and were often not reported to the appropriate level of management responsible for enforcing the associated remediation plans.

Management oversight can be improved by embedding key performance indicators into the execution of daily processes. Exception reports and dashboards produced should be linked to appropriate business owners to ensure remediation and improvement of the internal control environment.

Way forward

Control deficiencies identified as part of our benchmarking assessments negatively impacted on the financial and reputational environments of the retirement fund administrators and/or funds themselves.

We foresee that stakeholders, such as the board of trustees and regulators, will require retirement fund administrators and/or funds to continuously improve their internal control environments and to limit operational exposures. Retirement fund administrators and/or funds will be required to improve the maturity of systems and processes to keep up with changes in regulations and products and to limit operational losses while improving their service levels through process efficiencies.

Low profit margins will require retirement fund administrators to significantly automate processes and embed key calculations, validations and record keeping into systems with limited system override from the back-end through straight-through processing.

A high-level independent review can then be performed by management through dashboards and exception reporting to ensure that service levels are met and operational losses are limited.

The internal control environment will be required to be preventative in nature, with the frequency of review being daily exception reporting for transactional processes and monthly management reporting on possible event losses and key service levels. Management will be required to perform reasonability checks and reconciliations and remediate exceptions identified. Management will also be required to monitor key transactions and processes where straight through processes are overridden through journals or back-end system changes.

Ultimately, a stronger internal control environment will lend itself to improved IT governance, which will in turn create greater stakeholder value.

Fair value measurement: Implications of IFRS 13 for the real estate industry

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At a glance

The International Accounting Standards Board (IASB) issued IFRS 13, 'Fair value measurement', in May 2011 to provide a common framework for measuring the fair value when its determination is required or permitted by another reporting standard. The framework defines fair value and provides a single source of guidance for measuring it. It also eliminates various – and sometimes differing – provisions in existing frameworks and requires additional disclosures about fair value measurements. It applies prospectively for annual periods beginning on or after 1 January 2013; through earlier application is permitted.

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IFRS 13 defines the fair value of an asset as an 'exit price', being 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

IFRS 13 predominantly brings into a single standard the fair value concepts that were in other standards, but it also clarifies various requirements with regard to the appropriate measurement and disclosure of the fair value and its underlying inputs – for example:

- For non-financial assets, 'highest and best use' is the use to be assumed by market participants that maximises the value of an asset.
- The fair value measurement assumes that the hypothetical sale of the asset – or 'exit transaction' – takes place in the 'principal market' with the greatest volume and highest level of activity for the asset or liability. Alternatively, in the absence of such a principal market, the transaction should take place in the 'most advantageous market'. Management will therefore need to identify the relevant market.
- Disclosure requirements have been significantly expanded to provide users of financial statements with detailed quantitative and qualitative information about assumptions made and processes used when measuring the fair value.
- The three-level fair value hierarchy prioritises the inputs to be used in determining the fair value using certain valuation techniques.

For real estate entities, the new standard may result in the requirement to redefine processes and procedures; which will particularly impact the following areas:

- ***Investment property carried at fair value***: How investment properties are measured and the requirement for additional disclosures;
- ***Investment properties carried at amortised cost***: How to determine fair value less costs to sell for IAS 36, 'Impairment of assets', and IFRS 5, 'Non-current assets held for sale and discontinued operations', and fair value for disclosure under IAS 40, 'Investment property';
- ***Fair value for property, plant and equipment***: How to measure fair value under the revaluation model according to IAS 16, 'Property, plant and equipment';
- ***Fair value in a business combination***: How to estimate fair value in a business combination according to IFRS 3, 'Business combinations'.

How does IFRS 13 affect the real estate industry?

Definition of fair value

Fair value is defined as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' [IFRS 13 paragraph 9].

From a real estate industry perspective, in most cases there won't be substantial change in the estimation of fair value due to the amended definition, as the exit price will often be equal or almost equal to the 'exchange value'. In the current standard, the estimation of the relevant price should always be based on a market participant's view.

Under IFRS 13, a fair value measurement takes into account the characteristics of the asset. Applying this to real estate, those characteristics could be – as in the current IAS 40 – the condition and location of the asset and restrictions on its use. The concept of fair value as a market-based estimation therefore remains unchanged.

Fair value hierarchy

One of the major changes in IFRS 13 compared to IAS 40 is the change in the fair value hierarchy. IAS 40 defines a fair value hierarchy based on valuation techniques; IFRS 13 uses a different approach.

In IFRS 13, fair value measurements are categorised into a three-level hierarchy based on the type of inputs and no longer based on the valuation method. The new hierarchy is defined as follows:

- Level 1 inputs are unadjusted quoted prices in active markets for items identical to the asset being measured;
- Level 2 inputs are inputs other than quoted prices in active markets included within Level 1 that are directly or indirectly observable; and
- Level 3 inputs are unobservable inputs that are usually determined based on management's assumptions. However, Level 3 inputs have to reflect the assumptions that market participants would use when determining an appropriate price for the asset.

Due to the nature of real estate assets – which are often unique and not traded on a regular basis – and the subsequent lack of observable input data for identical assets, fair value measurements of real estate will be categorised as either Level 2 or Level 3 valuations. All observable market data (transaction prices) are given a higher priority and should be preferred over unobservable inputs, even if the market is inactive and transactions of comparable assets are rare.

The next table gives examples of inputs to real estate valuations and their typical categorisation in the fair value hierarchy.

Fair value measurement – valuation inputs

Input level	Input (example)
2 (observable)	• Sale prices per m² for similar properties in similar locations • Observable market rent per m² for similar property • Property yields derived from latest transactions
3 (unobservable)	• Yields based on the management estimation • Significant yield adjustments based on management's assumptions about uncertainty/risk • Assumptions about future development of parameters (for example, vacancy, rent) that are not derived from the market • Cash flow forecast using the entity's own data

Management should maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

Valuation techniques

In contrast to the fair value hierarchy in IAS 40 and IAS 16, IFRS 13 does not prefer a specific valuation technique. The fair value hierarchy in existing IFRS guidance prioritised the application of a market approach (or a comparable sales method) over the income approach (that is, a valuation technique based on discounted cash flows) and – for the valuation of property plant and equipment – the cost approach.

According to IFRS 13, there are generally three approaches that can be used to derive fair value:

- The market approach;
- The income approach; and
- The cost approach.

To measure fair value, management should use valuation techniques consistent with one or more of these approaches.

Furthermore valuation techniques that are appropriate in the circumstances and for which sufficient data is available should be used, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

The valuation has to be based on the specifications that are considered necessary to reflect the market participants' highest and best use of the property. As a result, specifications that include no added value to the market participants are not considered in the valuation.

Highest and best use

IFRS 13 defines the concept of highest and best use. The absence of a definition of this concept in previous guidance on fair value accounting has given rise to varying interpretations in the past. This is especially true for real estate valuations, as land values depend significantly on the assumptions about the land's (potential) use.

The 'highest and best use' takes into account the use of the asset that is physically possible, legally permissible and financially feasible.

Highest and best use is determined from the perspective of market participants. IFRS 13 provides some guidance on how to understand the highest and best use concept in the context of real estate.

Disclosure requirements

Following the financial crisis, the IASB has included significantly enhanced disclosure requirements in the new standard in order to provide users of financial statements with better information about the measurement uncertainty inherent in fair value measurements and to strengthen market participants' confidence in fair value measurements.

The required disclosures include:

- Information about assets measured at fair value that are used in a way that differs from their highest and best use;
- Information about the hierarchy level into which fair value measurements fall;
- Transfers between Levels 1, 2 and 3; and
- Methods and inputs to the fair value measurements and changes in valuation techniques.

Outlook

Market value should not change because of new fair value definition, as the concepts in IFRS 13 are in line with current practice in general. Consequently, so the measurement results should be quite similar – in most circumstances – under the new standard as under IAS 40.

Nevertheless, the new valuation premises and the new principles may have an impact on the real estate industry. Real estate entities should consider what kind of (limited) situations will require a redefinition of the rules and procedures to fulfil the requirements of the new fair

value measurement standard. At the same time, all real estate entities will face more disclosure requirements as a result of the new requirements. Management may need to reconsider some of the valuation procedures in place to minimise their impact as far as possible.

Regarding the valuation principles and valuations under IFRS 13, there may be a new challenge for management to make judgments and to explain their decisions and their resulting influence on the valuation results. During the next few months, management, valuation experts and auditors will become familiar with the IFRS 13 and will face new questions, especially when presented with scenarios to be considered in future valuations.

PwC Global Private Banking and Wealth Management Survey

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Regulations and client expectations are changing the status quo in the wealth management industry

The PwC Global Private Banking and Wealth Management Survey was conducted between December 2010 and April 2011. Open to members of the private banking and wealth management community, the survey was completed by 275 institutions in 67 countries, 62% of which came from Europe, 24% from the Americas and 14% from the Asia-Pacific region.

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The survey found that wealth management continues to be a lucrative business with untapped potential for significant growth if institutions can be agile in adapting to meet changing demands. The survey also revealed that the status quo in the private banking and wealth management industry is changing as the focus shifts to client service and value delivery.

While new competitors are challenging the dominance of established firms, the impact of new regulations and more demanding client expectations are forcing private banks and wealth managers to change their client service infrastructures and the way they operate. The survey indicates that those who can master change will be in a better position to win increased market share and lead the industry.

Other highlights identified by the survey include:

- Client evolution: Today's client is cautious, smart, less loyal and expects excellent service and clear value;
- The impact of regulation: Regulation has become the not-so-invisible hand, increasing the cost of operations;
- Operational excellence: Greater operational efficiency and effectiveness are required, not just to compete, but to survive; and
- Change is a reality: Standing still is no longer an option and institutions must now quickly adapt or face being left behind.

The survey also found that the industry faces multiple pressures in five key areas, which are discussed on the following pages.

Performance and change

The DNA of the wealthy investor has been transformed as a result of the global financial crisis and recent financial scandals. The result is higher expectations of service and value, with clients taking nothing for granted and probing the fundamentals of their advisor relationship by asking wealth managers and private bankers questions such as 'do you really provide a value add for me?' and 'so why exactly should I be loyal to you?'

Clients all across the wealth pyramid are increasingly taking charge and voicing a view that private wealth products and services should be simpler, more transparent and deliver clearer service. Furthermore, clients are more active in managing their affairs and are paying increased attention to reputation, regulatory compliance and risk management.

With clients taking a much more active interest, wealth managers now have to work harder to earn their long-term loyalty and trust. Delivering the clear value that clients want is contingent on understanding and anticipating their changing needs, circumstances and perceptions. Taking this into account, survey participants see new competitors emerging and more than 30% of respondents expect significant consolidation over the coming two years.

Performance of private banking and wealth management institutions remains under pressure and there is a wide divergence in performance across the industry. Nevertheless, wealth managers' average cost-to-income ratios remain stubbornly high.

Cost and regulation are the new drivers of change. Furthermore, securing sustainable revenue growth is key, particularly for offshore market players. Survey respondents anticipate having to achieve significant change across their business and operating models – but wealth management has traditionally struggled to deliver effective change.

13%

of organisations rated themselves as high performing in terms of transformative change.

42%

of survey respondents aspire to higher levels of performance in the coming years.

28%

of respondents reported cost-to-income ratios of less than 60%.

9%

of wealth managers achieved revenue growth in excess of 10%.

50%

of client assets leave the wealth management firm on international wealth transfers in many markets.

Markets and clients

The dynamics of global change in the wealth management and private banking industry are significant with shifting patterns of world wealth between emerging and established markets. The centre of gravity for wealth management is moving and established centres are under pressure from emerging markets.

In response to increased regulatory pressures, respondents see Switzerland, London and to a lesser extent, New York, all being challenged by the rise of Singapore and Hong Kong in the coming two years. In looking at the maturity of global markets (both onshore and offshore), it is important to note that the relative growth rates between established and emerging markets now vary markedly, with significant and sustained wealth management growth expected in emerging markets.

The industry must cater to clients' perceptions of what value added really is for them and the price they are willing to pay for it. Collaboration and more effective referral leverage is now a necessity, particularly by those with retail, corporate or investment banking arms.

Many respondents cited referrals from existing clients as the biggest source of new clients. Large financial organisations have identified untapped revenue potential through increased collaboration and referrals from other business units within their organisations.

The industry can no longer be all things to all people and must focus its energy on specific markets and segments. Institutions must be clear about what they will and will not do.

37%

of CEOs believe existing clients would recommend them to new potential clients.

Client relationship managers and human capital

The shortage of talent is one of the biggest barriers to future growth for wealth managers and private banks. Top quality people are becoming more valuable, more difficult to source and more expensive to train. No less than 40% of survey respondents rated their client relationship managers (CRMs) as only average or below in terms of their ability to meet client needs. Institutions must work harder to leverage their human capital investment by supplying their CRMs with appropriate tools and technology with the intention of further improving the institutionalisation of client relationships with the organisations.

Clear people value propositions are now essential as CRMs have reduced in record numbers. One in three respondents said the main reason CRMs left their organisation in the last two years was that they were encouraged to leave because of underperformance. Poaching talent from competing firms remains the top means of recruiting CRMs; however, given increasing institutionalisation of clients, this is now less about acquiring the CRM client assets and more about acquiring the experience they have.

Linkages between performance and pay are becoming critical and new strategies, incentives and support are needed to attract and retain qualified professionals. The most profitable firms have, on average, far lower ratios of clients per CRM. In the wealth band between US $5 million and $10 million, there are an average of 54 clients per CRM, but for those institutions with the lowest cost-to-income ratios, there are only 26 clients per CRM.

81% of survey respondents think that their firm's relationship managers greatly understand clients' investment objectives.

56% of survey respondents agree that they have a full grasp of clients' overall financial goals.

17% of survey respondents said that their CRMs currently have an established relationship with the likely heirs of their clients.

23% of CRMs bring more than 40% of client assets with them when changing jobs.

'The traditional role of the CRM is being reshaped, requiring new skills and mindset change. The entire front-office infrastructure is changing to meet client demands and keep pace with regulation. We see our respondents preparing for significant change in order to grow and prosper. The alternative is not attractive.'

Paul Wilson, BCM & Partners

Operations and technology

Never before has identifying and delivering excellence in terms of operational and systems efficiencies been so important. Shared services, outsourcing and new technologies are gaining acceptance. The real challenge is not just delivering efficiencies and cutting costs, but also improving the overall quality of the client experience, which requires achieving all of these at the same time. We are entering an age when only those that can deliver transformative change cost-effectively will lead the industry.

Respondents are at different stages of their operational evolution with many continuing to run legacy systems and manual processes. Technology budgets are being directed to better support client relationship managers and the front-end client experience. The infrastructure requirements of regulatory compliance create opportunities for technology firms and outsource service providers.

'Transformation of the wealth manager business model is overdue, and this year's report shows new urgency for change from an industry that has not needed, nor been able, to adapt swiftly in the past. We found nearly universal acceptance by senior wealth management executives that standing still is no longer an option and that there is a need for wholesale changes in the way their organisations deliver value. Those that are ahead are looking beyond the pressures of today to address operational, cultural and technology issues that are standing in the way of future growth.'

C Steven Crosby, Americas Leader, PwC Global Private Banking and Wealth Management

17% of survey respondents rated their front-office systems as excellent.

60% of survey respondents indicated that their technology budgets have risen in the past two years.

42% of survey respondents have increased their operational budgets over the past two years.

Risk management and regulation

Regulation continues apace and the financial services industry is clearly under scrutiny with the global wealth management industry now at the forefront of regulatory change.

Regulation has profound impacts and consequences for all business models. Survey respondents cited increased regulation and its associated cost as the number one challenge to business growth. Regulation is the increasingly not-so-invisible- hand trimming profitability. In our view this will only accelerate as regulatory developments continue coming hard and fast. Furthermore, managing risk is central to reputation. Reputational risk was viewed as the top risk to the organisation, ahead of market, credit and operational risk.

The industry will need stronger risk management infrastructures, particularly in the front office and around client interaction, to cope with current and future regulatory initiatives that strive to protect consumers from the organisations or professionals they entrust with safeguarding their wealth.

Risk management systems and processes are being upgraded to provide integrated approaches to better align risk and value. Cross-border standards, customer protection and transparency are anticipated to impact the front-end client experience and increase costs. In this environment, business models will need to evolve dynamically in order to keep pace as strategic directions change in reaction to the implementation of fast-moving regulatory agendas.

71% of survey respondents have reviewed their risk management frameworks within the last six months.

30% of survey respondents indicated that the regulatory environment will have a significant impact on their operating costs.

41% of CRMs were rated as having average or below average ability to meet client risk management and regulatory requirements.

57% of respondents believe that new regulation is beneficial despite the adverse financial impact.

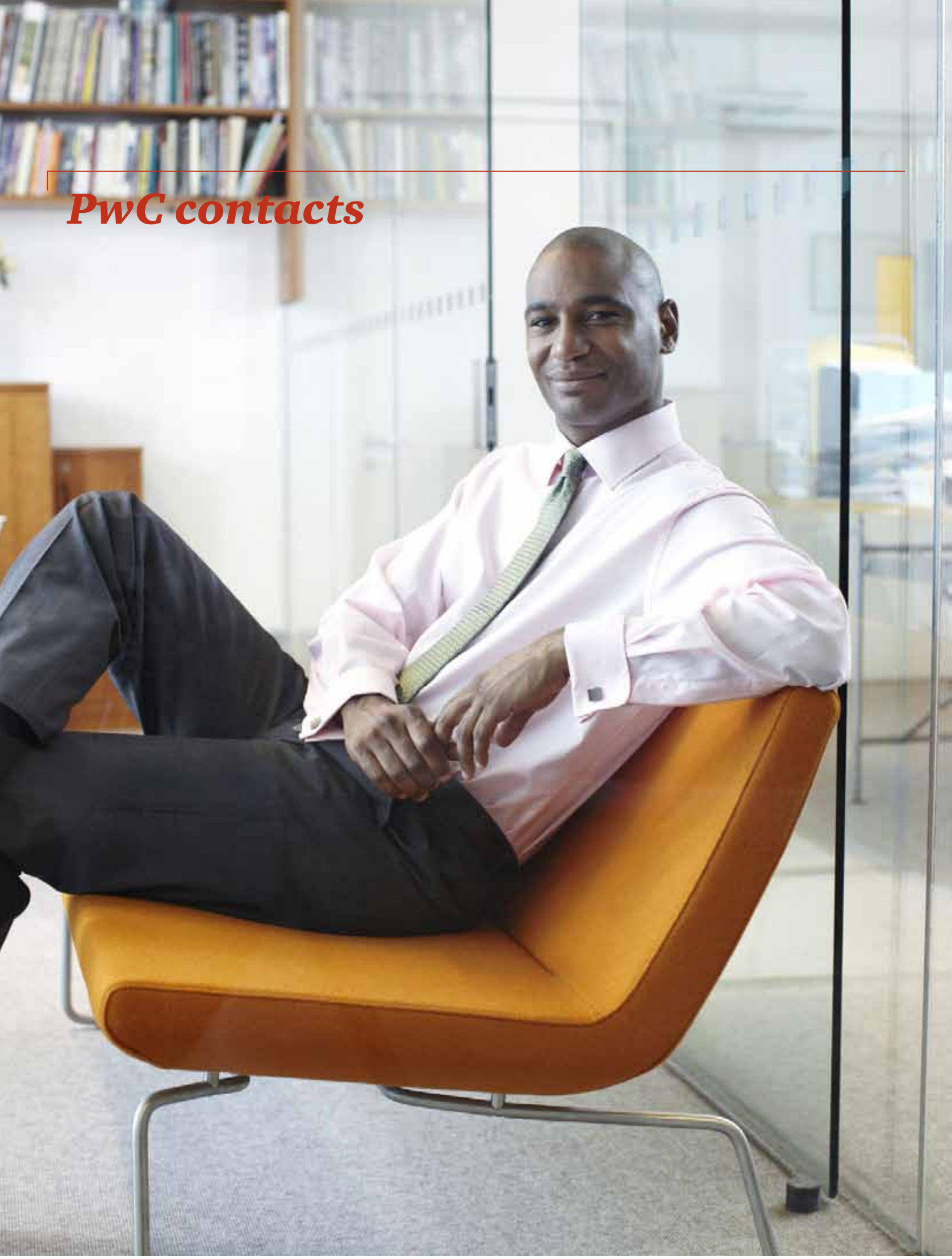
Conclusion

The industry's track record in executing complex cross-functional change has not always been good. The sheer enormity of change driven by these current themes is vast. But, it is equally clear that the status quo is not an option either for profitability today or survival tomorrow.

Leading a private wealth management business is a challenging experience right now and is becoming even more so. Institutions need to chart a clear course and direction to come to grips with how they approach barriers and challenges to change. The survey reveals that barriers span right across the industry, in every wealth segment, and every business model and type. It also brings to light the fact that leadership, for a variety of reasons, may not truly be focused on innovation and the investment necessary to effect transformative change.

Whether this is temporary, a legacy of the global financial crisis or a consequence of the weight of regulatory compliance, it is clear that mastering transformational change across all its dimensions will be an essential characteristic of those institutions who will be the future leaders in the industry.

PwC contacts



We are grateful to the partners, associate directors, managers and staff that assisted in the production of this publication. If you would like to discuss any of the issues raised in this publication, please speak to your regular PwC contact or one of the following:

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