

Financial Services

# The Southern African Financial Services Journal

Sharing insights on key industry issues\*  
October 2008



\*connectedthinking

PRICEWATERHOUSECOOPERS 

Welcome to the Financial Services Journal, which is published annually, to address certain key issues driving the industry. If you would like to discuss any of the issues raised in more detail, please contact the individual whose details are listed at the end of each article or your usual PwC contact.

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# 01 Editor's comments

Welcome to the Southern African Financial Services Journal. We are proud to introduce the tenth edition of the journal with relevant, thought-provoking articles on issues in the financial services sector. This edition builds on previous editions and is devoted to providing insights into strategic, operational and technical issues facing the financial services industry.

Globally, the macro-economic environment is characterised by slower economic growth, rising inflation and volatile stock markets. The global sub-prime credit crisis is expected to continue to have an effect on economic growth. With no exception, the South African economy also experienced a roller-coaster year.

A new addition to our journal is a macroeconomic overview by Dr Roelof Botha, the economic advisor to PricewaterhouseCoopers, he provided us with some insight into South African macroeconomics and also highlights some positive trends in economic indicators and provides us several reasons for optimism for future economic growth.

Worldwide, the financial services market is evolving rapidly and is likely to look very different at the end of the decade. New asset classes such as private equity and hedge funds are attracting a growing number of investors, shifting the centre of gravity in the world's capital markets. We start this journal by investigating the concept of what a hedge fund actually is and unveil the mystery around hedge funds.

South Africa is one of the most promising emerging markets in the world today, and boasts a vibrant financial services sector. It is acknowledged that emerging markets are becoming increasingly important sources of growth for financial services entities in mature economies, which expand their businesses and investments to these markets.

With globalisation, comes more exposure to volatilities of global marketplaces. Determining fair values in volatile and illiquid markets has been a subject of much debate over the past few months. In our third article, we consider the existing accounting literature that is relevant when establishing fair value of financial assets and financial liabilities for measurement purposes.

Internationally, regulatory and compliance are high on the agenda of CEO's. In a recent published global financial services industry outlook, one of the key issues executives need to confront is regulation and risk. Globally and locally, there have been many regulatory changes. Recently, we have seen the publishing of the Insurance Laws Amendment Bill (Bill), which impacts the way in which short-term insurers, long-term insurers and intermediaries conduct business. In our fourth article, we consider the proposals contained in the Bill.

Europe's Solvency II capital regime for insurers adds to the regulatory pressures globally. Solvency II will happen and will overhaul the regulatory capital approach not only in Europe, but beyond. In the journal's fifth article we consider why Solvency II has become relevant for South African long-term insurers and how Solvency II could change capital requirements in South Africa.

Government's social security and retirement reform proposal is expected to have a great impact on the retirement fund industry going forward. The national savings fund proposal attempts to achieve mandatory saving, equity, the pooling of risk, administrative cost efficiency and social solidarity. The ultimate aim is to ensure that all South Africans will be in a financial position to retire. In our article, retirement fund reform – the dawn of a new era, we cover the background to the proposed national savings fund and provide a brief overview of the key principles involved and the possible impact on the retirement industry.

In the journal's final article, we see that extensive auditing by various assurers has companies feeling overwhelmed and over-audited. Combined assurance is discussed as a possible answer to audit fatigue. This approach effectively co-ordinates the efforts of all the assurers, increases their collaboration and develops a shared and holistic view of the organisation's risk profile.

I hope that you will find these articles of interest. Please do continue to provide us with feedback on topics you would like to see addressed in future issues.



**Barry Stott**  
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A handwritten signature in black ink that reads "Barry Stott". The signature is written in a cursive, flowing style.

# 02 Macroeconomic overview



To date, it has been a roller-coaster year for the South African economy. The surge in exports on the back of a weaker currency and record commodity prices has been countered by higher inflation, slower world growth and higher interest rates.

Following a four-year period of extraordinarily high levels of household consumption growth, during which the country's growth ceiling was lifted from 3% to 5%, a number of growth constraints started appearing in 2008.

Key constraints facing the economy include infrastructure deficiencies, skills shortages and the decline in output levels in industries linked to durable consumption expenditure. The latter are under severe stress as a result of an increase of almost 50% in the cost of credit (and working capital) since mid-2006.

Higher global inflation underpins the return to stricter monetary policy in South Africa. Since the end of 2007, international shortages of staple foods and the dramatic increase in the price of oil have wreaked havoc with the long-standing era of relative price stability that has existed over the past two decades. Barely eight years ago, oil was trading at \$26 per barrel. In July 2008 it reached a new record high of almost \$148 per barrel.

The lack of adequate infrastructure spending since 1994 has inevitably started to take its toll, particularly with regard to unreliability in the supply of electricity. Virtually all other modes of hard and soft infrastructure are also

under severe pressure, mainly as a result of sustained positive economic growth and progress with basic service delivery (on the demand side), but inadequate infrastructure spending at all levels of government.

The latter includes South Africa's roads, harbours, oil pipelines, water supply, education institutions and rail facilities. From cement and electricity to beverages and petroleum, South Africans have had to cope, for the first time in modern history, with supply shortages. This situation is regarded as temporary, however, as it has acted as an incentive for a surge in private sector capital formation and, belatedly, a commitment by government to increase infrastructure spending.

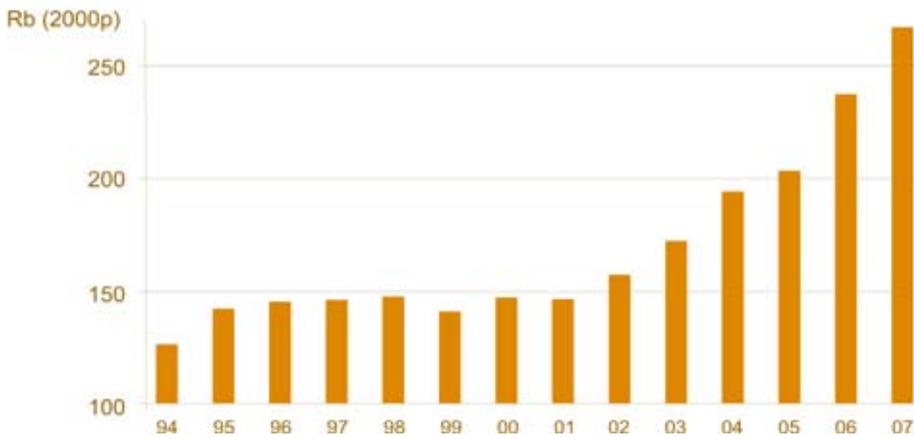
### Surge in capital formation

The SA government has committed R1 trillion of fiscal resources to the maintenance and upgrading of the country's infrastructure over the next decade. Between 2003 and 2007, the average annual real growth rate in capital formation amounted to more than 11% (see the figure on the following page).

Although the public sector has been rather lethargic in creating new infrastructure, the private sector has been investing heavily in new productive capacity.

The expansion in productive capacity is more broad-based than at any time in the country's history, with virtually every sector of macroeconomic endeavour experiencing improved demand conditions.

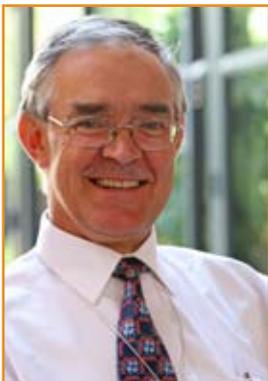
## Real capital formation in the SA economy – post-election scenario



Combined with positive trends in a number of other key indicators, positive real GDP growth remains on track for South Africa in 2008. Reasons for optimism over the country's ability to continue with its 15-year uninterrupted economic growth phase include the following:

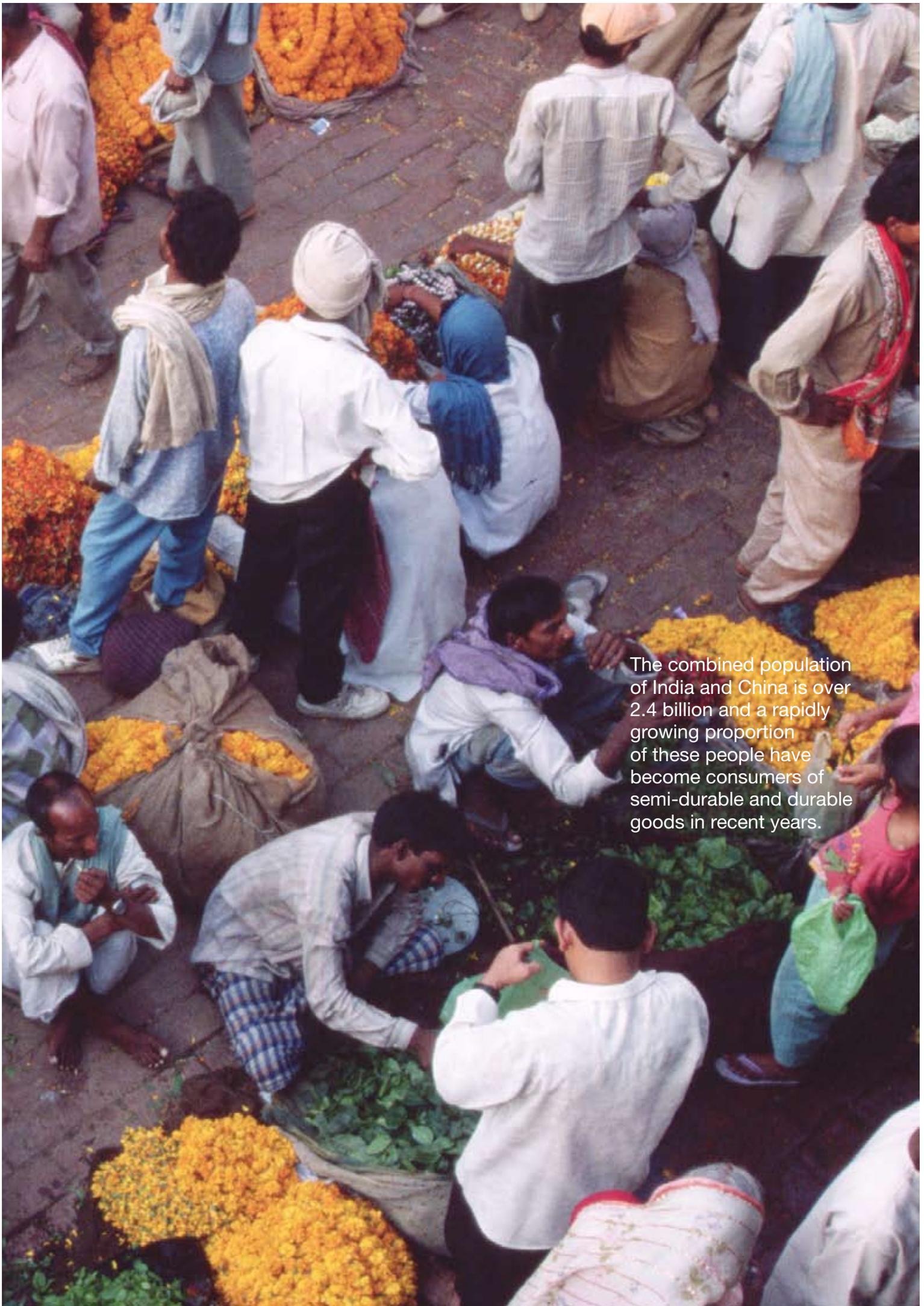
- Little doubt exists that the commodity boom will continue well into the future. The combined population of India and China is over 2.4 billion and a rapidly growing proportion of these people have become consumers of semi-durable and durable goods in recent years. The average growth momentum of between 7% and 9% (in real terms) recorded by these two "superpowers in waiting" is unlikely to end soon, which will continue to act as a stimulus for a variety of South African exports and should also serve to keep commodity prices at high levels.

- Slowly but surely, the infrastructure backlogs are being addressed and Government has committed approximately R1 trillion to this end over the next decade.
- Preparations for the hosting of the 2010 Soccer World Cup finals will provide the economy with a substantial degree of growth momentum for the remainder of this year and also 2009, with the tourism industry expected to move to a structurally higher level.
- Inflation is likely to peak within October and should start declining quite sharply towards the end of the year or early next year, leading to lower interest rates in 2009.



**Dr Roelof Botha**

Economic Adviser to PricewaterhouseCoopers



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# 03 Hedge funds – Unveiling the mystery

The key objective of most hedge fund strategies is to achieve risk adjusted returns exceeding that of traditional investment strategies.



The first hedge fund can be traced back to 1949, when Alfred Winslow Jones, an Australian living in the United States conceived the idea of using leverage to increase exposure to the market and short selling to avoid market risk while working for Fortune Magazine. He set up a fund utilising these strategies and was so successful that he outperformed some of the best mutual funds over many years. But it was only in 1966 when Fortune magazine coined the phrase “Hedge Fund” in an article it published on: “The Jones that Nobody Keeps Up With” that hedge funds achieved any significant level of publicity. In the ensuing years many hedge funds were established as managers and investors saw the benefits of his strategies and tried to emulate his achievements. Since then the hedge fund industry has continued to grow exponentially around the globe and is now estimated to exceed US\$ 2 trillion from just US\$550 billion a mere five years ago.

Hedge funds have developed into a significant element of the alternative investment management industry in South Africa over the past few years and this growth is expected to continue, both globally and locally. Alternative investments also include asset classes such as, private equity and real estate. Hedge funds are often seen as a high risk investment vehicle and this has not been helped by publicity around hedge fund failures in the past. Certainly, there are hedge funds that are badly managed and should be considered high risk, but on the other hand, a well managed fund with an appropriate strategy can be an effective way of providing superior risk adjusted returns to investors than the so-called traditional strategies. In this article we will demystify the concept of a hedge fund and describe some of the more common strategies employed in the South African market as well as consider the more important risks associated with hedge funds.

The concept of what a hedge fund actually is, is the first misconception that needs to be elaborated on. The difficulty is that no standard international definition exists. Globally a hedge fund has become the “catch all” phrase for funds not subject to formal regulation and has tended to include all funds that do not fit into the traditional, long only fund that does not leverage, sell short or hold derivatives in its portfolio. This does create misconceptions regarding the hedge fund industry as some might even consider private equity

funds to also fit into this space. The biggest difference between hedge funds and private equity funds is that private equity funds tend to invest in illiquid unquoted investments where investors are locked in for longer periods; while hedge funds typically invest in more liquid tradable securities and therefore investors can redeem their investment monthly or quarterly.

Originally, a hedge fund was synonymous with a type of private investment fund that charges a performance fee, uses leverage to magnify returns and short selling and derivative instruments to limit market risk. Although this definition fits many of the hedge funds in South Africa it is not all encompassing. It can be said that it is easier to recognise a hedge fund than to define it.

The most appropriate definition for true hedge funds would be that of “funds aiming to achieve positive returns at a reduced level of risk”.

There are certain characteristics which make hedge funds unique such as the use of derivatives, short selling, leveraging and, in general, more active trading but not all hedge funds necessarily employ all of these characteristics. Generally a hedge fund manager will identify a strategy for a fund that may include one or more of these strategies. It is imperative that an investor fully understands the strategies employed by the fund and the associated risks.

Globally, and in South Africa, by far the most common strategy is an Equity Long-Short strategy where managers hold long positions in some equities and short positions in others but usually maintain a net long position. We estimate that in excess of 50% of the hedge fund market in South Africa is invested in this strategy. Through this strategy managers will hold long positions in equities they consider to be undervalued and short positions in equities that they see as overvalued. In order to create the short positions, the manager will borrow the securities they view as overvalued and then sell them in the market with the expectation that the price of that security will fall and that they will be able to buy back the security in the market at a price lower than they sold it for and then return the securities they borrowed to the lender. In this way the manager can generate returns in a falling market or returns that are substantially different to the underlying market return. These Long-Short strategies

can be higher risk than other hedge fund strategies as they have enhanced directional exposure to the market. In a declining market a manager may employ a strategy with a Short-Bias where the manager maintains a net short position in the market. In this way the manager can generate better results, or even positive results in a bear market.

This basic Long-Short strategy can be enhanced to become an Equity Market-Neutral strategy. This is the next most popular strategy in South Africa with approximately 20% of the market and is a relative value strategy where managers hold long and short positions of the same size in a specific sector, industry or country in order to exploit price differences and also creating a hedge in order to limit exposure to overall market factors. In this strategy stock picking is critical as the manager will be long in say five stocks that they expect to outperform the market and short in the five stocks they expect will underperform. The result is that overall market movement in that particular sector, industry or country is neutralised as the gains on the long positions will be offset by losses on the short positions and therefore the individual performance of the stocks relative to each other is what drives the overall performance.

Other strategies employed in the South African industry include the Multi-strategy, around 10% of the market, where various strategies are combined within a fund to obtain a specific objective and various forms of Fixed Income strategies. The two most common fixed income strategies are Fixed Income Long-Short, which is similar to Equity Long-Short except that trading is in listed fixed income securities, and Fixed Income Arbitrage, where pricing inefficiencies between related fixed income securities are exploited. Another example of an arbitrage strategy is Merger Arbitrage where the manager will buy the stock of the target company and short the stock of the acquiring company where the stock of the target company is perceived to be undervalued and that of the acquiring company overvalued.

Globally various other strategies are also employed such as:

- Macro strategies that anticipate the effects of global macroeconomic events.

- Event driven strategies where pricing inefficiencies are exploited from anticipated corporate actions. This includes distressed securities (companies trading at a discount due to potential financial difficulties) and merger arbitrage (price inefficiencies between merging companies).
- Emerging market strategies where investments are made into securities in emerging market countries such as India, China, Brazil and South Africa.
- Relative value arbitrage where mispricing between related securities is exploited.

So why are there fewer strategies being employed in South Africa compared to the global industry?

Firstly, the South African market is in its infancy phase compared to the global industry. The majority of investments into single strategy funds at present are made through Fund of Hedge Funds ("FoHF"), where the manager provides investors with their expertise and knowledge of the industry. However, as the industry develops, investor understanding and knowledge of the industry will increase, dispelling the misconceptions of the industry and allowing investors to, with confidence, invest directly into single strategy funds. The inflow of funds in to existing strategies should increase, but as managers start to establish themselves in the industry inflows will also be directed towards these managers' new strategies.

The one common element amongst hedge funds is that the managers are highly incentivised to generate strong performance as they usually have significant performance fee structures. Managers will therefore be encouraged to employ new and innovative strategies in order to generate these returns.

Secondly, our local securities markets are much smaller than the major global markets. Due to this limitation it is difficult to find suitable shorting opportunities to hedge positions or to employ event driven strategies due to the limited number of events occurring within our markets. Within sectors there are also limited opportunities to arbitrage due to the fact that the underlying listed securities are highly correlated.

In addition, global managers have access to exchanges across the globe due to limited exchange control where

South African managers require special dispensation to invest in foreign markets. This limits the options and opportunities for South African managers.

The key objective of most hedge fund strategies is to achieve risk adjusted returns exceeding that of traditional investment strategies, however, the following risks associated with hedge funds should be considered:

**Liquidity risk** - Most hedge fund strategies do not allow managers to liquidate portfolio holdings at short notice without having a detrimental effect on performance, resulting in hedge funds generally having liquidity restrictions on investors. Potential investors must understand these liquidity restrictions to match hedge fund products to their liquidity profiles.

**Quality of hedge fund managers (operational risk)** - In recent years the pool of hedge fund managers has increased exponentially with the continuing entry of new managers with low levels of funds under management. This invariably leads to a potential reduction in quality. This is where, arguably, the main inherent risks of the hedge fund industry lie. Investors must therefore ensure that they invest with experienced reputable managers that are registered with the Financial Services Board.

**Market risk** - A hedge fund employing reckless short selling can potentially be exposed to unlimited losses should a security that has been shorted gain significantly in value rather than decline. This again emphasises the need to assess the credentials of a hedge fund manager.

In order to mitigate these risks, an investor could invest in a FoHF rather than in a single strategy fund. FoHFs invest into a portfolio of other hedge funds rather than trading assets directly. The advantage is that investors can access a diversified pool of underlying hedge funds and rely on the skills of the FoHF manager to identify the most talented managers and products. The cost of such diversification is that investors pay fees to both the FoHF manager as well as the underlying managers.

Hedge funds generally under-perform traditional long only investment strategies in a sustained bull market due to their performance fee structures as well as the cost associated with employing hedging techniques. In

a bear market hedge funds can offer superior protection against downward market movements and volatility. As such hedge funds play an important role in an investor's diversified portfolio due to their enhanced risk adjusted returns and low correlation to the returns of traditional asset classes.

The global economic downturn and the local economic conditions have placed significant pressure on the industry, particularly as the industry is expected to out perform the traditional long only managers. Nevertheless the future of the industry in South Africa is positive as more and more institutional investors start to allocate portions of their asset pool to the hedge fund industry. However, accompanying this growth, the industry needs to ensure that investors understand the dynamics of the industry and that the highest levels of transparency in reporting is maintained in order to ensure that investors understand the risks associated with the investments they have made.



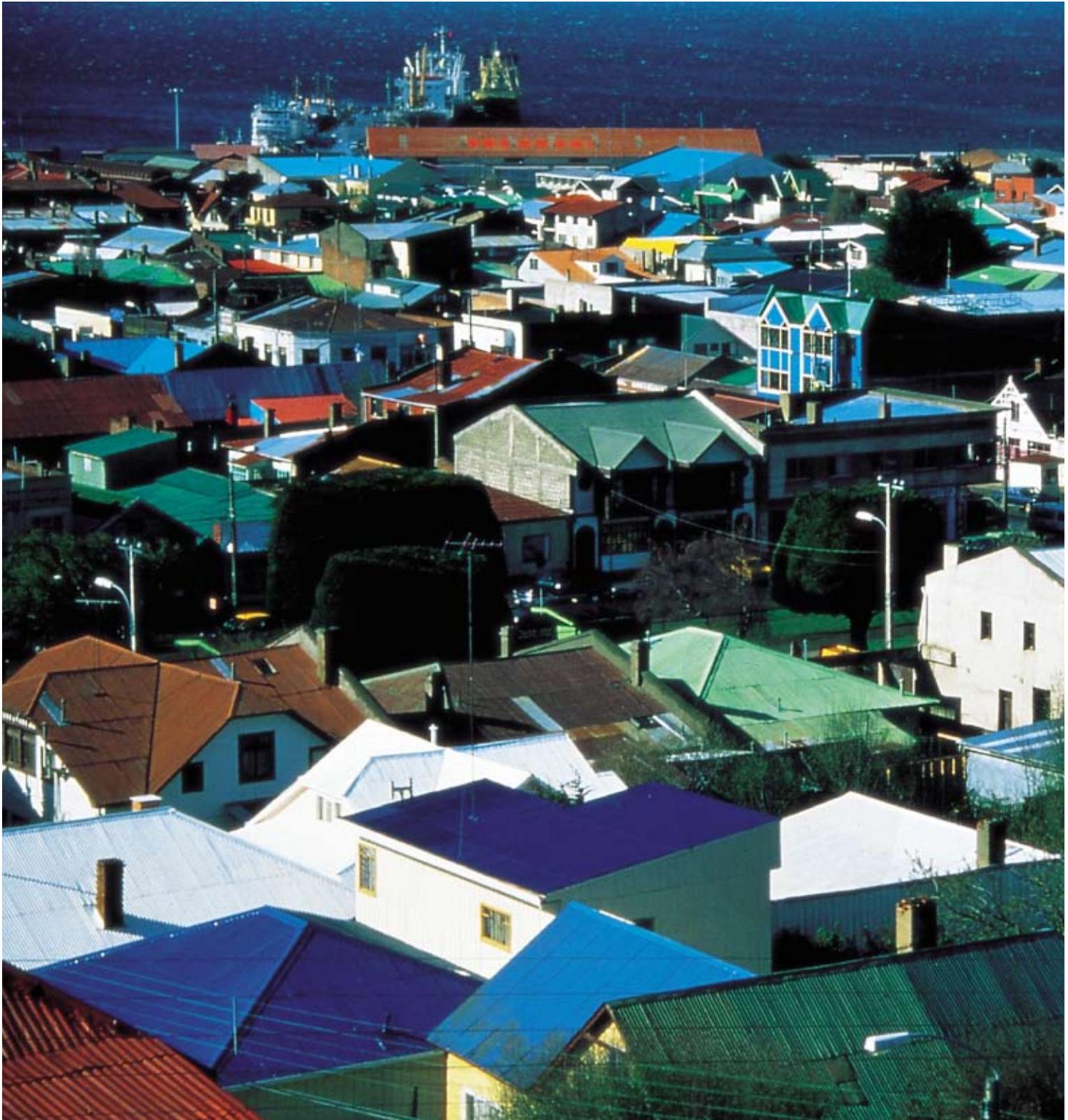
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# 04 Establishing fair values in volatile and illiquid markets

Consistent rigorous valuation processes should be undertaken periodically across all locations and products to review independently the valuation of financial instruments held.



In recent months, financial market conditions have been characterised by significant volatility compounded by a liquidity crunch. Although the primary market shock arose due to defaults on sub-prime mortgages in the United States, the effect has been felt globally due to widespread use of structured securities and leveraged funding.

Entities with exposure to the financial markets through debt, equity, derivative and leveraged finance activities may continue to experience significant price volatility as a result of liquidity, credit and other issues. The immediate consequences of current market conditions are credit losses on direct and indirect investments in sub-prime mortgages and securitised loans. However, there have been more widespread effects as lenders and investors have re-evaluated their willingness to provide funding. As a consequence all entities, not only those with direct or indirect exposure to sub-prime mortgages, could be affected by current market conditions.

In addition to the credit crunch, recent examples of large losses from unauthorised trading have emphasised the need for additional and consistent focus by management and boards in creating the proper culture and implementing sound risk management practices, and functioning robust end-to-end controls.

This article highlights:

- those aspects of existing International Financial Reporting Standards ('IFRS') accounting literature that are most likely to be relevant when establishing the fair value of financial assets and financial liabilities for measurement purposes; and
- some key considerations that should be taken into account in developing a structured approach to the valuation environment and then further explores valuation sources for price verification that can be used by both banks and other financial institutions.

## Fair value in terms of IFRS

Measurement of financial instruments in accordance with accounting standards is integral to reporting to shareholders of financial institutions. IAS 39 Financial Instruments: Recognition and Measurement contains the following hierarchy for the determination of fair value:

- Quoted prices in active markets provide the best evidence of fair value and must be used when available;
- In the absence of such quoted market prices, an entity uses a valuation technique. The chosen valuation technique incorporates all factors that market participants would consider in setting a price, minimising entity-specific inputs and is consistent with accepted economic methodologies for pricing financial instruments; and
- Equity investments that do not have a quoted market price in an active market may be recognised at cost if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed.

Prior to recent market events, entities would generally have determined whether an active market exists for a financial instrument. Given the general lack of liquidity as a result of recent market events, some observers have asserted that market pricing is irrational. These observers further argue that observed prices do not necessarily represent traded levels in an active market.

Proponents of fair value accounting have countered this view by pointing out that it represents the most transparent, easy-to-understand and relevant measure available. They argue that the multibillion dollar fair value write-downs, reported by a number of banks since the turmoil began, are a reflection of the economic reality of current market conditions.

Given that entities will need to justify a proposed change from one level of the valuation hierarchy to another (for example, determining fair value using quoted prices to determining fair value using a valuation technique), it is useful to explore further the definition of an active market in terms of IFRS.

### Active markets

A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices represent actual and regularly occurring market transactions on an arm's length basis.

IAS 39 also states that fair value is not the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale as there is a presumption that the entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms.

'Regularly occurring market transactions' does not mean that there needs to be a consistent number of market transactions from one period to another. Consequently, a lower than normal volume of transactions does not provide sufficient evidence that there is no active market, and that the observed transactions are forced transactions or distressed sales. Similarly, a lower than normal volume of transactions does not automatically mean that the transactions that are occurring are motivated other than by normal business considerations. As a result, it would not be appropriate to disregard observable prices in an active market even if the market is relatively thinner or more illiquid when compared to previous periods.

However, if observed transactions are no longer regularly occurring even if prices might be available, or the only observed transactions are forced transactions or distressed sales, then the market would no longer be considered active. What is understood by and interpreted to be 'regularly occurring' and 'forced transaction' or 'distressed sale' is a matter of judgement in the light of the particular facts and circumstances of each observed transaction.

### No active market

If the market for a financial instrument is not active, then IAS 39 requires use of a valuation technique. The chosen valuation technique should incorporate all factors that market participants would consider in setting a price. When there is evidence of a change in credit spread, liquidity or other perceived risks that a market participant would consider in pricing the instrument, IAS 39 requires the effects of the change to be considered in determining its fair value. It follows that determining fair value using a valuation technique requires factoring in current market conditions, including current credit spreads and the relative liquidity of the market.

### The valuation process

Given the level of judgement required in establishing fair values under IFRS, many local and international investment banks and other financial institutions have developed a structured approach to the valuation environment. We discuss the key elements of such a structured approach further below.

#### **Governance:**

A clear and delineated governance structure should exist to ensure appropriate segregation of duties. Appropriate resources should be put in place to ensure the control, risk management and valuation procedures are implemented and performed.

The governance function should also develop a valuation framework within which the institution will operate, maintain oversight over the framework and ensure that it is consistently applied throughout the organisation from one period to the next.

#### **Policies and procedures:**

Comprehensively documented policies and procedures should be established for the valuation of financial instruments. These should be reviewed periodically and include the methods and processes the institution should use to determine fair values.



The policies should be drafted taking into consideration all relevant internal and regulatory requirements, as well as the accounting considerations discussed above.

#### **Reporting and risk management:**

Transparent disclosures should exist regarding the impact of valuations on financial instruments. Differences between valuations used for financial reporting and the day-to-day risk management results should be evaluated and explained.

#### **Valuation and independent price verification:**

Consistent rigorous valuation processes should be undertaken periodically across all locations and products to review independently the valuation of financial instruments held. The results of this exercise should be evaluated by appropriately trained people.

The performance of independent price verification procedures is as straightforward or complex as the financial instruments that an enterprise trades in. It

goes without saying that the results of the price testing process are dependant on the sources of information used in the process.

The extent to which an entity may place reliance on a value provided by a third party (for example, a broker quote or pricing service) for an instrument that is not quoted in an active market, will depend on how the third party has derived that valuation and whether it is in accordance with the requirements of IAS 39. Factors to consider include:

- whether it reflects a price at which the entity could be expected to transact (for example, a market to which the entity has access);
- whether and how the valuation incorporates recent market events (for example, does it include 'stale' prices);
- how frequently the valuation is updated to reflect changing market conditions;

- the number of sources from which the valuation is derived (a valuation derived from many quotes or data sources is generally preferable to one based on a small number of observations);
- whether it reflects actual transactions or merely indicative prices; and
- whether it is consistent with available market information, including any current market transactions in the same or similar instruments.

We discuss the considerations of various pricing sources available to financial institutions in more detail below.

### Price sources for Investment Banks

- **Interdealer Broker Quotes:** These refer to quotes from brokers who act as intermediaries between investment banks. Although broker quotes are generally representative of traded market levels, this may not be the case in an illiquid market. If an institution obtains only a single quote, there is a risk that the quote may be at a more favourable rate to the institution than the true market level. Where multiple quotes are obtained an institution should mark to an appropriate or consistent point within the spread.
- **Bloomberg:** Bloomberg Generic (BGN) is the default pricing source on Bloomberg, which takes an average of available pricing contributions from banks. The quality of the available pricing sources can vary considerably.

Institutions should periodically assess the quality of BGN data before relying on it. This is particularly the case in current market conditions where liquidity of any given security can be unpredictable.

- **Consensus pricing services:** The main consensus pricing services available for over-the-counter ('OTC') derivatives are Mark-It (Credit, Commodities) and Totem (Fixed Income, Foreign Exchange and Equity derivatives). These services have developed significantly over the last five years and are invaluable in providing pricing information to banks for less liquid products. A representative number of South African banks already contribute to Totem,

while others are currently considering whether to use this service in future.

The quality of a consensus service is determined by the number of contributors to the service, the length of time the service has been running and the spread between the highest and lowest contribution. There may also be considerable variety in the number of contributors to consensus pricing services.

- **Comparable levels and proxies:** Where there is little price transparency, such as in structured credit, many institutions price positions using comparable instruments. New issues are commonly used as comparables where available.

Another common technique is to price a security against an observable index, which involves making assumptions as to where a security should trade relative to the index, which increases the complexity and level of judgement required in establishing fair values.

- **Model based valuations:** Institutions may price instruments using valuation models that consider discounted cash flows or asset correlation. In many cases model prices can diverge from market prices (particularly in the current environment).

Finally, institutions should also consider traded levels in determining fair value. As discussed above, forced or distressed transactions do not constitute levels used to determine fair value.

### Price sources for other financial institutions

Several of the key sources used by investment banks are not regularly available to other financial institutions. As a result these institutions need to rely on other types of pricing sources, which have a different set of risks. Some of these might include:

- **Bloomberg/Reuters:** Provides generally available pricing for cash instruments (government and corporate bonds) or vanilla derivatives.
- **Dealer quotes:** These are widely used by non-investment banking institutions as one of their primary pricing sources. However, these quotes are often indicative and not necessarily representative of levels at which trades can be executed.

Quotes could also be received from the lead issuer of a given security, who may provide an above-market price.

- **Client valuations:** Client valuations in respect of OTC derivative products have historically been a difficult area for banks. Valuations are frequently generated from the bank's internal records, which may not always correspond to levels at which the bank is prepared to trade with a client.

## Conclusion

As noted above, establishing fair values under IFRS is generally subjective and difficult to validate. The level of complexity associated with fair value measurement and recent market events have created heated debate on the merits of fair value as a financial reporting measure.

Leading financial institutions have responded to the complexity associated with fair value measurement by establishing a structured approach to the valuation environment. Key building blocks of the structured approaches adopted include a strong 'tone at the top' and a culture of accountability and ownership. The approaches are also adaptable to changes in the complexity of financial instruments, as well as the availability and quality of the pricing sources.

Financial institutions will also have to comply with the requirements of IFRS 7: Financial Instruments: Disclosure. IFRS 7 increases the disclosures associated with fair value measurement, in particular information relating to valuation techniques applied and the sensitivity of estimates to changes in key inputs.



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# 05 Proposed amendments to the Insurance Acts

The Insurance Laws Amendment Bill represents a landmark in the regulation of the insurance industry and will impact the way in which short-term insurers, long-term insurers and intermediaries conduct business.



## Introduction

The Insurance Laws Amendment Bill (Bill) has gone through the parliamentary process and is submitted to the President for assent. We expect the Bill to be enacted imminently. The process was not without controversy with the industry claiming that they had been allowed inadequate time to consider the proposed changes and to formulate their responses. Last minute consultations resulted in changes to the Bill to allow for further amendments to be introduced by way of regulation, particularly concerning the definition of health policies and profit sharing with intermediaries through the use of binder agreements. The regulations relating to health policies will be drafted first and thereafter those relating to binder agreements. The latter will only be finalised in 2009.

Some of the more important proposals are considered below:

### Financial condition reporting for short-term insurers

The Bill clears the way for the introduction of financial condition reporting. This includes providing for the appointment of a statutory actuary to short-term insurers. This requirement will only apply if the insurer uses an internal model to calculate capital requirements. As a consequence the requirements for the maintenance of the contingency reserve, calculation of IBNR's and solvency capital based on net written premiums have been removed. The Bill requires that the position of statutory actuary be restricted to fellows of the Actuarial Society of South Africa having appropriate practical experience relating to short-term insurance business. As the short-term industry has not generally made extensive use of actuarial professionals it is submitted that there is likely to be a shortage of such skills in the initial years. The capital requirements for short-term insurers will now be published in a Board

Notice. The publishing of these requirements outside of the Act is already practice for the long-term industry.

### Audit committees

The Act has been changed to align the requirements for audit committees with the changes to the Companies Act contained in the 2006 Corporate Laws Amendment Act. Insurers will therefore no longer be able to use the less onerous requirements of the existing Insurance Acts. There is a general shortage of adequately experienced independent non-executive directors but the added challenge for insurers is to find such people having a working knowledge of the insurance industry and the special risks it poses.

### Accounting issues

The Bill aligns with the Companies Act's reference to financial reporting standards, stating that insurers should comply with those standards applicable to widely held companies. The concept of fair value is aligned to the definition in financial reporting standards. However, the Registrar has the ability to direct that a fair value is not a reasonable value in specific circumstances. If invoked this would result in different values between financial statements and annual returns.

### Auditors and actuaries – watchdogs or bloodhounds?

Section 19 of the Act has always required the auditor to report to the Registrar and the board of directors of the insurer if he/she becomes aware of any matter which may prejudice the insurer's ability to comply with Section 28(1), which is the requirement to maintain a financially sound condition. This section has now been amended to refer not only to Section 28(1) but also to, any other section of the Act. The section also includes a requirement to report on any matter which may in future

prejudice the insurer's ability to comply with any section of the Act. All matters should be reported without delay to the Registrar and the board of directors of the insurer. Whilst the auditor is only expected to report matters which he identified during the conduct of his audit, the extension to a total compliance with the Act extends his liability significantly. The requirement relates to all instances of non-compliance and makes no allowance for issues which are immaterial or inconsequential.

The Financial Services Board's (FSB) response to the auditing profession's comments on the Bill was "the auditor's work is viewed as an extension of that of the regulator". This results in additional audit cost as the auditor needs to analyse whether a contravention has indeed taken place.

The above reporting requirements also apply to the statutory actuary in respect of their duty as statutory actuary.

As part of the FSB's risk-based supervision approach they will in future insist when conducting on-site visits to meet with the auditor separately from the client. This is a departure from the practice of the Reserve Bank, where tri-lateral meetings have been a feature of banking regulation for many years.

### Intermediaries and binder agreements

The proposed changes are so broad as to include every delegated authority granted to brokers and would be difficult to implement in practice. These changes are introduced to further regulate the relationship between the insurer and intermediaries. It sets out the conditions under which the insurer may authorise another person to perform duties on its behalf. Conditions for profit share including eligibility to enter into binder agreements will form part of the regulations to the Act. This section enforces that the insurer remains liable for compliance with the Act and the payment of all claims

arising, thus enforcing a direct relationship between underwriter and insured, irrespective of arrangements with intermediaries. This section will have far reaching implications for short-term insurers with underwriting agreements and long-term insurers with "white label agreements". The recently published directive on motor vehicle warranty and extended motor vehicle warranty cover further reflects the FSB's intention to enforce compliance with the Act where intermediaries are part of the insurance arrangement.

### Accident and health policies

The Bill gives the Minister the ability to determine via regulation that certain types of business constitutes accident and health business. This is designed to avoid conflict between the Insurance Act and the Medical Schemes Act. The Minister will therefore be empowered to review the classification of top-up policies which was recently determined by the courts. Insurers writing health policies which offer a stated benefit as allowed by the current Acts may find themselves in a different position if this option is not included in the Regulations.

### Returns to Registrar – a sting in the tail?

Section 35(3) has been added which allows the Registrar to nominate a person to compile certain information which an insurer has failed to supply in its returns. The cost of appointing such a person is to be met by the insurer. It is therefore possible that the Registrar could for example invoke this provision where a short-term insurer has not adequately complied with the newly introduced claims run-off statistics required in the annual return. Many insurers experienced difficulty in providing this information in 2007. The cost of such an exercise could be prohibitively expensive for the insurer.

### Option for payment of policy benefits in money

These changes will impact all long-term insurers underwriting assistance business. Currently a policyholder can request payment in money where benefits are offered in specie for example a policy which provides for funeral benefits. As from 1 June 2009 the policy should indicate the monetary value of all benefits in specie and the fact that the policyholder has the option to request the monetary benefit. All benefits (monetary and in specie) will be subject to the assistance policy limitations per the Regulations.

### Conclusion

This Bill represents a landmark in the regulation of the insurance industry in many respects.

The FSB has clarified the status of directives and this gives them the ability to change the regulatory environment quickly and efficiently in response to industry developments. This will give the FSB

the power to significantly change the competitive environment in the industry over the coming years.

It is also apparent that the FSB is gaining significant teeth in dealing with real or perceived non-compliance with the Act. The extent to which this power is exercised will determine what additional cost burden will be felt by the industry. The FSB will have additional powers to recommend fines and penalties through the establishment of an enforcement committee in terms of the Financial Services Laws General Amendment Bill.

Internationally regulatory pressure and compliance issues are high on the agenda of CEO's. The monitoring of compliance with the all regulatory requirements including the Amendment Act will be challenging for the regulator.



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# 06 From pillars to goal posts – Solvency II becomes relevant to South African Long-term insurers



# South African insurers need to understand the principles and techniques of Solvency II because there are several areas where implementing Solvency II-like models is critically important.

Solvency II, the new regulatory requirements for Europe being created by the European Commission, developed by Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and supported by the International Association of Insurance Supervisors (IAIS) is now relevant to South African insurers. However, the goals and paths of European insurers differ from those of local insurers, and local insurers have to weigh up different costs and advantages in deciding how best to benefit from Solvency II.

## What's in it for Europe

The solvency rules across Europe are a tangled mess of simplistic, risk-insensitive and inconsistent requirements. The original percentage of technical provisions, sum at risk and premiums are universally acknowledged to be inappropriate drivers of capital.

Worse, these rules encourage risk-taking since increasing retained risks has no effect on capital, leading to an increase in expected return on regulatory capital. Risky options and guarantees have no effect on capital requirements and, perversely, lowering prudence within the calculation of technical provisions actually decreases the capital requirements in most cases.

Several countries have adopted improved capital requirements for the insurers that they regulate. These requirements are inconsistent across countries, hindering the effective functioning of the European Single Market as they tend to create a competitive advantage for less prudently managed companies if they are permitted to sell cross-border insurance into the better regulated market.

Clearly, this had to change.

The primary aims of Solvency II in Europe are to:

- Improve customer protection
- Deepen market integration
- Increase international competitiveness of European insurers
- Create a clearer focus on prudential supervision for Groups

Figure 1 The primary aims of Solvency II in Europe

## The case against Solvency II in South Africa

The situation in South Africa is different. The Actuarial Society's Professional Guidance Note 104 "Valuation of Long Term Insurers" (PGN 104), first issued in 1985 and improved and refined significantly several times since then provides for a risk-based capital requirement termed the "Capital Adequacy Requirement" (CAR). The Financial Services Board (FSB) requires solvency capital to be calculated in terms of the Board Notice 72 of 2005 ("Prescribed requirements for the calculation of the value of the assets, liabilities and capital adequacy requirement of long-term insurers"), which incorporates PGN 104 principles. For many years, this risk-sensitive formula-driven capital requirement was significantly more advanced than the equivalent requirements in the UK, Europe and many other established insurance markets around the world.

Many South African long-term insurers have operations in other countries in Africa. Many of our immediate neighbours informally adopt PGN104 due to the large number of South African actuaries performing actuarial valuations and capital calculations for insurers in these countries. The need for harmonisation of capital requirements is not urgent. Further, South African adoption of Solvency II-like principles will not automatically lead to required adoption in our neighbouring countries.

Our allowance for the market consistent valuation of financial options and guarantees is in line with best practice around the world. We took these steps without having been fatally stung by guaranteed annuity options, minimum investment guarantees, burn-through costs on with profit policies or guarantees implicit in variable annuities.

Finally, our CAR in terms of PGN 104 is being refined to incorporate current thinking around credit and operational risk.

Clearly, the European drivers of Solvency II do not translate directly to South Africa.

### What is Solvency II and how is it relevant to South Africa

Solvency II is a risk-based, forward-looking regulatory regime founded on a market-consistent approach. Companies will be encouraged and given incentives to run their business with an increased focus on risk, governance and further transparency through disclosure.

Solvency II has adopted the Three Pillars of the Basel Accord on banking.

While recognising the areas where Solvency II does not have the same benefits for South African companies as it does for Europe, there are several areas where implementing Solvency II-like models is critically important.

- For South African insurers interested in pursuing European opportunities, either at an operational or shareholder level, compliance with Solvency II principles will improve their credibility in dealing with European stakeholders.
- Our FSB is a member of the IAIS and has supported the ideas behind Solvency II in principle. Financial Condition Reporting, closely linked with Solvency II, for general insurers shows the direction of the FSB's thinking.
- Rating agencies and the FSB will follow developments in Solvency II when considering what weight to give various forms of capital in supporting the risks an insurer faces.
- Many local insurers are developing internal economic capital models. For large and small insurers alike, Solvency II provides a carefully thought-out framework for developing such a model and provides a template to use and adapt as necessary without reinventing the wheel.
- For those insurers that have made significant progress with their internal models, the Solvency II approach and proposed standard calibration provides a "sense check". This is especially relevant given the difficulty of calibrating many areas of these models.

- Some small and medium insurers have no immediate plans to create fully fledged internal models due to the high development costs. Solvency II can suggest a path to refine PGN104's CAR in key areas that provide maximum benefit with quite reasonable cost.
- Internal audit and integrated risk management functions will form an important part of the Solvency II regulatory environment. With few exceptions, internal audit in South Africa does not form a key part of the integrated risk management of market and insurance risk. Risk management functions tend to focus on operational and credit risk in isolation of corporate actuarial departments focussing on insurance and market risk. The linking up of corporate actuarial, risk management and internal audit is a pre-requisite for a shift to a Solvency II world.

Through discussions with many local insurers, as part of our Actuarial Process and Governance Survey, it has become clear that a significant proportion of South African insurers are embarking on these steps already. Those that get left behind at this stage will find catching up challenging.

## How Solvency II will change capital requirements in South Africa

### Tiers of capital to back solvency capital requirements

The FSB's current rules for allowable capital to back the CAR create an all-or-nothing situation. Ordinary shareholders equity and preference shares and subordinated debt meeting certain criteria are, on approval, 100% eligible to back capital requirements.

In contrast, Solvency II separates capital into three tiers, based on ambiguously defined criteria such as subordination, loss absorbance, permanence, perpetuality, lack of mandatory servicing costs and absence of encumbrances. All three tiers can be used to back the total Solvency Capital Requirement, but no more than a third can be the worst "Tier Three" and at least a third must be the strongest form of capital "Tier One". More onerous requirements exist for a core sub-minimum capital requirement termed the Minimum Capital Requirement.

Given the long term of typical securities issued by insurers (including preference shares, subordinated debt and other hybrid capital), it is likely that securities that have already been issued or will be issued over the next few years will need to be used to back capital requirements well into the future, potentially under a Solvency II-like environment. Inadequate consideration of the characteristics of these instruments requiring them to be classified as Tier One or Tier Two capital could have costly implications in future.

### Refined approach towards diversification

PGN104's CAR has another "all or nothing" characteristic. When allowing for the combination of risks, it is either assumed that:

- There is no benefit from diversification since the risks are entirely dependent and will occur at the same time; or
- Risks are completely independent and full recognition for diversification benefits is achieved through the "square root of the sum of squares" approach.

## Solvency II QIS 4

- Equity shock up to 45%
- Yield curve shock based on shifts and tilts
  - Up between 94% and 37%
  - Down between 51% and 31%
- 0% correlation between fixed interest and equities.
- 20% property shock

## PGN104 CAR

- Equity shock up to 30%
- Yield curve shock based on parallel shift
  - Up 25%
  - Down 25%
- 100% correlation assumed between fixed interest and equities
- 15% property shock

Figure 2 Market risk comparison of Solvency II QIS 4 and PGN104's Capital Adequacy Requirement

Solvency II adopts a more refined approach.

- Each individual risk factor is calibrated to the desired 99.5% level.
- Then, correlations between risk factors are specified to ensure that the combined scenario is still calibrated at a 99.5% Value At Risk level.

If CEIOPS calibrates the standard model correctly, this will ensure appropriate capital requirements regardless of the level of diversification that exists within each long-term insurer's portfolio.

The so-called "correlation matrix" is not without detractors. Correlation is a linear measure that measures constant, linear relationships between two variables. This is typically not the nature of relationships between the risk factors involved. This is most easily demonstrated when considering bond and equity returns. In normal market conditions, there is little correlation between these two asset classes. However, in the event of a market crash, both asset classes often decline sharply together. The correlation that is relevant to us is that which applies in the 99.5th percentile tails of the distributions.

CEIOPS has targeted these "tail correlations" in their current calibrations. However, one of the few exercises more difficult than estimating the 99.5th percentile tail of an empirical distribution is estimating the relationship between several variables in the 99.5th percentile tail.

### Market risk under Solvency II

Market risk typically forms between 50% and 75% of long-term insurers' capital requirements, depending on mix of business and hedging activities. Solvency II and PGN104's CAR both use scenarios to shock assets

and liabilities, but use a different calibration approach. The CAR targets 95% solvency over the lifetime of the book where Solvency II targets 99.5% solvency over a one-year horizon. PGN104 allows implicitly for diversification through its choice of individual asset shocks, where Solvency II allows for this explicitly. The implicit allowance for diversification is not sensitive to the actual extent of diversification within the portfolio. As a result, Solvency II should indicate a more accurate solvency capital requirement when comparing portfolios with different degrees of diversification across asset classes.

Market risk capital requirements for South African long-term insurers under a Solvency II approach could be significantly different. It may also encourage careful consideration of the diversifying benefits of asset allocation.

Many insurers will find that they need to update their systems to allow for the valuation of assets and liabilities using yield curves rather than single spot rates to accommodate the more advanced shock scenarios underlying Solvency II. Fixed interest assets valued at market value will still need to be valued using a model (calibrated back to market prices) so that the shock scenarios appropriately reflect sensitivity to key durations rather than simple discounted mean terms.

### Solvency II, Market Consistent Embedded Values and International Financial Reporting Standards (IFRS)

So far, this article has focussed on the capital requirements under Solvency II. Perhaps as important, is the proposed method for calculating technical provisions or liabilities. The approach is a market

consistent one, where risk margins are added to best estimate provisions for non-hedgeable risks to approximate the market consistent price at which an arms-length transaction could be concluded.

This approach is closely aligned to the CFO Forum's (the forum for Chief Financial Officers of major European listed, and some non-listed, insurance companies), Market Consistent European Embedded Value Principles launched earlier this year. Although there are some non-trivial differences, a possible outcome of the IFRS 4 (Insurance Contracts) Phase II project is also very similar.

South African insurers need to understand the principles and techniques underlying the new market-value based or "economic balance sheet" approaches for long-term regulatory compliance, medium-term financial reporting, supplemental embedded value reporting and short-term economic capital modelling and management.

Solvency II's three pillars have become clearly defined goal posts with compelling advantages for South African insurers who recognise the opportunities and take clear steps towards this nascent future.



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# 07 Retirement fund reform – The dawn of a new area

A clear consequence of the proposed fund would be a reduction in the large number of existing private funds.



In his 2007/2008 budget speech, Minister of Finance, Trevor Manuel, unveiled an overview of the planned social security and retirement reforms for South Africa. This was strengthened by the so-called “second discussion paper” on 23 February 2007 and followed by various statements, commentary and debates by government and industry representatives. Everybody now awaits the second draft of the retirement reform discussion paper, indicated to be released towards the end of 2008.

This article covers the background to the proposed national savings fund, provides a brief overview of the key principles involved and considers the impact on the retirement fund industry going forward. The facts provided are based on available information at the time of writing, as the exact details have not been finalised by Government.

### Reasons for the proposal

- Social assistance and security are two of the constitutional responsibilities of Government. Issues such as the alleviation of poverty, providing temporary income support and a basic level of income protection in the event of retirement, unemployment, injury, disability or death, need to be addressed to include as many levels of society as possible.
- South Africa has one of the lowest national savings to Gross Domestic Product (“GDP”) ratios in the world, at between 1% (for household sector) and 15% (for corporate and government sectors). A compulsory savings vehicle would contribute to reaching a more desirable savings rate of between 20% and 35%, achieved by other growing economies in Africa and East Asia.

- The existing retirement saving system is adequate to some extent, but has certain shortcomings that need to be addressed. The system tends to focus more on (and benefit) middle to high income earners (via tax subsidies), whilst the large informal sector is ignored. Preservation remains an issue and leakage of savings before retirement often occurs. Lastly, costs associated with retirement provisioning are considered to be unacceptably high.
- The current “pillars” for retirement delivery are not in line with international trends. In South Africa we have three levels of old-age support :
  1. Government funded social assistance via social old-age grant (“SOAP”)
  2. Compulsory private savings via retirement funds (so called occupational savings to which the formally employed contribute)
  3. Voluntary private savings via various products

The World Bank and the majority of the governments of the world, suggest a fourth pillar, namely a national savings fund, to fit between the first two pillars.

### The national savings fund proposal

There is consensus that the current old-age pension scheme will continue to exist, albeit with certain changes, such as doing away with the means test (thus fewer qualifying requirements). This benefit will continue to be funded by Government through general taxes and as such no separate contributions are required. People belonging to the national savings fund would be able to receive an old-age benefit as well.

The proposed savings fund would consist of two funds, with the following characteristics:

### 1) First-tier fund

- Defined benefit fund that would pay a retirement annuity benefit of between 0,75% and 1,5% for each year of service based on closing salary (capped at a salary contribution ceiling possibly between R75,000 and R150,000).
- Retirement age between 60 and 65 and normal retirement taxation rules would apply.
- Death, disability and funeral cover would be provided and could account for 4%-6% of the contribution.
- Compulsory membership for all individuals in employment, including those self-employed, those in informal sector, domestic and agricultural workers as well as part-time and seasonal workers.
- Contribution rate of 12% to 18% on all earnings between R15,000 and the salary ceiling (R75,000 to R150,000) per annum (for example assuming the higher contribution rate and a ceiling of R150,000 is implemented, the first R27,000 of a high earning individual's retirement fund savings for the year would go to the fund (18% x R150,000) of which 6% will pay for risk cover and the balance for defined retirement benefits).
- The bottom earners (those earning less than R15,000 per year), who cannot afford this percentage deduction on their take home pay, would be subsidised by government from normal taxes. (This subsidy may be extended on a sliding scale to help those falling in the lower levels between R15,000 and say R50,000).

### 2) Second-tier fund

- Defined contribution fund that would accumulate a "member individual account" for each contributor, in much the same way as current retirement fund arrangements.
- This account would be maintained regardless of whether a member changes employment and contributions to the same account would continue by any new employer. On change of employer, no withdrawal would be allowed.

- Retirement age between 60 and 65 and lump sum at retirement to be limited to one third cash or a lower limit, with the balance to be invested in an income draw-down product.
- This could mean preserving a minimum sum that would buy the member two or three times the SOAP in the form of a living annuity.
- Contribution rate of 12% on all earnings between the first tier ceiling (R75,000-R150,000) and R750,000. Assuming a R150,000 ceiling, R72,000 per annum would go to this fund (R750,000 – R150,000 x 12%).
- Membership would be voluntary for individuals belonging to existing retirement funds, on condition that those funds first apply to "contract out" i.e. members of large occupational and bargaining council funds would qualify for exemption from joining the second-tier national saving scheme if those funds comply with minimum prescribed standards.
- These standards would include minimum criteria regarding costs, minimum benefits offered and increased governance requirements, before "contracting out" would be considered.

The practical administration of a fund of this size and nature would require significant effort and the proposals around this aspect are as follows:

- SARS to enrol all taxpayers and act as collecting agent for the contributions in a similar way as for monthly PAYE.
- All funds to be invested by accredited government appointed third-party asset managers and a maximum of five investment options would be available.
- SARS would pay over contributions to the investment administrators, who would have to invest into the five investment choices (mandated structures).
- Other accredited retirement institutions (ARIs) could provide other services such as risk and disability insurance.

## The impact on the industry

### Number of existing retirement funds to reduce

A clear consequence of the proposed fund would be a reduction in the large number of existing private funds. All current stand-alone funds would need to “contract out” if they wished to continue to exist independently, and an application with the Financial Services Board, complying with certain minimum standards, would have to be lodged. A target of approximately 1000 remaining funds has been mentioned (there are currently between 9000 and 13000 active funds), indicating that the criteria would be set high in the new accreditation framework.

Small funds would thus be forced into joining the national fund or another accredited fund.

All funds would outright lose all their members earning below the first-tier fund level of R75,000. In particular, those funds with a high proportion of lower income members (often unionised) may be at high risk of having to close down.

Certain large funds could find a large exodus of members who join the second-tier national fund on a voluntary basis, thereby reducing them to small funds that no longer meet the contracting out criteria.

### Human resource issues

It is clear that employer/employee relationships would come under strain in the period leading up to the implementation of the national savings fund. Issues to consider would be:

- Explaining the options and consequences in a manner that all employees can make an informed decision.
- Comparing current benefits and contribution rates to those of the national fund and either matching them or making a decision to cancel some or all existing arrangements.
- How will lower “take home pay” of employees affect staff moral and future demands for increases? In fact, will the employer carry a portion of the

increased contribution burden or is it part of the current wage bill? One can only speculate as to the extent to which labour unions will be prepared to accept a reduction in “take home pay”.

- Must conditions of employment be adjusted or maintained e.g. changing of retirement ages or taking extra cover over and above the national savings fund to match the employment promise?
- Contractors need to be catered for and will be more expensive to employ, as they would be scoped in as contributing members to the new fund. Employers are likely to pick up a portion of the cost or face an increase in the contractors’ rates to compensate for their “loss in cash flow.”
- Large group companies with various subsidiaries may want to consider consolidation of all their individual retirement funds in the group into one accredited fund for the whole group.

### Service providers

There is no doubt that the number of service providers currently active in the industry will be greatly affected.

Employee benefit consultants, professional trustees, professional principal officers, auditors, financial institutions and investment management consultants would have a smaller pool of funds to service. Only the brightest and most innovative would be able to secure the services for the remaining pool of accredited funds, or the national savings fund itself.

Asset managers, providers of risk assurance and financial institutions would need to position themselves to be appointed as accredited retirement institutions (“ARIs”) to either the national savings fund or the remaining 1000 accredited funds. One can expect a move towards world-class standards in all areas of service delivery across all service industries, with the following added benefits:

- Lower costs with some form of standardisation; and
- More regular measurement and monitoring of service level agreements.

Existing risk underwriters are likely to see a move of group schemes from private sector funds to the national fund (or at least a substantial shrinkage of the underwriting book as member numbers decline or schemes are cancelled).

The consolidation of funds would leave umbrella arrangements in a favourable position to absorb those funds and members who choose to opt out from the second-tier fund. Large umbrella funds are likely to emerge and could dominate the accredited pool of funds in years to come.

Although investment management arrangements could be passed on to certain asset managers (there will be five key mandates available), there would be shrinkage of the space for other private investment vehicles and products. "Boutique" investment providers might find it harder to survive.

### **Labour issues**

It is known from past joint press statements that both Government and labour are committed to the principles of introducing a compulsory comprehensive saving scheme. The introduction of a national savings fund would have the following consequences for unions:

- Loss of direct influence and control over funds' investment assets, as current member trustee representation on trustee boards would fall away; and
- Loss of bargaining power and regular interaction with management via the fund structures

Alternative arrangements would need to be made through negotiation at the National Economic Development and Labour Council (NEDLAC).

### **Individual financial planning**

The compulsory nature of the National Saving Fund together with the proposed involvement of SARS in the registration process, would result in all registered tax payers becoming contributors to the fund. Those self-employed who have been saving via other vehicles would thus have to budget for this new contribution and reassess their current monthly savings positions.

As mentioned earlier, one of the criticisms of the current retirement saving system is the fact that current tax incentives are inclined to benefit higher income earners and incentivise them, rather than the lower earners. The following changes in personal taxation are envisaged and would impact on personal retirement planning:

- The tax treatment for all types of retirement funds will be harmonised.
- The approach is likely to be favourable tax treatment of the basic savings elements, some tax encouragement of the second-tier supplementary component and no special relief above a specified ceiling.
- For example, the maximum deduction for retirement contributions excluding risk cover will be R90,000 per annum (assuming the above 12% contribution scenario for income up to R750,000).
- The 15% deduction for contributions to a retirement annuity fund could fall away.
- Any voluntary savings on earnings over and above the R750,000 income ceiling, could receive no further taxation relief.

The proposed compulsory preservation when individuals change from employer or retire, will require re-planning of cash needs on retirement. It is unclear at this stage if the distinction between pension and provident funds would continue to exist, but it is clear that the need to preserve a minimum SOAP lump sum must be taken into account. The days of taking a full lump sum from a provident fund on retirement are probably over.

### **Government structures**

It is estimated that between 66% and 80% of people in permanent employment in the formal sector contribute to retirement funds. Government estimates that at least 60% of these members will join the national savings fund. In addition, there are an estimated six million employed individuals who do not contribute to any form of retirement fund at present. The challenges of implementing and administering a fund of this magnitude, would require significant planning:

- Special legislation for the national savings fund needs to be drafted and the current Pension Funds Act would need revision.
- Transitional arrangements for the implementation years need to be established. Many individuals planned for retirement under the existing arrangements and can't now be penalised under new rules.
- SARS's systems need to be geared and staffed for the additional collection burden.
- The position of government employees needs to be clarified and consolidated with the new proposed fund.

With an optimistic initial planned implementation date of 2010, (more likely to be 2011 or 2012) much needs to be done to finalise details.

## Conclusion

The introduction of a national savings fund is an attempt to achieve mandatory saving, equity, the pooling of risk, administrative cost efficiency and social solidarity – all at once. The ultimate aim is to ensure that all South Africans will be in a position to live their lives with dignity when they retire. It represents the single most significant retirement fund industry event since the introduction of the Pension Funds Act in 1956 and will have a significant impact on the way in which we plan for retirement in years to come.



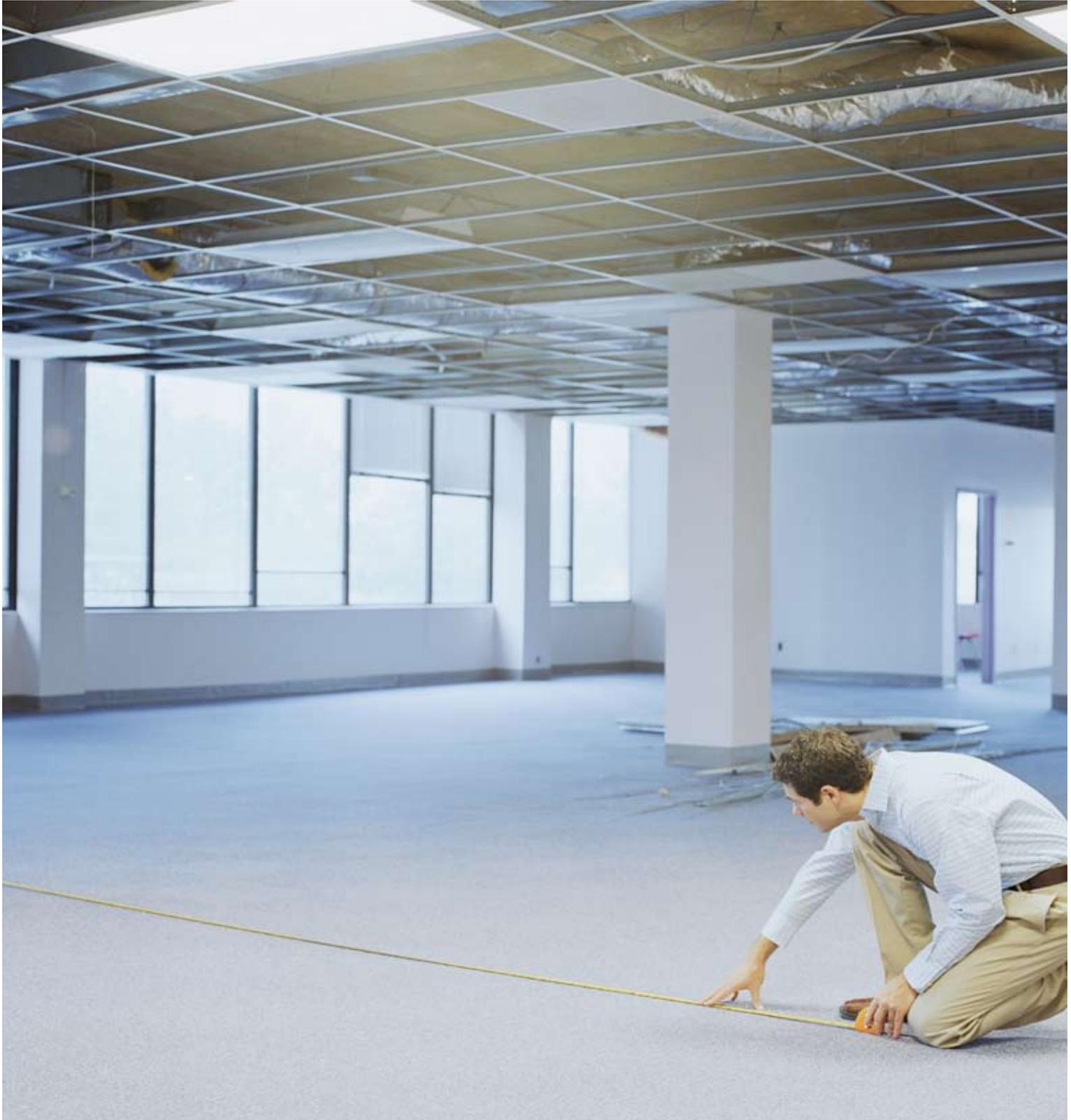
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## 08 Less can be more with combined assurance

Less can be more – extensive auditing by several parties is no guarantee that all company risks are being addressed.



Companies are suffering from ‘assurance fatigue’. At any point in time, there will be several different auditors and verification agencies on site, and the disruption caused to management continues throughout the year. The same questions get asked by different parties time after time, findings are duplicated and sometimes even conflict with each other, some key areas are missed out altogether, and reports do not reach the appropriate levels in the organisational structure. Companies understandably feel overwhelmed and over-audited and become reluctant to cooperate on issues that are crucial to effective governance.

The audit and assurance parties visiting a company’s site during the course of a year can relate to internal and external audit, compliance, Sarbanes-Oxley requirements, risk management, information security, fraud assessment, insurance reviews, operating standards, and environment, health and sustainability. All of these providers work in isolation and as their efforts are uncoordinated, the same company activity can be reviewed several times during the year.

Another factor that detracts from the efficiency of the current system is that many reports provide recommendations that address issues rather than causes. With so many reporting parties involved, company management becomes confused as to what to prioritise for corrective action. No single picture of the company’s performance, risks and controls is created as all these groups operate with a bunker mentality. Their findings feed into different divisions and committees and their recommendations get lost in this myriad of reporting structures.

A radically new approach is needed which effectively co-ordinates the efforts of all these parties, increases their collaboration and develops a shared and holistic view of each organisation’s risk profile. This change

would mean that the board could be presented with a comprehensive overview of how the key risks in an enterprise are being covered by all the assurance providers involved.

Combined assurance is the name of the new approach that shifts priority onto the identification of key risks and their causes. At present, each assurer decides what it believes are the important risks - something which should be done by management. Lapses in company policy and procedure are often wrongly classified as risks.

Each company ought to identify its own key risks using a comprehensive risk matrix. It should decide how these risks should be audited and by whom – and who should be addressing the arising issues and findings, and how this should be done. The risks identified need to be quantified and this means putting a Rand value to the risk as it presently stands, and to what it should be reduced to. This helps prioritise where the assurance focus should be directed. The traditional and somewhat vague ratings of low, medium and high do not sufficiently highlight which areas need urgent attention.

This new approach goes way beyond a more coordinated logistical relationship between external and internal assurance providers which minimises business disruption. Rather it represents a completely new strategy for risk assessment that would drastically reduce the attrition caused by the current system and leave management free to focus on the future of the business. For this strategy to be truly effective, information and processes need to be far more integrated. Through the use of more streamlined and integrated risk and control efforts, risk reporting can be done in a single language that all parties, both internal and external, understand.

# What is meant by 'Combined Assurance'

## Today



- No single view of assurance across organisation
- Differing perspectives on risk (audit vs business, inherent vs residual, business unit vs group)
- Potential for duplication and gaps in assurance
- Little board/audit committee level visibility of the linkage between sources of assurance

## Tomorrow



- Collaboration between assurance providers
- Develop common view of risk to organisation
- Presents to board how key risks are being covered by assurance providers
- **THIS IS MORE THAN** developing improvements in risk-based internal auditing

The final outcome of all these efforts would be a holistic view of the risk and control environment of the entity from a multifunction perspective. All assurance providers know the risks they should be considering and clarifying and can cross-share information and findings. A more co-ordinated and combined effort from all parties should then result in one view of the truth instead of the fractured pictures presently being reported to management.

Key to this change is both buy-in and control from top executive level. Without an executive driver to oversee this transformation, such an integrated approach will not materialise and the segmented view of assurance will perpetuate. There should be an identified sponsor – ideally the CEO or CFO - who can assign assurance providers to the risks they should be considering and determine where their assurance reports should be going.

A company's internal audit department is probably the most suited to oversee the detailed processes involved

- such as ensuring the proposed coverage by all the assurance providers will provide the required level of assurance, and that the assurance providers are competent and able to deliver what is required.

Ideally all assurance providers should be measured against predetermined standards – ensuring that they are independent and objective, do not have conflicts of interest, are appropriately skilled, experienced and qualified, are using suitable methodologies and belong to recognised industry and or professional bodies. If the assurance provider lacks competence, there would be little value placed on its findings.

Addressing audit fatigue through this combined assurance approach may have the effect of bringing down assurance costs, but the real benefits lie elsewhere. In fact, a combined approach may even increase assurance costs as companies realise the gaps in their risk profile which need to be addressed and where more work needs to be done. The true benefits come in the form of reduced business disruptions

throughout the year. Because these are not easily quantified, companies are not realising the enormous costs associated with constantly having various assurance providers on site.

A more effective assurance strategy would free up management to focus on the core business. The other key benefit is that the quality of assurance would increase significantly - the appropriate risks would be addressed by the right people, and suitable remedial action would be taken at the right levels in the company.

International companies such as Procter and Gamble and AngloGold Ashanti have developed or are in the process of developing a combined assurance approach. The approach clearly can be applied to most organisations.

If companies genuinely want to address the realities of audit fatigue, they do need to view their risk management approach in an entirely different way - which means active management of the key risks, allocating resources effectively based on risk assessments and ensuring the active involvement, oversight and support of the board. Otherwise the continual stream of uncoordinated audits will continue unabated and shareholders may even begin to lose faith in management's ability to manage risk.



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# Notes

A series of horizontal dotted lines for writing notes.





