

ASISA Conference – Opening Address

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The role of the financial services sector in the South African Economy

1. Introduction

The role of the financial services sector in the South African economy is reviewed specifically from a savings and investment (SI) perspective. This address concentrates on a number of separate but related issues, namely:

- The **changes** in the environment, particularly the changing institutional landscape and the impact of the recent financial crisis;
- the **role** of the financial services industry, with special emphasis on mobilization and allocation of savings, and financial intermediation;
- **response** to the challenges; and
- the **role of ASISA** in charting the course ahead.

I have deliberately refrained from dwelling on the comprehensive paper entitled “A safer financial sector to serve SA better” released by Treasury on 23 February 2011. This will be the topic of detailed discussions and workshops, the first which is scheduled for May 2011. At this moment in time it is sufficient to say that many of the sentiments expressed in the document are shared. And as an industry, we are supportive of the main proposal, i.e. to separate prudential and market conduct regulation, and the proposed new framework which takes a holistic approach. We look forward to actively engaging and collaborating with all stakeholders on the way forward.

2. A changing environment

A changing institutional landscape

A defining characteristic of the savings and investment (SI) terrain in South Africa has been the changing environment and competitive landscape, mainly as a reaction to increased consumerism and regulatory change. This has led to numerous new entrants in SI space with increased and more efficient competition.

At the **retail** level, large insurance companies dominated the SI space up to the mid-1990's due to mainly two factors, i.e. the barriers to access individuals faced in buying shares directly and the tax advantages linked to insurance policies vis-à-vis other types of SI products. With the introduction of electronic share trading platforms and the removal of tax benefits associated with insurance products, the playing field was leveled. This allowed several new players to successfully enter the market, eroding the dominant position of the three or four large life insurers.

At the **institutional** level, the balance of power moved from employers to employees with the advent of the virtually en-masse move from defined benefits to defined contributions. This led to the fragmentation of the employee benefit value chain. In this process, the single integrated provider of all EB-related services answerable to an employer was replaced by different specialist providers in the areas of consulting, administration, risk products and investments answerable to boards of trustees and individual investors. This in time resulted in the investment space going through massive change with the advent of new solutions and players, for example multi-managers, specialist asset classes, hedge funds, etc. Consumerism led to 'value to the client' being the major driver of change.

These changes in the environment led to the substantial erosion of the dominant position of life insurers and life insurance products as new entrants came into the SI space, particularly from 1990 onwards. The life insurers with their expensive cost structures and rigid products initially found it increasingly hard to compete with smaller, and more flexible and nimble, focused competitors. But they did survive, often by embracing exactly those tactics that the new entrants had deployed in order to gain differential advantage.

The result is that today we have an SI that is much more competitive and client orientated with good value for money to clients. Also gone are the days where we have

a 'one size fits all' approach. Client-centricity and choice are drivers in keeping up with the increased demands of well-informed consumers and their advisers.

However, in spite of what we in the industry experience as positives, negative perceptions about the industry's role and contributions often dominate following the recent global financial crisis.

Impact of the recent global crisis

We still find ourselves in the aftermath of the recent global financial crisis. The way people think about the role of the financial sector is filtered through their perceptions of the causes of the crisis and the behavior of financial institutions in the run-up to and after the crisis.

This applies especially to politicians and regulators, including those in South Africa. The statement has been made repeatedly that the regulation of the financial sector must be reformed to prevent a repeat of the crisis, even by South African regulators. These calls come in spite of the domestic financial services industry not being party to the crisis. This creates the risk of unnecessarily tight regulation and unwarranted intervention.

It can nevertheless not be denied that the financial crisis presented the biggest challenge to the world economy since the Great Depression of the 1930's and that it had severe consequences that have not been fully resolved to date. The impact of the crisis on the real economy is of particular importance, leading to the linkages between the financial economy and the real economy coming under severe scrutiny.

Penetrating questions are being asked about the size of the financial sector and of what benefit a large financial sector is to society and the economy. This also applies to South Africa – see for example the Industrial Policy Action Plan 2 and the New Growth Path. Lobbying in support of policies that promote the growth of the financial sector will have to reckon with this sentiment and will need to demonstrate the beneficial effect of financial development on the real economy. The current focus on unemployment and job creation will provide the acid test.

The danger is that people's interpretation of the financial crisis and what it means for society today could be distorted by long-held ideological prejudices and that the crisis could be used in an opportunistic way to promote positions that are essentially unrelated to it. For example, the crisis is being used rather indiscriminately to question the efficacy and morality of markets and to motivate greater government intervention in the economy, even in matters unrelated to the financial crisis.

We need to recognize that the crisis originated in a specific location (the USA), in a specific sector of the economy (the housing market/banking sector), in a specific political economic context (the promotion of home ownership among low income households combined with financial deregulation), and against a backdrop of large global imbalances (a savings glut causing a search for yield and the downplaying of risk). We should therefore be careful to avoid unsubstantiated generalizations.

This does not mean that people should not be brutally honest and incisive in their assessment of what went wrong and the role of the financial sector in the development of the crisis. We should not be blind to possible shortcomings in the financial services sector and we should be prepared to be proactive in resolving them. But we should be careful not to lose sight of our unique domestic context.

The bottom line is that there are many reasons why trust in financial markets and institutions has been eroded. Locally, in the case of the New Growth Path (and IPAP2), it culminates in proposals for government institutions to take over the role of private financial institutions. Note, for example, the support for a repositioning of the development finance institutions, the creation of a state-owned bank to specifically serve the needs of rural areas and micro-enterprises, and the rationalization of SME financing.

3. Role of Financial Services Sector

At a time when virtually everything about the financial services sector is being questioned, it is perhaps a good idea to start from first principles, specifically with regard to the way the financial system delivers economic value, viz. through:

- Payment services (enabling transacting);
- Insurance services (enabling risk management);
- The creation of markets (enabling price discovery and liquidity); and
- Financial intermediation (enabling the flow of funds from surplus units to deficit units).

It is well known that the South African financial system is highly rated internationally and that we are world leaders in many respects, especially within our emerging market peer group. However, we should recognize that this rating is based on first world criteria, while the essential dilemma of the South African financial services sector is how to bridge the divide between the first world and the third world dimensions of the economy.

Criticism of the financial services industry is therefore focused on matters of access with regard to payments and insurance services, and the intermediation of savings to developmental needs:

- The first matter has been addressed by special initiatives such as the Mzansi bank account, Zimele life insurance brand, and Fundisa savings account. The challenge is to do even more and to do it in a way that makes business sense. A lack of access to financial services is generally regarded as an important obstacle to economic development and we will do ourselves as an industry a disservice not to acknowledge this.
- The second matter can be divided into two questions, firstly the mobilisation of savings, and, secondly, the allocation of those savings.

Mobilisation and allocation of savings

With regard to the mobilization of savings, the low level of savings in South Africa is a perennial topic for discussion. To improve on this, the starting point should be the elimination of government dis-saving – it is absurd for government to criticize the market system for the way it allocates savings while in the words of the 2011 Budget Review “Government is currently borrowing to finance short-term consumption. Long-term debt is being used to finance higher current expenditure on wages, interest and goods and services”.

Secondly, we should realize that corporate savings (the main source of savings for quite some time now) will respond to an improvement in the investment climate. An expansion in profitable investment opportunities will motivate corporates to save more, i.e. to retain a greater part of earnings for the expansion of their businesses. The point is that indirect measures can actually do more to promote savings than direct measures - in other words those measures that pull savings higher may be more effective than those that try to push it higher.

As for household savings, it is a long-standing axiom that saving is mainly a function of income. As such it means that it is futile to target household savings explicitly as a way to promote growth and investment. It rather means that as the economy grows, the increased level of household income that comes with growth will be accompanied by an increased level of household savings.

But that still leaves the matter of the propensity to save unresolved, and we should ask what Government and financial services providers can do to improve the propensity to save. Government can counter inflation to protect real returns, avoid punitive taxation of investment returns, ensure the stability of the financial system through appropriate

regulation, encourage self-reliance rather than dependency on the state, make saving for retirement compulsory, etc. The financial services sector can promote saving by providing the right products for customer needs, being efficient to lower costs and therefore increase net returns, educating consumers on the benefits of long-term savings, discouraging dis-saving, etc. But there is something like a savings culture that depends on the value system of society.

One should accept that low-income South African's do not have much capacity to save. Higher income households probably have a fairly high gross savings rate, mainly due to their retirement provision; the problem is that they also have a high propensity to borrow resulting in a much lower net savings rate. They have relied increasingly on asset appreciation instead of cash saving as a way of boosting their net wealth, and even then the withdrawal of equity from, for example mortgages, has been rife. The dilemma is that denying investors access to their long-term investments and thereby robbing them of liquidity could discourage contractual, long-term savings in favour of short-term, liquid funds.

Financial intermediation

The final matter to be addressed is the intermediation function of the financial system. The South African financial services sector has at various times been accused of investing in "unproductive" investments (e.g. shares listed on the JSE) instead of "productive" investments, an inability to satisfy the financial needs of small and medium enterprises, enabling conspicuous consumption through excessive lending to high income households, and holding back the growth and development of the economy by raising the cost of capital. Policymakers see the "solution" in government interference in the process of the allocation of capital, wanting to direct investment to preferred destinations (so-called prescribed assets).

It is a basic misunderstanding of the process of intermediation to approach the allocation of capital from the supply side only. The idea that the creation of large pools of funding will cause the suppliers of capital to go out and themselves create the opportunities for investing the funds at their disposal is just wrong. Trying to turn financial institutions such as retirement funds into development agencies will not have the desired results and will cause a misallocation of capital. Intermediation is about bridging the gap between the suppliers of capital (savers) and the users of capital (businesses, large and small, public enterprises, government, etc.), which are by definition different entities. Much more attention should be paid to developing the demand for capital by creating a favourable investment environment. The financial

services sector should not be used as a scapegoat for deficiencies in the broader business environment.

4. Response to the challenges

How should the financial services industry respond to all these challenges? Four responses come to mind:

- Firstly, we should recognize that financial services industry, and particular its savings and investment (SI) component's, right to exist is fundamentally intertwined with people's perceptions regarding the social usefulness of what it does;
- Secondly, the financial services industry should be pro-active in identifying and rectifying short-comings in the provision of financial services to achieve the four functions listed above;
- Thirdly, we have a duty to run financial institutions as profitable businesses; and
- Fourthly, we should argue forcefully against those statements that are blatantly untrue or incorrect.

South Africa has come to a major junction in its history. Increasing the growth rate of the economy and doing so in an inclusive way is an undisputed imperative for our society. The efficient provision of financial services has an important contribution to make in achieving this objective, and we should accept the challenge enthusiastically.

5. ASISA's role in the process

ASISA was formed to specifically play this role within the savings and investments space. ASISA formally opened its doors at the beginning of October 2008. Incorporated under Section 21, it represents the majority of South Africa's asset managers, collective investment scheme management companies, linked investment service providers, multi-managers and life insurance companies. At the end of December 2010, a total of 160 member companies managed R3.2 trillion in assets.

Our Purpose and Mandate

As the custodians of the bulk of South Africa's savings and investments, ASISA and its members must ensure, in the interest of the country and its citizens, that the South

African savings and investment industry remains relevant and sustainable into the future. ASISA's strategic purpose and mandate are therefore to remain a trusted partner to stakeholders in the financial services industry and to proactively engage with them on regulatory and other important issues of common concern.

It is also ASISA's role to ensure that as a collective our industry remains relevant and sustainable by delivering solutions that are in line with the needs of our country, taking into consideration global and local developments and challenges. At the same time we need to recognise the hurdles created by the country's legacy and work with our policy makers to develop solutions that will help us overcome these.

ASISA aims to be an active participant in creating an environment that promotes equal opportunities for its members through holistic legislation, while at the same time considering the interests of consumers and ensuring the sustainability of the industries it represents and the intermediaries who promote these industries and their products.

ASISA actively works towards promoting a culture of savings and investment in South Africa.

Mission

In a nutshell, ASISA's mission is to:

- Actively promote a transformed, vibrant and globally competitive financial sector that reflects South African demographics.
- Develop and actively participate in education, transformation and social development projects.
- Continue to build a strong national economy by encouraging and incentivising South Africans to save.
- Promote transparency and disclosure.
- Create an environment enabling of more holistic regulation.
- To always have a consumer focus.
- Endeavour to ensure ethical and equitable behaviour from members by applying a code of ethics and standards.
- Help create a simple and efficient regulatory framework that promotes savings and investment.
- Engage with Government to ensure the creation of level playing fields for all members while at the same time promoting healthy competition.
- Collectively engage with Government on policy issues and actively partner with Government on the SA Inc strategy aimed at promoting South Africa as the economic gateway to Africa.

The Approach

The future of the South African savings, investment and insurance industries must be driven strategically at the highest level and without any bias. Therefore, ASISA's key approach is about achieving balance and democracy within its structures:

- **Balance:** ASISA membership can only be attained at the highest appropriate level in a company's corporate structure. In addition, members can only be represented on the ASISA Board by their most senior representative. The aim is to ensure that high level strategic thinking, not product-aligned agendas, shapes the future of the financial services industry.
- **Democracy:** ASISA applies the principle where a full member has one vote. This means that the big conglomerates have the same vote as a small independent company. The ASISA founding statement commits ASISA and its members to the principle that the consumer's best interest will govern all decision making. At the same time, the importance of minority views will be recognised, processed and presented together with the majority view.

2010 Achievements and strategic goals

Finding common ground with the aim of achieving common gain requires, first and foremost, a change in attitude and, second, a change in approach. Judging from the significant progress made in so many different areas of our industry during 2010, I share in the views of our CEO, Leon Campher, who believes there has been a definite change in attitude with key stakeholders starting to pull in the same direction, while at the same time respecting each other's differences.

When we find ourselves around the negotiation table, common gain increasingly seems to be the driving factor, where individual agendas had previously impeded progress. This is certainly true for ASISA and its members, where the bigger picture now drives our work streams, as opposed to product-aligned motivations as had been the case before ASISA was formed.

During 2010, we had 35 projects in the pipeline at any given time. Running with these projects were 80 ASISA committees and working groups, 1291 member representatives and the ASISA staff. In addition, all of these projects involved external stakeholders such as National Treasury and the Financial Services Board (FSB). With so many projects on the go, it is incredibly difficult to pick out only a few achievements. Our CEO gives a special mention to the work on the Financial Sector Charter (FSC), ASISA's advocacy role, and regulatory reform. The latter includes, among others, the following:

- Regulation 28
- Consumer Protection Act
- UCITS III Equivalent Regulation
- Binder Agreements
- Solvency Assessment Management (SAM)
- Conflict of Interest Legislation
- Amendments to Section 13B of the Pension Funds Act
- Regulation of the over-the-counter (OTC) derivatives market

The theme of the 2010 ASISA Annual Review is *Common Ground for Common Gain* and we have given the 2011 ASISA Conference a similar theme, because we believe that the “common ground” approach is the only one that will help us achieve our goals as a collective – the latter referring to our members, our intermediaries, our clients, our regulator, our policy makers, and other key stakeholders. We recognise that the bigger goals can only be achieved in partnership and ASISA is certainly committed to continuing on this path that has worked so well for us in 2010.

The ASISA Board reaffirmed its support for ASISA’s medium-term strategy at the end of last year and asked management to define our list of priorities for 2011. This has been done and approved by the Board. I look forward to making progress on ASISA’s four strategic areas of intervention:

- Market environment
- Market conduct
- Market operation
- Relevance and sustainability

6. Closing remarks

As discussed earlier, South Africa has come to a major junction in its history. Increasing the growth rate of the economy and doing so in an inclusive way is an undisputed imperative for our society. The efficient provision of financial services has an important contribution to make in achieving this objective, and we should accept the challenge enthusiastically. We therefore support and want to participate in all discussions that will take us forward on this road. In particular, we welcome the clarity provided by the recent document on “A safer financial sector to serve SA better”. We look forward to contributing to the debate and being part of the solution.

Ladies and gentlemen, thank you for listening and thank you for the support. Enjoy the conference.