

**TIPS 1999 Annual Forum**  
at Glenburn Lodge, Muldersdrift  
*19-22 September, 1999*

**The South African Financial Sector: Background Research for  
the Seattle Round**

By

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Industry**

**July 1999**

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## **Overview**

# **Background research for South Africa's offer on financial services to the WTO**

This report presents background research aimed at assisting the formulation of South Africa's offer on financial services for the Seattle Round of the World Trade Organisation. The report provides a framework for assessing financial sector policies, including those provisions regulating foreign access. It scans the various financial subsectors, providing basic data. The report goes on to initiate, for each subsector, a discussion on access provisions. Finally, financial services exports from South Africa are discussed.

Finance plays three critical roles . . .

Some of the most successful economies in the world have recently fallen foul of debilitating financial crises. Excellent real economy fundamentals – increasing productivity, good human capital, high savings rates, globally competitive firms – succumbed before the effects of a poorly performing financial sector. These recent events focus the mind on the roles of the financial sector in a modern economy. Three roles stand out:

- The financial system **allocates the economy's resources in the form of capital**. A poor financial system squanders these resources: in the Asian countries weak banks and capital markets channeled resources to low-return projects. In contrast, a competitive financial system achieves high output from limited resources: research shows that countries with liquid and well-developed financial systems grow quicker as a result.
- The financial system **manages the financial risks in an economy**. Firms and markets that intermediate between providers and users of capital need to manage three types of risk: maturity mismatches, currency mismatches and credit risk. It was the extraordinary build-up of risks in corporate and banking balance sheets that made Asian economies so vulnerable to economic volatility.
- Finally, the financial system **generates value added in the economy**: Financial firms contribute to GDP, employ many people, and generate tax revenues and foreign exchange earnings. In South Africa the financial sector has been responsible for a quarter of total economic growth in the 1990s and employs upwards of 220,000 people.

. . . so finance policymakers have four objectives

From the above, policymakers can infer objectives that ought to inform all financial regulation, including the regulation of access. They are:

- A financial system which is efficient in terms of allocation and operations
- A financial system in which risks are well-managed, with low systemic risk
- The promotion of local value added.
- **And in addition:** Protecting vulnerable and uninformed individuals against sharp or reckless financial operators.

The lessons of Mexico, Asia and Russia suggest a hierarchy of objectives. Allocative efficiency and the management of risk are of critical importance, followed by protection of vulnerable individuals. The promotion of local value-added, though desirable, is subordinate.

#### A regional financial centre for Africa

South Africa is well-placed to become a regional financial centre for Africa, a role currently fulfilled by default by London. Africa needs a financial hub to intermediate the large flows of foreign capital that will be required to rebuild the continent. At the same time, the financial systems of the African nations need to be rebuilt, so as to mobilise capital and reduce the considerable risks inherent in investing in, and trading with, many African nations.

Financial centres are characterised by a particular dynamic, which is described extensively in another report. In short, three necessary elements – a **deep pool of financial talent**, the presence of many **foreign financial institutions**, and well-organised and highly **liquid markets** – jointly create the advantages that make a financial centre attractive for raising and investing capital and for managing risk. A decision that South Africa ought to position itself as a regional financial centre would thus have implications for the policy that regulates the access of foreign financial firms to the South African market.

There is a further critical point on Africa: South Africa needs to take the lead in improving financial systems in the continent. In the absence of such improvements, there is a high degree of probability of an Asia-type financial crisis occurring in Africa just as the region's recovery starts gaining speed.

#### A revolution in competition (and the Internet has only begun)

Throughout the 1990s competition has intensified in financial systems around the world. The report identifies five sites of heightened competition: competition for deposits, competition for long-term investment services, competing providers of credit, competing customer channels, and competing trading infrastructure.

The Internet will bring a further quantum leap in competition in all these areas as barriers to entry fall away. The Internet makes viable, for the first time, the provision of a host of **cross-border services**; it is therefore likely that the coming WTO Round will be characterised by an intense focus on cross-border access issues. South African negotiators will need to be prepared for this.

The central question for South African policymakers is how to take advantage of the increases in global competition while successfully managing the risks inherent in financial systems.

#### South Africa's financial sector: foreign entry, local power

A number of foreign firms have entered our banking, insurance and broking markets since South Africa rejoined the world community in 1994. The report

details the impact of foreign entry in the various financial subsectors. The most notable gain in foreign market share has been in broking, short-term insurance and investment banking. In general, foreign entry has accelerated innovation, increased product choice, improved regulatory standards and intensified demand for financial talent. In some cases price competition has become more fierce. A majority of foreign entrants exports financial services from South Africa to the region.

Foreign entry remains negligible in such important activities as banking services for individuals, lending to medium-sized and small corporates, and long-term insurance. In each of these markets the four largest South African firms dominate the market: market share for the top four ranges from 73 percent (long-term insurance) to 84 percent (retail banking). Are there regulations or policies that impede foreign entry in these areas? This question is addressed in the chapters dealing with access provisions.

Access to South Africa's financial markets: a new ball-game?

Since the early 1990s South Africa has welcomed foreign ownership of local financial firms. In general, policies and regulators have not discriminated between **SA registered entities owned by foreigners** and those owned by South Africans. On the other hand, our policies have significantly constrained – and in some cases prohibited – the activities here of **foreign-registered firms**. For example, branches of foreign banks that operate in South Africa may not rely on their parent companies' capital, but need to hold their own capital on-shore, with a high minimum value. Branches of foreign banks are effectively barred from the retail banking market. In insurance, operations of foreign-registered firms are prohibited other than through a domestically-owned subsidiary. Exchange controls and financial regulations also inhibit, and in some cases prohibit, the cross-border supply of services by foreign firms.

There are advantages to serving a market such as South Africa through the parent company. A South African operation that is a part of the parent legal entity has the benefit of the parent's credit ratings, can be more tightly integrated into the processes of the parent firm, with resultant scale economies, and allows for a more effective global allocation of resources, particularly capital. Notably all the foreign banks with banking licenses in South Africa have chosen to operate as branches of the parent and not as subsidiaries – which are separate legal entities – despite the restrictions imposed by our regulators.

Foreign firms sometimes claim that these restrictions are a disguised form of protectionism. Regulators, however, justify the restrictions on prudential grounds. It is indeed true that the techniques used by South Africa's financial regulators to ensure the prudent management of risks are built on assumptions of locally registered corporates with locally invested capital reserves.

Foreign firms operating in South Africa – and their home governments at the WTO – question whether local registration and investment of capital reserves really add to the protection afforded either clients or the financial system as a

whole. These critics prefer, instead, to emphasise co-operation between national regulators. Specifically they advocate that well-regarded home regulators of global firms be relied upon to enforce prudential standards. Were that possible, more foreign firms would enter, whether through branch structures or cross-border provision. This would increase competition and consumer choice. These issues are sure to be raised during the next Round.

#### Preparing for the Seattle Round

The 'access' chapters in this report are designed to help negotiators prepare for the Seattle Round. They contain, for each subsector and arranged by mode of entry, the following: a summary of South Africa's access rules, our existing WTO commitments, and possible requests from the US and the EU. As per the instruction from TIPS the 'access' chapters are indicative in nature, and many points deserve further consideration. In particular, and within the wider policy context, the following themes require further analysis:

- **The impact of the Internet on cross-border access to financial services, and the implications for the regulation of cross-border access. (This issue is made more pressing, in the South African case, by the relaxation of exchange controls on individuals).**
- **Restrictions on branch activities of foreign banks and insurers in South Africa, and in particular local entity and capital requirements.**
- **The economic time-bomb created by Africa's (excluding South Africa's) poor financial systems. These systems are characterised by risky national payment systems, weak banks, poor local banking supervision, small and illiquid capital markets, and non-existent instruments for risk management. South Africa's leadership in these areas is an essential part of any plan to integrate markets and spur regional recovery.**

# 1

## The Financial System: Roles & Objectives

### The Three Roles of Finance in a Modern Economy

Experience, theory and common sense concur that healthy and sophisticated financial sectors are of critical importance to the well-being of societies. In short, the financial system is the 'brain' of the economy. The financial system mobilises and allocates the resources in the economy held in the form of



capital. When a country becomes an international financial centre, its financial sector improves in terms of its level of activity and the competition it faces. As a result, the country has a more liquid, more sophisticated financial system, or 'brain'. This has a strong impact on overall economic performance.

Domestic users of financial services – firms and investors – derive great benefit from the availability of the sophisticated and efficient financial products and facilities that make up the hub. Firms raising capital can now issue at a lower funding cost, with lower transactions costs, and to a more diverse funding base than before. Investors benefit, because a world-class asset management industry can tap a more diverse range of investments.

The second role of the financial system is equally critical. It is the management of financial risk in the economy. Because savers and investors face varying risks and constraints, banks and other intermediaries have to manage – and in some cases assume – many forms of risk. If this is done well, risk adjusted returns to projects rise, and more projects are funded; importantly, too, the chances for a damaging financial crisis are considerably reduced.

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The financial sector has been responsible for a quarter of total economic growth in the 1990s.

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Thirdly, the financial sector makes a direct contribution to the economy in terms of its value-added contribution to GDP, employment and taxation paid. In 1997, South Africa's financial sector contributed R95 billion or 16 percent, to GDP, and employed 221 000 people. During the 1990s, finance has been one

of the most dynamic sectors of the economy. Financial sector employment has grown by a 34 000, or a fifth, since the start of the decade. Almost a quarter of growth in the overall economy during the 1990s is accounted for by growth in the financial sector. Because financial centres often sell their services to foreigners, they are large earners of foreign exchange. Figures quoted below show that the City is one of Britain's largest exporters. We now briefly review each benefit.

## A World-Class Financial System and Growth

Can the increased efficiency, innovation and liquidity a financial centre brings really improve the economic performance of its domestic real economy?

Joseph Stiglitz, who originated the metaphor of the financial system as the 'brain' of the economy, elaborated on what it means in a recent speech:

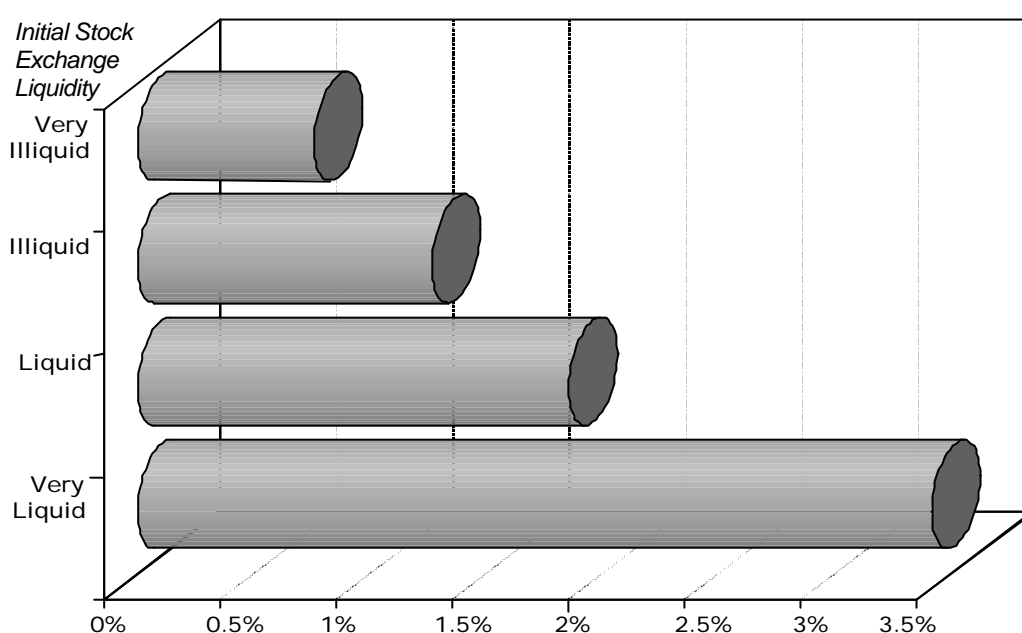
Well-functioning financial systems do a very good job of selecting the most productive recipients for [capital] resources. In contrast, poorly functioning financial systems often allocate capital in low-productivity investments. Selecting projects is only the first stage. The financial system must continue to monitor the use of funds, ensuring that they continue to be used productively. In the process, it serves a number of other functions, including reducing risk, increasing liquidity, and conveying

information. All of these functions are essential to both the growth of capital and the increase in total factor productivity.

**LIQUIDITY AND ECONOMIC GROWTH.** There is strong evidence to support Stiglitz' view. Take the most general measure of market efficiency, liquidity. Stock exchanges transmit information most efficiently when they are liquid – in other words, where the price reflects underlying value rather than be distorted by the effect of the most recent transactions.

Recent research by Levine (1996) shows that stock market liquidity is positively and significantly correlated with growth, capital accumulation, and productivity growth – even after controlling for economic and political factors.

The chart on the previous page compares countries with different levels of stockexchange liquidity in a given year, 1976. The cylinders show the



**Figure 1: Growth in GDP (Annual Per Capita, 1976-93) at Different Levels of Stock Market Liquidity**

*Source: Levine, 1996*

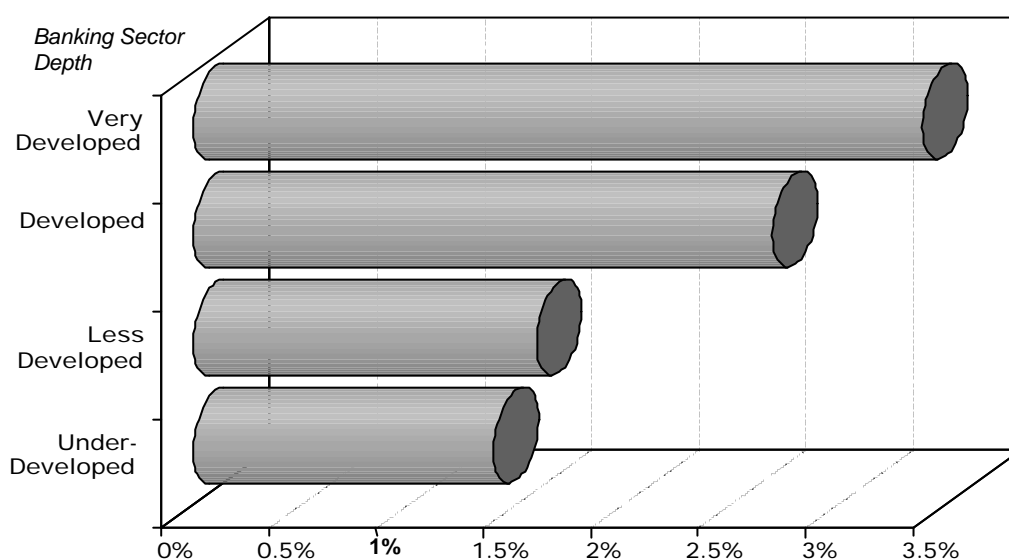
growth performance of each category during the subsequent 18 years. There is a remarkable correlation between liquidity and subsequent long-term growth in the economy.

This result supports the view that financial markets – securities markets and, as we shall see, banks – are critical conveyors of information that is essential for the allocation of capital in the economy. This informational role, along with the on-going monitoring of investments, is of even more value to the economy than the direct contribution to capital mobilisation.

**BANKING AND ECONOMIC GROWTH.** The development of the banking sector can be measured by total bank loans to private enterprises as a percentage of GDP. Using this measure, experience shows that the level of banking development also spurs growth.

These studies have shown that countries that have both deep banking sectors and liquid stock markets grew faster than any other group. These results underline that financial markets and institutions provide important services for long-run growth. Does this mean that every country needs an active stock market to grow? In another forum Levine has addressed this question:

Unfortunately there is not much evidence available to answer this question. In principle, all countries do not need domestic stock markets. They do, however, need easy access to liquid stock markets where residents and domestic firms can buy, sell and issue securities. It is the ability to trade and issue securities easily that facilitates long-term growth, not the physical location of the market. In other words, there is little reason to believe that California would grow faster if the New York Stock Exchange were moved to Los Angeles.<sup>1</sup>



**Figure: 2 Annual GDP Growth (Annual Per Capita, 1976-93), relative to Banking Sector Development**

*Source: IMF*

### The Financial Sector as a Manager of Risk

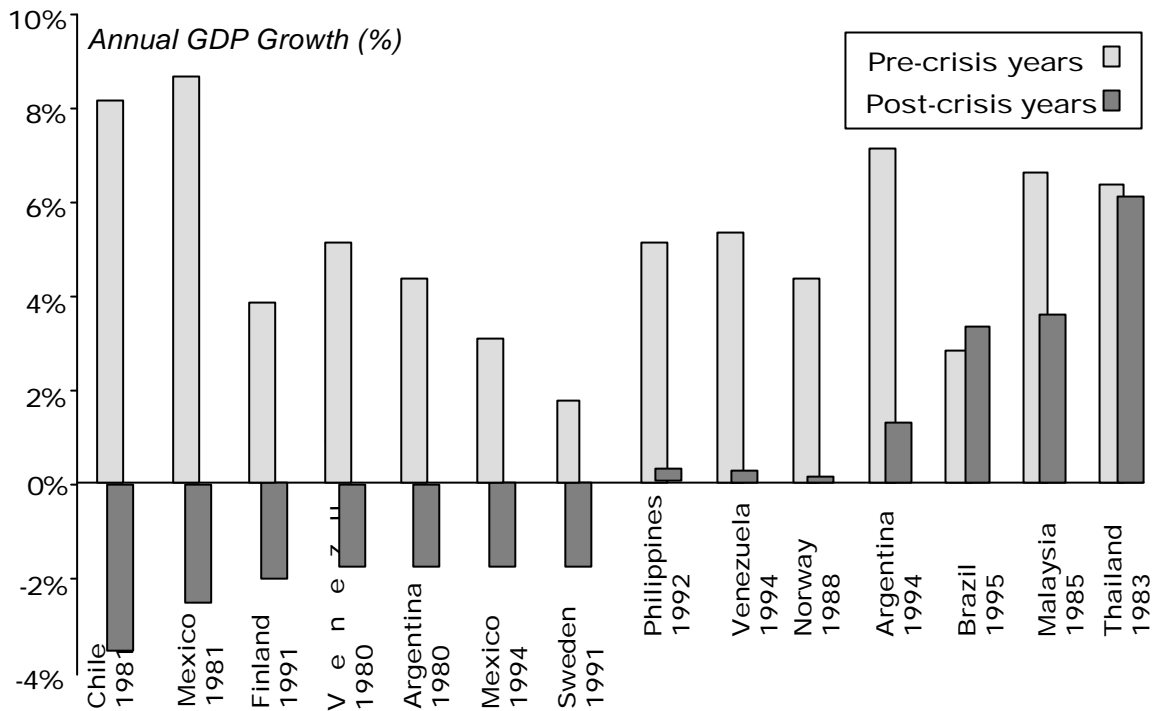
Banking crises are notoriously costly to societies. Apart from the direct costs of resolving the crisis, which can exceed ten percent of GDP, but is in the nature of a transfer, overall output suffers severely. A banking crisis can push an economy into a deep recession from which it may emerge only after a number of years.

For example, the banking crisis of the 1980s in Chile saw output growth drop from 8 percent per year in the five years preceding the crisis to only 1 percent in the five years after it. In Finland, growth averaged 4.5 percent in the years preceding their banking crisis, dropping to *minus* 4 percent in the three years after the crisis. The chart on the next page shows the difference in growth rate

<sup>1</sup> Levine (1996) 10.

of a number of developing countries in the year preceding and the year following the banking crisis. Commonly, growth falls by more than five percentage points of GDP from the year before to the year after the crisis.

**POORLY MANAGED FINANCIAL INSTITUTIONS CAN LEAD TO CRISIS.** As an example, consider the effect of an asset-price bubble in the context of poor management of risks. Both debtor performance and the quality of collateral are now riding on overvalued assets.



**Figure 3: The Effect of Banking Crises on Economic Growth**

*Source: World Bank*

The risks, as Andrew Sheng of the Hong Kong Monetary Authority has pointed out, are of three kinds.

First, maturity mismatch where short-term funds are lent long-term.

Second, currency mismatch where foreign currency debt is used for projects that generate domestic currency.

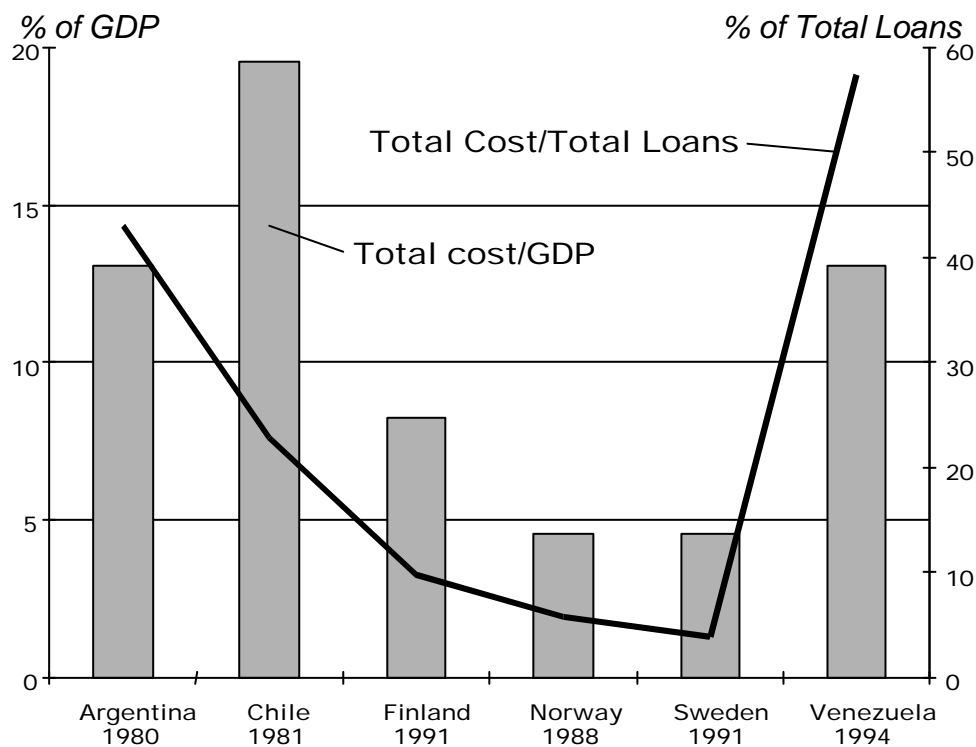
Third, credit risk, where undue optimism on the side of investors and bankers motivates investments into over-priced asset.

When the market turns – as foreign investor markets easily do on changed perceptions of returns, risk or liquidity – the entire financial system is in trouble. A fall in the currency and asset prices means a real loss of wealth, much of which is borne by the banking sector as the major intermediary in the economy. The maturity mismatch causes liquidity problems, and the currency

mismatch and credit risk together create both liquidity and solvency problems. The weak balance sheets multiply through the economy, and the banking system is badly weakened. As write-downs in its loan book and losses in its market portfolio reduce capital, banks reduce lending in step, so as to comply with prescribed capital adequacy ratios. A weak banking system imparts further weakness to the economy as a doubtful provider of payment services and an unwilling provider of short-term credit. By that point, the availability of long-term credit in the economy has dried up entirely.

**THE COSTS.** That is why banking crises are so costly. The effects on growth are pointed out above. Here we focus on resolution costs. Salvaging a weak banking system takes a long time and is expensive. The resolution cost of the Savings and Loans scandal in the United States reached five percent of GDP and almost eight percent of total loans. The costs are often higher in developing countries. In a study of 14 developing country banking crises, the World Bank found that average resolution costs amounted to ten percent of GDP and 23 percent of loans. “High” points were reached by Chile in 1981 with costs of one-fifth of annual GDP, and Venezuela in 1994 where costs exceeded half of total loans.

Domestic banks are often not the only participants to miscalculate during the asset boom. In 1997, a record proportion of internationally syndicated credits were taken up by developing world borrowers, often on sharply improved terms. Many major players in that market now face sizeable losses on their Asian portfolios.



**Figure 4: Costs of Restructuring the Banking System**

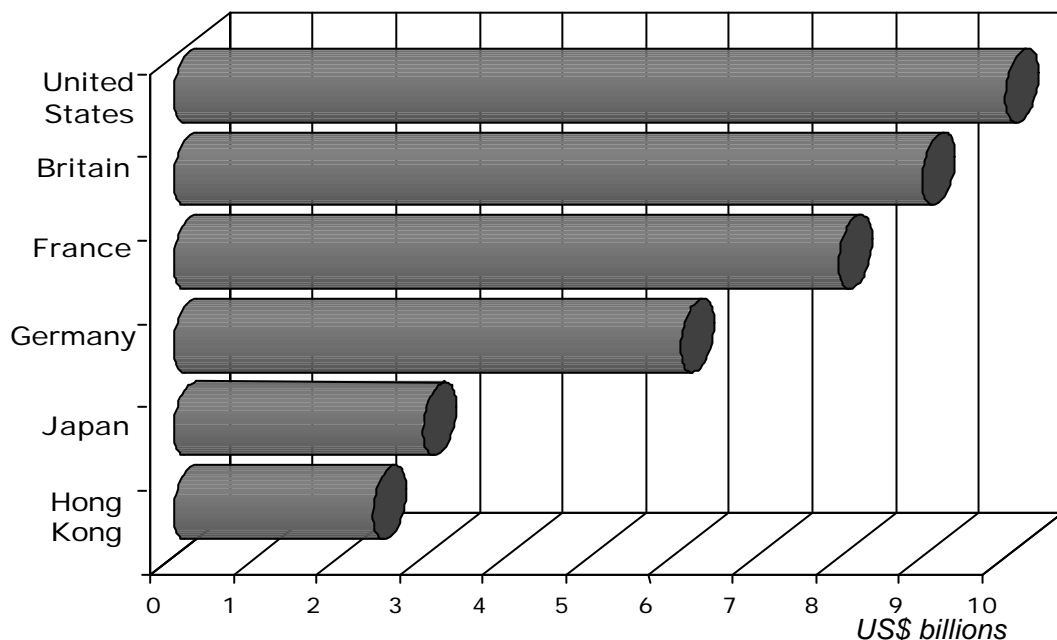
Source: Rojaz-Suárez and Weisbrod

## The Financial Sector Produces Output, Jobs and Foreign Exchange

The direct contribution to the economy already made by South Africa's financial sector is mentioned above. As long as the financial sector serves a largely domestic clientele, its size and employment is ultimately constrained by the size of the domestic economy. A financial sector serving an international clientele, on the other hand, can grow much larger, with much of its earnings in foreign exchange. The direct benefits of a financial hub can therefore be listed under the headings employment, contribution to GDP, and foreign exchange earnings (the fourth direct benefit, tax revenues, is of great importance, but data is scarce).

**EMPLOYMENT.** Finance and related services provide one-fifth of total employment in both New York and London. Greater London boasted about 617,000 employees in finance, accounting for 19 percent of employment. In New York, finance and insurance account for 23%, or 443,000 employees.

**CONTRIBUTION TO GDP.** As is the case for most developed countries, the broad church of financial services provides the United States and Britain with between a fifth and a quarter of GDP. In the case of the United States, with its financial sector mostly focused on serving its giant hinterland economy, this proportion has been fairly stable over the last twenty-five years. In the case of Britain, by contrast, the on-going expansion of cross-border financial



**Figure 5: Exports of Financial Services, 1996**

*Source: IMF*

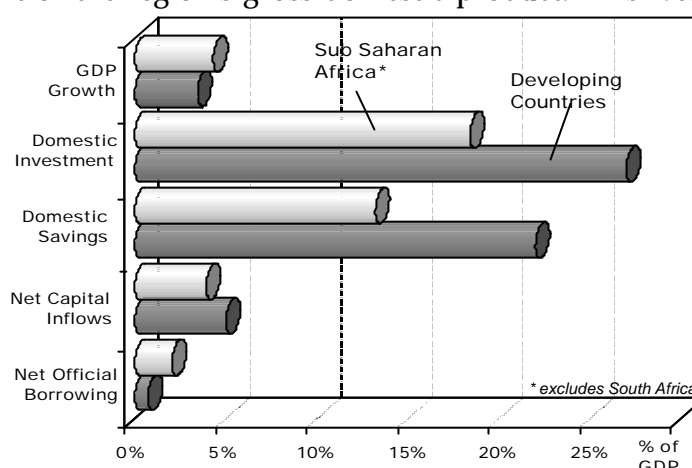
transactions has allowed its financial sector to grow from 13 percent of the economy in 1970 to almost 25 percent today.

**FOREIGN EXCHANGE EARNINGS.** Countries that are international financial centres consider their international financial services to be major export products. The accompanying chart shows the foreign exchange earned by the major exporters of financial services. In 1996, the United States earned \$10 billion from the export of financial services. Britain earned \$9 billion. Other high earners were France (\$8 billion) and Germany (\$6 billion). After accounting for imports of financial services, a number of countries have large net surplus earnings. Britain leads with a financial services trade surplus of \$ 8.1 billion in 1996. Hong Kong, Germany and the United States also show sizeable surpluses.

The need for, and viability of, an African hub depends on the region's appetite for international capital. This section estimates the future capital requirements of the African region (south of the Sahara, excluding South Africa) needed to fund a higher growth path for the region.

### Africa's Current Savings and Investment Performance

The level at which Sub-Saharan economies invest, and how that investment is funded, differs sharply from other developing countries. Although Sub-Saharan Africa (excluding South Africa) invested \$172 billion during 1990-1995, that accounts for only 18 percent of the region's gross domestic product. This rate of investment is low compared to the investment level achieved by developing countries as a group, and is too low to support sustained high growth. In 1995, the latest year for which data is available, developing countries dedicated 27 percent of GDP to investment, compared to 18 percent for the region.



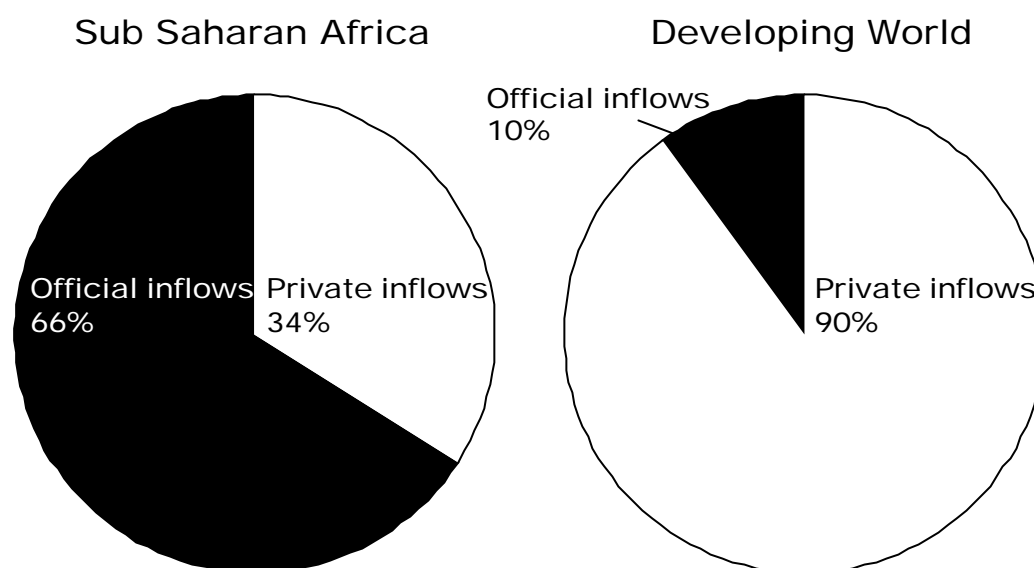
**Figure 6: Savings, Investment & Growth, 1995**

*Source: World Bank Data*

There is a similar performance gap with respect to savings. As the graphic shows, Africa's 1995 savings rate of 13 percent is extraordinarily low compared to the developing countries as a group, which saved 22 percent of GDP. To achieve sustained growth, the region will need to raise investment levels, which are currently constrained by the low availability of capital.

Developing countries and the Sub-Saharan region have both relied on foreign inflows to fund the gap between investment and domestic savings. During 1995, the last year for which comparative data is available, capital inflows to both groups of countries averaged five percent of GDP. The critical difference lies in the **origin** of the inflows. Africa has traditionally relied heavily on flows from official sources, namely other governments and the multilateral aid organisations, a source the developing world as a whole now largely eschews for purposes of investment funding. During the 1990s, official flows accounted for almost two-thirds of net capital inflows into Africa, the rump of one third coming from private sources such as banks, institutional investors and





**Figure 7: Origin of Net Capital Inflows, 1990-95**

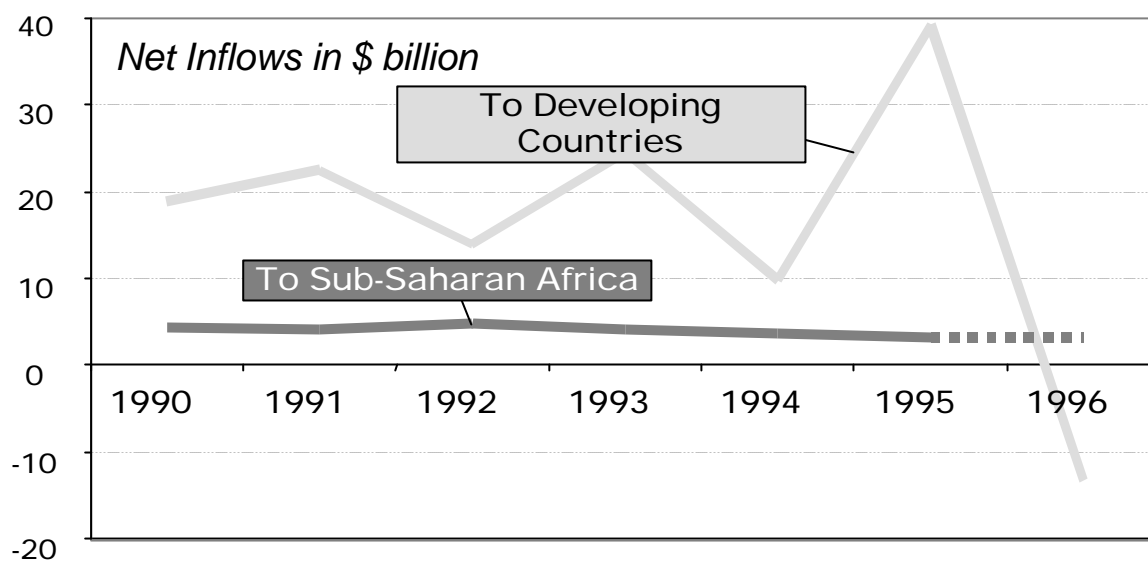
*Source: IMF, Genesis Staff Calculations*

corporations. By contrast, the developing world has relied on private sources for 90 percent of capital inflows during the 1990s. Only ten percent came from other governments and the international organisations such as the IMF and the World Bank.

Africa will not be able to rely on official flows to fund its future growth path. Official lending is a declining source of capital for investment purposes, as can be seen in the chart. Developed country governments are cutting expenditure on foreign aid and development lending, whether disbursed directly or through the international organisations. Note the flat and declining level of flows to the Sub-Saharan region in the chart below.

The focus of multilateral organisations has in recent years reverted to crisis lending precipitated by balance of payments difficulties or large-scale financial crises. The sharp changes in flows to the developing countries on the chart reflect lending during crises and repayments thereafter.

It can also be argued that official lending is less useful than private flows for investment purposes. Private flows carry with them valuable information or other attributes that strengthen the economy receiving the flows. For example, capital entering a country in the form of foreign direct investment often brings with it new technology, market access and management techniques. Portfolio flows, for all the risks they carry, help local financial markets to become more liquid and sophisticated, with considerable spin-offs for the real economy. (The impact of different types of inflows will be considered in a moment). Official flows, on the other hand, usually do build the private economy and domestic financial markets. Indeed, if wrongly designed, official flows distort the political economy and delay reform. In defence of official flows it can be said that they



**Figure 8: Official Debt Flows, 1990-96**

*Source: IMF, World Bank Data*

can carry valuable information along with them and the balance of payments support offered is real.

Irrespective of one's view of the relative merits of official and private flows, there is little doubt that official flows will not be available in large magnitudes for the financing of investment. Africa will need to follow the developing countries in switching to private sources of foreign capital. The first signs of this shift appeared in 1995, when official flows to the Sub-Saharan region Africa fell to 39 percent of total inflows. It is too early to say whether this constitutes a trend.

Along with different origins, the type of capital flows to Africa has differed sharply from the developing country norm. The bulk of foreign flows to developing countries has been in the form of FDI and portfolio investments, each representing more than a third of net inflows. Only 29 percent of inflows have been in the form of bank debt. The change from the previous episode of high flows during 1978-1982, which was dominated by bank lending, is dramatic. The composition of Africa's inflows remains loan-heavy. During the 1990s, debt and related flows accounted for more than half of capital flows to Africa. FDI accounted for twenty percent of African inflows.

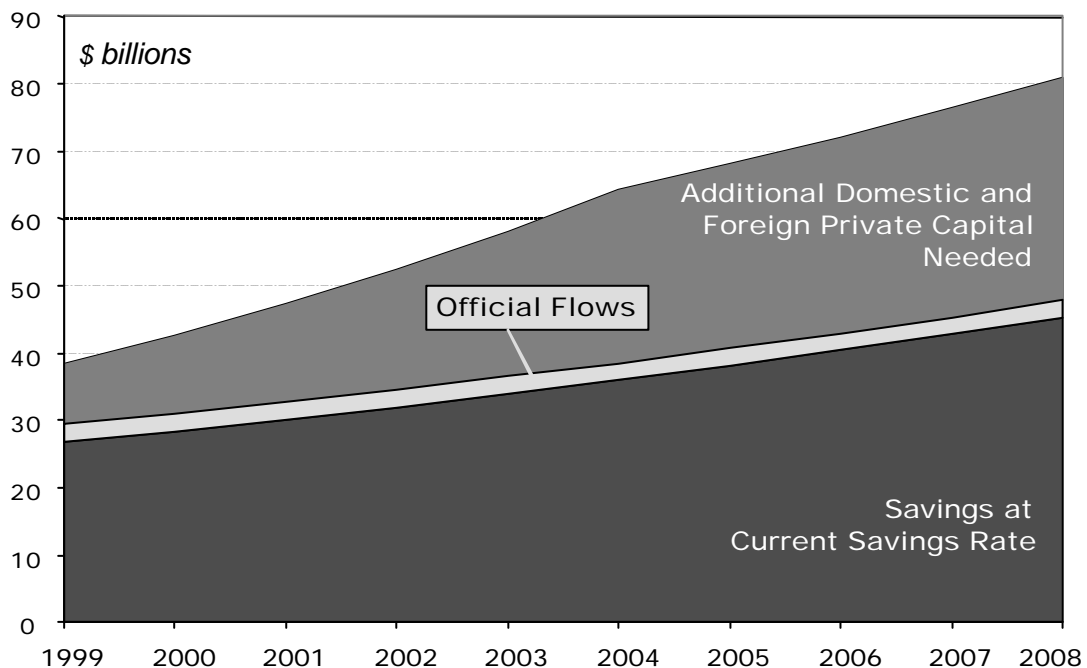
For Africa to follow the rest of the developing world in diversifying its capital flows from loans to securities such as shares and bonds, it will require the services and markets typically offered by an international financial centre. Direct investors into a region, too, benefit from the risk management, information and monitoring services offered by the hub servicing that region.

## An Estimate of Africa's Future Capital Needs

It is when we estimate Africa's future capital needs, and evaluate the ability of current sources to satisfy this need, that the role for a regional financial centre becomes evident. The simulation itself proceeds in a straight-forward way. We investigate a scenario in which the region gradually builds up to a six percent growth rate, achieved in the year 2000 and sustained beyond that. That, in turn, requires a commensurate increase in investment levels. Hence an assumption that investment climbs gradually from present levels to reach 25 percent of GDP in 2004. The reader is reminded that this level still falls below the 1995 average for developing countries of 27 percent, and far below the level reached by Asian countries during their high-growth era, around 36 percent.

Under this growth scenario, Sub-Saharan Africa (excluding South Africa) will need to invest a total of \$600 billion on a gross basis in the next ten years. Given the low level of domestic savings, it is no surprise that a constraint arises on the funding side. To start, we assume a stable rate of savings, as a percentage of GDP, as well as flat foreign inflows in real terms, which may be optimistic. Under those circumstances, additional funding of \$221 billion would be required to fund the investment levels stipulated. Over the next decade, Sub-Saharan Africa can raise the \$221 billion shortfall from only two sources. These are increased **domestic** capital mobilisation and the attraction of **foreign private savings**. In both cases, tapping these sources requires vastly better financial intermediaries and markets.

Even a rapid improvement in domestic savings behaviour cannot fund the full investment programme required for higher growth. If the rate of domestic



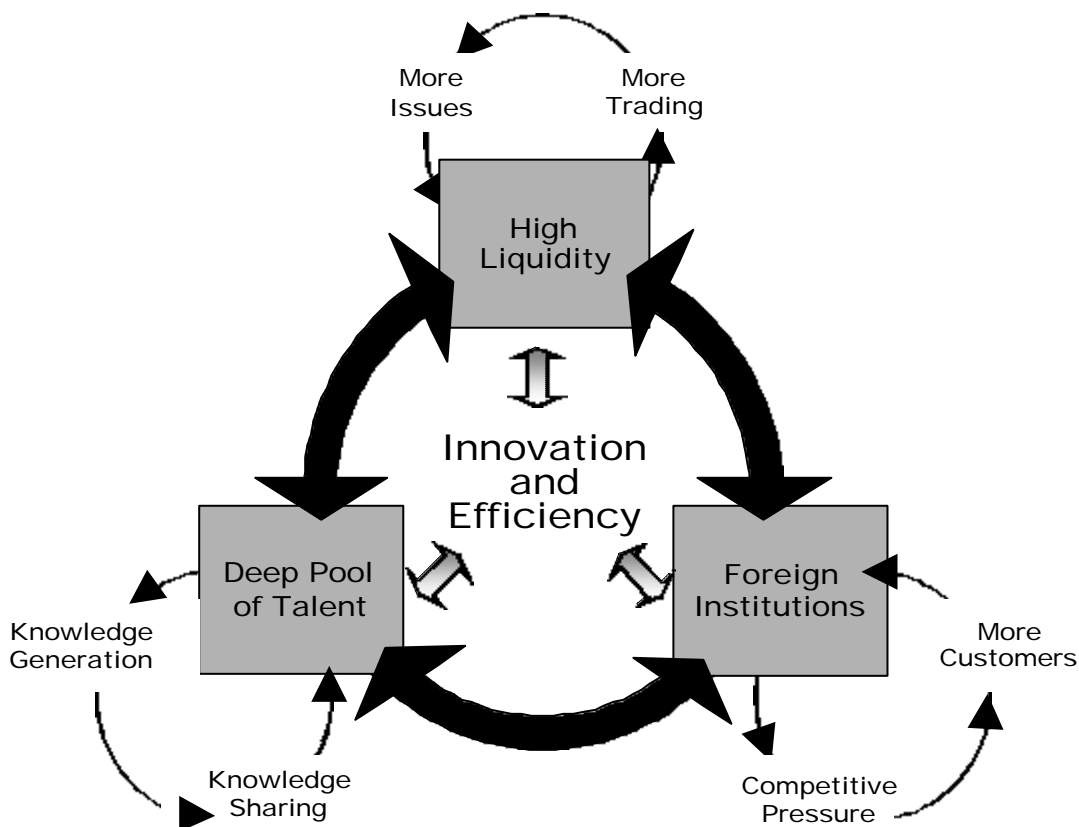
**Figure 9: Africa's Funding Needs, 1998-2008**

Source: Genesis Staff Calculations

savings relative to GDP were to increase by .75 percent of GDP per year throughout the period, private foreign inflows of \$127 billion would be required, equal to five percent of regional GDP for the period. Africa requires, then, improved mobilisation of both domestic and foreign private capital to fund higher growth. This creates a role for a regional financial centre, as long as it is consistent with strengthening domestic financial systems in the region.

## How to become a regional financial centre

Of the four greatest advantages London has over its rivals, three are a direct consequences of the City's incumbent position as an international financial centre. These advantages are the **liquidity** of its capital markets, a large pool of **qualified staff** and the presence of **foreign institutions**. These elements feed on one another, and together generate the continuing efficiency and innovation that, in turn, bring about yet more liquidity, good people and large institutions. Together, they bring about an on-going dynamic of innovation and increasing efficiency – the two competitive advantages that pull financial centres ahead of their rivals. The lead in innovation and efficiency (i.e., low cost) attracts yet more listings, trading and liquidity to the centre, followed by more institutions and good people. And so the cycle continues, as the graphic shows.



**Figure 10: The Pro-Competitive Cycle of International Financial Centres**

Source: Genesis Analytics

## ■ **Liquidity**

Liquidity is the ability to buy or sell an asset with minimal delay or impact on the price. In an illiquid market, a party's transaction inevitably causes an adverse price movement, which makes it difficult for an investor to realise profit or change a position. Most importantly, a lack of liquidity makes it difficult to manage downside risk. An investor can be stuck with an unwanted exposure because of a lack of liquidity. Also, a lack of liquidity in the underlying asset inhibits the development of derivative markets and hence the laying off of risk. Most recently, during the recent turmoil in Asian markets, a dramatic loss in liquidity increased investor losses tremendously.

Liquidity is commonly thought to have four dimensions: width, determined by the bid-ask spread for a given number of securities; depth, the amount of securities that can be traded at given bid and ask quotes; immediacy, the amount of time to carry out a transaction; and resiliency, the time it takes before prices revert to former levels after a large order has been absorbed by the market.

The focus on liquidity has worked to the benefit of the larger financial centres, who have a built-in advantage that is critical to the virtuous circle. Liquidity is an asset that appreciates naturally as trading gravitates to the centre that offers the most of it, in terms of greater immediacy of transaction and depth. Note the self-reinforcing process.

Because of the need for liquidity, institutional investors demand market infrastructure characterised by efficient wholesale markets which can process very large transactions very rapidly and contribute to liquidity.

## ■ **A Large, Skilled Financial Workforce**

Financial centres boast an extraordinary large and sophisticated pool of financial talent. The huge financial services labour markets give firms considerable flexibility in constructing teams for developing products and servicing clients. New York's financial skills pool numbers around 450,000 persons, and Greater London's, more than 600,000.

Large skills pools are particularly important in international financial services for a number of reasons. Firstly, people account for 50-60 percent of an investment bank's costs. The proportion is higher still for asset managers and consulting. Secondly, large pools of specialised skills increase the level of competition by enabling new and small firms to find employees readily. The increased level of competition, in turn, improves efficiencies and acts as a spur to innovation.

Like liquidity, this advantage feeds upon itself. The existence of the pool of talent attracts more businesses, whose employees add to the size of the pool. And within the pool there is a constant transmission of best practice amongst employees. It is not something that can be built up overnight. That is why the skills pool is one of the most difficult elements of an international financial

centre to replicate. And yet, where the skills pool is located, matters. The economy that wins the value addition of this corps gains enormously in terms of additional demand, tax revenues and foreign exchange.

### ■ **The presence of foreign institutions**

The presence of foreign institutions is perceived to be the largest advantage London has compared to Paris and Frankfurt. The Governor of the Bank of England describes the City as “an extraordinary concentration of the strongest financial businesses from all around the world.”

A large foreign presence is also cultivated by the younger financial centres. Hong Kong is host to around five hundred foreign banks from over forty countries, including 82 of the top hundred banks in the world. Of the 152 commercial banks active in Singapore, 140 are foreign. Foreign bankers frequently mention that their offices in London serve as important relaying points for new products and techniques.

This attribute, too, is self-reinforcing. With the presence of foreign institutions comes talent, innovation, business opportunities and the spur of competition. With competition and the movement of employees, the knowledge one firm has spills over to other firms. Each firm derives extra benefit from the proximity of other firms.

### ■ **The result: constantly improving efficiency and innovation**

We explained above how, once achieved, liquidity, a pool of talent and the presence of foreign institutions each tends to be self-reinforcing. What makes the position of a financial centre with those elements present so strong, is that they also tend to be mutually reinforcing. Liquidity draws traders, analysts and corporate finance teams from around the world, firms are attracted by the pool of talent available, and the increase in trading from all these participants improves liquidity further.

But liquidity, talent and foreign institutions combine far more powerfully to strengthen the position of the incumbent: The competition so generated precipitates an on-going process of increasing efficiency and product innovation. Thus we can conclude that the pro-competitive cycle is at the heart of the success of a regional financial centre:

## Four Objectives to Underpin South Africa's WTO Offer

**What are the implications of this chapter for South Africa's input into the WTO negotiations? It strongly suggests that such inputs should be motivated by the same objectives that underlie financial regulation more generally. These are:**

- **A highly efficient financial system (in terms of allocative and operational efficiency)**
- **A financial system in which risks are well-managed, leading in aggregate to low systemic risk**
- **A system in which vulnerable individuals are protected against sharp or reckless financial operatives**
- **The promotion of local value added.**

**The lessons of Mexico, Asia and Russia suggest a hierarchy of objectives: efficiency and systemic stability are critical matters, to which the promotion of local value-added should be subordinate.**

## 2

# The Context of the Negotiations: A Revolution in International Finance

Policymakers and regulators in finance need to master the change dynamics that are sweeping financial sectors in virtually all countries. These structural changes have destroyed old locational advantages and created new ones, causing the locus of financial services provision to shift, with important implications for cross-border supply. At the root of the change are tectonic shifts in technology, regulation and consumer preferences. These shifts, in turn, have heightened the level of competition in virtually all aspects of finance. We have identified six 'sites of competition' where intense rivalry is contributing to a number of critical trends.

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South Africa's response to these major trends will determine our competitiveness as a financial centre.

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In this flux, the overall effect will be to increase choice. Any particular transaction will have a number of markets available for execution. In time, both wholesale and retail markets will become internationalised. In South Africa and the region, banks, established exchanges and insurance companies

will look very different a few years from now as their core activities change. In this chapter five critical trends are identified. These trends flow from the higher intensity of competition, which we consider first.

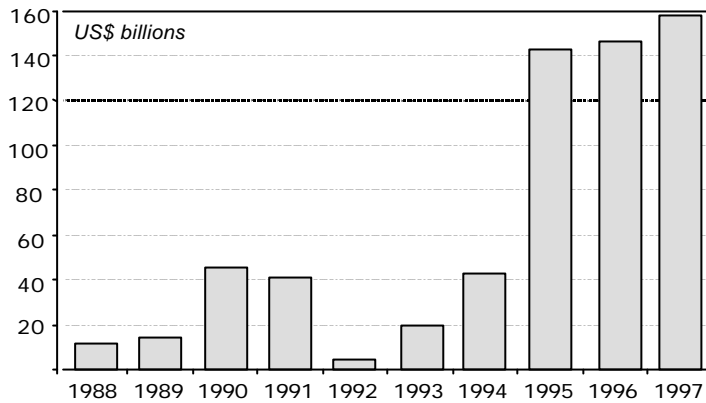
### Five Areas of Heightened Competition

Established financial institutions and exchanges find themselves surrounded by new competitors. 'Balance sheet' intermediaries like banks and insurance companies are facing competition from firms using securities markets to bringing providers and users of capital together. Established exchanges are increasingly competing with one another, while facing challenges from alternative trading systems and over-the-counter trading. And in many areas, regulated providers of services and products are confronted by unregulated rivals. This translates into competition between different regulatory regimes. The overall picture is one of exciting growth opportunities and significant threats to existing franchises. It is a picture that is best understood by considering each of the six sites of competition.



## ■ Competition for deposits

The growth of money market funds that act as deposit accounts has rocked the foundation of traditional banking. These products, also known as 'cash management accounts' or 'cash unit trusts' are initially launched into the



**Figure 11: US Money Market Funds: Net Inflows**

*Source: Federal Reserve*

market by mutual fund companies. The effect has been to decimate margins on retail call and cheque deposits, leading to a reassessment by banks of their entire balance sheets, and by extension their strategies. The result: a profound change in how money is saved, and how investment capital is sourced.

Because money market funds fulfil a function

similar to bank deposits, the expectations of investors are different. Specifically, money market funds are expected to maintain the value of units at one currency unit, while earning high returns. These expectations have led to a on-going series of regulatory responses by the Securities and Exchange Commission, aimed at maintaining confidence in these products. The first South African money market unit trusts were launched in May 1997. At the time of writing, assets were reported to exceed R 15 billion.

## ■ Competition for long-term investments

Traditional investment products like bank savings deposits and life insurance have lost business to booming mutual funds and related products. In South Africa, insurers have lost single-premium policy business to unit trusts. The intensity of competition is seen in the growth of unit trusts over the last ten years: the number of unit holders is up five times, assets under management up twenty-fold, and annual gross sales up thirty-fold.

## ■ Competing providers of credit

Intense competition on the asset side has been mirrored in increased competition on the liability side. Banks in mature economies are facing new rivals in credit provision, particularly alternative originators of loans that are subsequently securitised. The result: a margin squeeze. In response, banks and non-banks have become more aggressive across all risk classes, with margins being driven too low in certain cases. Even at the time it was clear that, by the middle of last year, margins on internationally syndicated loans to East Asia no

longer reflected perceptible risk. When low margins combine with increased risk, banking regulators have cause for vigilance.

### ■ **Competing customer channels**

Large-scale access to retail customers traditionally required massive fixed costs to build a branch network and a brand name. This has been a crucial determinant of industry structure. The up-front costs raised barriers to entry, with a commensurate limiting of competition. For banks, the high value of incumbency created a strong incentive to act prudently, adding to the stability of the banking sector. In future, industry structure will be very different. Use of the Internet (and of the plain old telephone) will enable entrants without a branch network to compete for customers. The second barrier to entry, the brand, is also under attack. In many countries, well-regarded non-financial brand names are used in new ventures to sell financial services. As competition proliferates, costs will fall and efficiencies improve. On the other hand, changing industry structure will encourage increased risk-taking by all market participants.

### ■ **Competing trading infrastructure**

In the United States and Britain, alternative systems for trading equities, also known as alternative trading mechanisms or ATMs, are proliferating, although they have yet to make serious inroads into the market share of the established stock exchanges. In other securities, over-the-counter trading is long-established. Overall, competition is redrawing the lines between exchange-traded, ATM-traded and OTC products. Competition between exchanges has also intensified: securities are increasingly listed on a number of exchanges, often with different trading systems and regulatory frameworks.

What are the implications when investors and issuers have a choice of trading platform? The consequences are complex, and the choice of regulatory response a difficult one. For example, the effects of market fragmentation on liquidity and price discovery are not always well-understood. Regulators will navigate this terrain successfully only if they have a clear sense both of the purpose and the effects of their regulatory stance. For their part, established exchanges will have to assess the implications of alternative trading platforms with great care.

## The Internet is supercharging these competitive forces

Ubiquitous use of the Internet for financial transactions is no more than 24 months off. A host of services are offered, and uptake has been quicker than expected, both in the United States and in follower countries like South Africa. Substantial take-up of **cross-border financial services offered through the Internet** is probably at the most 24-36 months away, by which time exchange controls on individuals will probably have been lifted.

The overall effect at this point in the evolution of the Internet distribution channel is to further heighten competition in each of the five areas of competition mentioned. Competition for deposits will increase as new Internet banks – some based on cybercash services, some as ‘narrow banks’ and some full-service banks – enter the market without the need for branch networks. Many of these entrants will leverage off large existing customer bases, and will therefore be started by insurance companies, utilities, and the like.

Similarly, asset management services (brought to the market in the form of investment products such as unit trust and tailored pension plans) will experience a proliferation of direct Internet-marketing. Traditional sellers of long term investment products such as independent financial advisers and tied agent forces will find a growing cyber-generation of clients balking at their high fees. As fee competition increases, customers will enjoy cheaper and more transparent financial products. Client protection will gain prominence and changing savings patterns will give food for thought for policymakers.

Capital markets will not be spared the turmoil. A number of Internet-based alternative stock exchanges are creating formidable competition to the New York Stock Exchange and NASDAQ in the United States. Similar trends may occur in South Africa, threatening the traditional monopolies of the JSE, SAFEX and the Bond Exchange. Brokerage services will be hit with a plethora of low cost broking services. As these entities move to the provision of margin financing in order to make money, new risks may emerge, placing a larger load on broker monitoring by exchanges just as these self-regulatory organisations will face their own competitive pressures.

It can be expected that life and property insurance will internationalise further increasing the need for co-operation between national regulators in these areas.

Finally, regulators will need to give thought to the many difficult enforcement issues that will arise in an Internetised and internationalised financial sector.

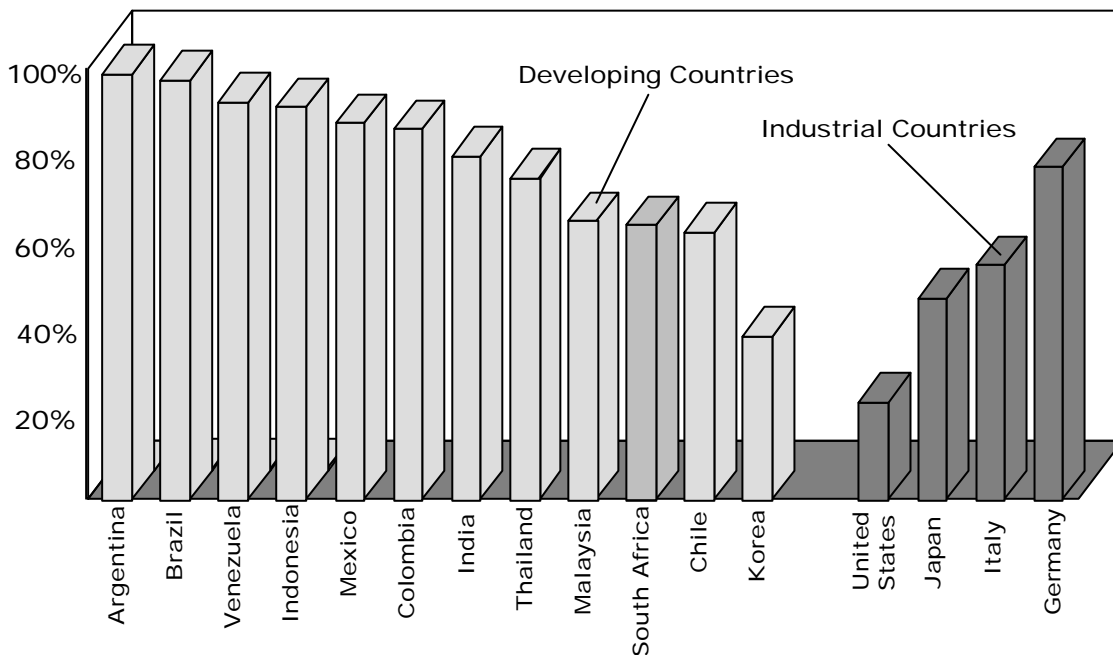
## Five Critical Trends

Competitive pressures have set off successive cycles of entrepreneurial action, competitive counterattack, and regulatory response. From this five major trends have emerged.

### ■ The shift to market intermediation

As margins of some traditional banking activities have fallen, banks have reassessed their use of capital. This is done by comparing the income generated by a loan, or other use of resources, to the cost of the capital held against it to comply with the Basle capital adequacy requirements.

It is not surprising, then, that the margin squeeze has led to a redeployment of the bank's resources. Money that would previously have been borrowed from a bank is now often raised in the bond or other securities markets. In technical jargon, funds previously intermediated through the banks are now intermediated through the securities markets. The chart below shows how much smaller banks' share of intermediation are in the advanced economies than in developing economies. This is a result of the move to the market.

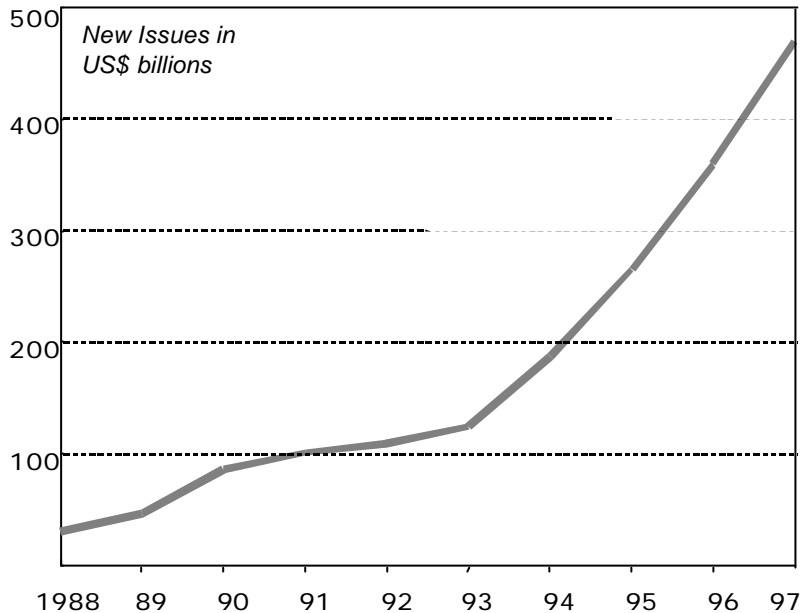


**Figure 12: Banking Sector Assets as a % of Total Financial Institutions' Assets, 1995**

*Source: Bank for International Settlements*

The two most important forms of market intermediation are the issuing of corporate bonds and the process of securitisation. Large corporates are tapping the bond market for an increasing share of external financing. In the United States, lower tier corporates can also access the bond market with ease.

Securitisation occurs when assets such as home mortgages are removed from the balance sheet of the originating institution, pooled, and the future cash-



**Figure 13 :World-wide Issue of Asset-backed Securities**

*Source: The Economist*

flow sold in the form of traded securities. The mainstays of the market continue to be home mortgages and credit for consumer durables. The securitisation of corporate loans is now gaining ground. In five years, world-wide annual issues of securitised assets have quintupled to \$500 billion.

To be sure, regulatory arbitrage aimed at minimising exposure to the Basle capital requirements has encouraged the move to the market. But at the same time securities markets have proved to be an attractive and viable substitutes for bank credit that may in some cases also be cheaper.

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**Securitisations are increasingly done off-shore - in centres with the right skills and legal infrastructure.**

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The move to market intermediation has implications for banks, securities markets and regulators. Most importantly, it is a vital element in the future evolution of financial services. This it achieves, firstly, by fanning the flames of competition. While the result

of competition, market intermediation, by making it possible for non-traditional firms to enter new market areas, intensifies competition further (see the next section).

The use of securities in this way has spin-offs for financial market development, and financial centres. Securitisation is increasingly done off-shore in centres with the right skills and legal infrastructure. Securities of this kind also require large amounts of information and analysis to assure potential buyers of their value. The secondary markets in these securities makes possible the development of options and futures based on the value of the underlying

asset pool. These derivatives may turn out to be valuable devices for managing credit risk.

## ■ **Product and risk components are being unbundled**

A financial product hitherto provided as one product and sold by one provider, is now often split into components. The purchaser can choose which components to purchase from whom, and which to leave out entirely, or pass on. In many cases, a product's 'value chain', or production elements, are being unbundled. Still more ubiquitous is the unbundling of the various risk elements of an instrument. Below, an example of each form of unbundling is given, and consequences for the location of financial activities sketched.

**UNBUNDLING THE VALUE CHAIN.** A securitisation may involve one firm originating the loans, another servicing them, and a third structuring the securitisation. A fourth group, the holders of the securities, might provide the capital. Unbundling allows for each link in the value chain to be taken care of by the most efficient entity. There is more competition, as niche firm providing only a certain component can enter the market. One example is the host of non-traditional originators of mortgage loans spawned by securitisation.

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Unbundling means that locations will compete, on efficiency grounds, for every link in the value chain.

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The unbundling of the value chain will determine the future shape of financial centres. Product elements benefiting from the scale economies of the centre will increasingly be located and executed at the hub. Elements where customer proximity is important will be diffused.

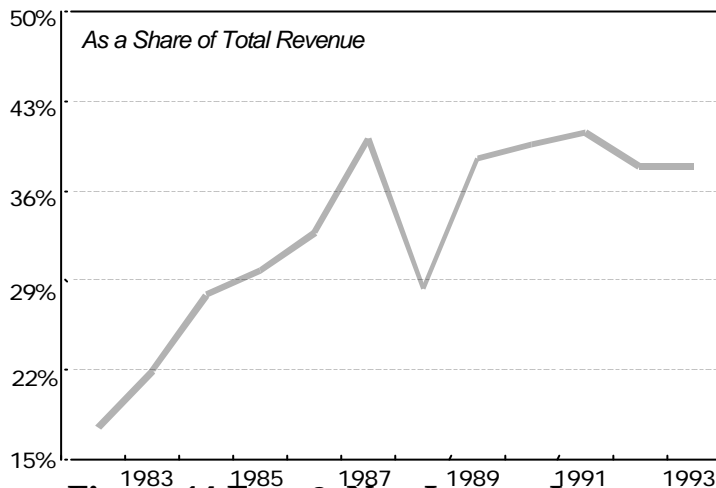
For example, a derivative product may be sold to a Greek corporate treasurer by a salesman based in Athens, but the product will be structured, priced and traded in London. Unbundling means that all locations will compete separately, on efficiency grounds, to retain every link in the value chain.

**UNBUNDLING RISKS ELEMENTS.** Derivative instruments are used to separate complex risks into their constituent parts. Take for example, the risks faced by a dollar-based investor in a Turkish bond. The risks posed by currency fluctuations, changes in interest rates and the solvency of the counterparty can be stripped off and traded separately. This enables parties to choose only the risks they are prepared to evaluate and manage, and to lay the other risks off in the market. This ability has encouraged many investors to invest in emerging market assets, contributed to the increase in cross-border flows. Risk management instruments have also become an invaluable tool for traders, producers and investors in the real economy. In the African context, the lack of similar tools to manage risks inhibits cross-border transactions in both the financial and the real economies. Designing and trading risk management instruments are traditionally dominated by the financial centres, and are crucial hub skills.

The risks laid off are of course passed on to a counterparty. Derivative instruments have changed and greatly complicated the risk profiles of many financial institutions, creating challenges for their managers and regulators alike.

## ■ The changing nature of banks

How have banks in advanced economies reacted to the slew of pressures? In the United States, banks have shifted emphasis towards capital markets.



**Figure: 14 Fees & Non-Interest Income at U.S. Banks**

*Source: Federal Reserve*

They have utilised their competitive advantages in loan origination and servicing, the utilisation of their customer base, and other fee-based services.

The chart shows the rise in fees and non-interest income of U.S. banks during the transition period from the early 1980s to the early 1990s. Income not related to interest rose from a fifth of total revenues to a third.

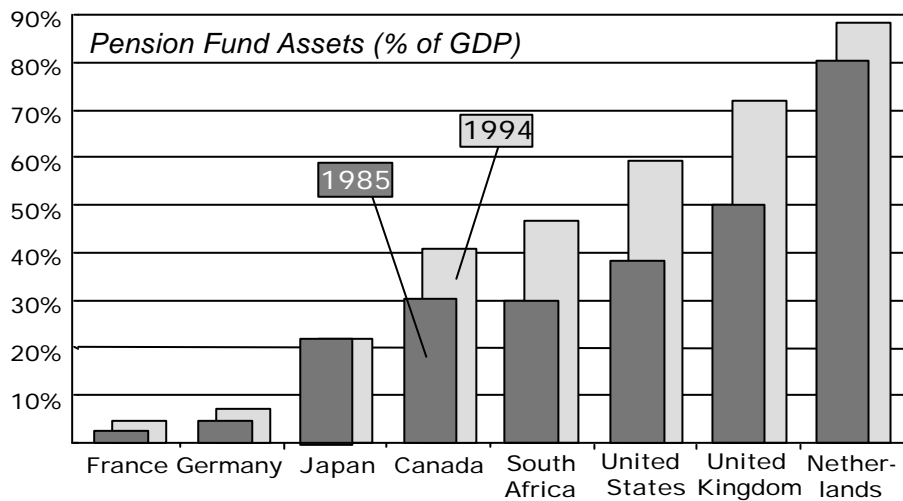
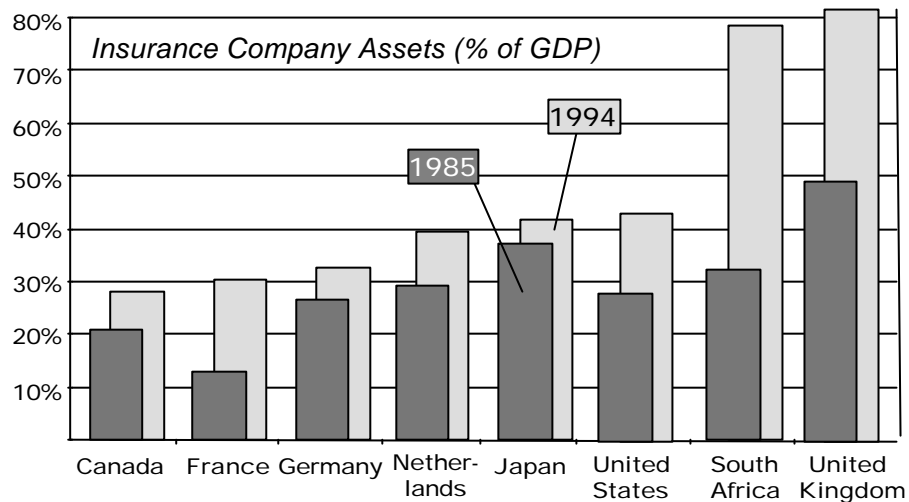
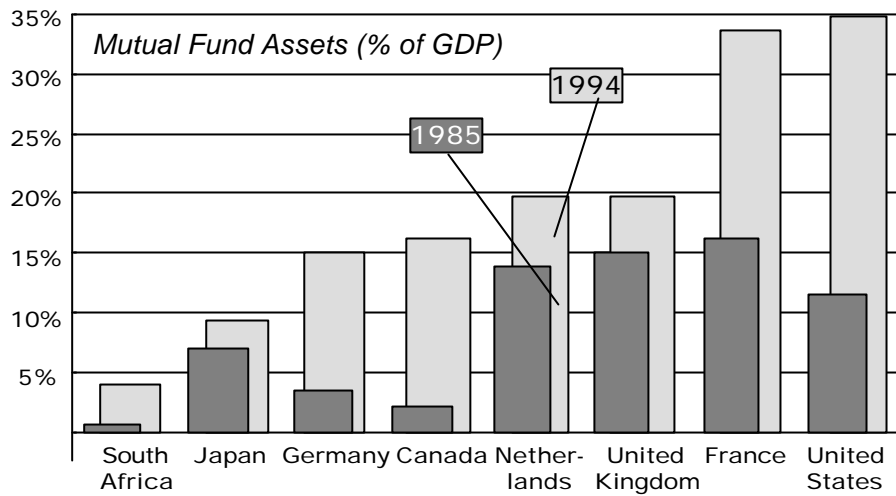
In Europe, a similar shift has now started. Most

analysts believe changes in the banking sector will be hastened by the competitive pressures about to be unleashed by the adoption of the euro. With the changed revenue structure comes a change in banks' risk profile and management strategies.

## ■ The rise of institutional investors

Institutional investors – insurers, mutual funds and pension funds – have become the preferred form of investment for households. Between 1985 and 1996, assets of U.S. institutional investors doubled as a percentage of GDP to 140% of GDP. Today, institutions in the mature economies control more than \$20 trillion in assets.

## The Rise of Institutional Investors



Source: World Bank, SARB.



Institutional investors played a central role in the redirection of funds to the developing world during the 1990s. Institutions have been equally instrumental in the wave of changes described in this chapter. As the OECD has pointed out, a strong community of institutional investors is a precondition for the development of deep securities markets with sophisticated financial instruments. Trends such as securitisation, the growth of bond and equity markets and the use of derivatives developed in large measure in response to the institutional investor community.

The charts opposite show the growth of institutional investors. Relative to GDP, the assets of mutual funds (unit trusts), pension funds and insurance companies have grown significantly in virtually all advanced economies. The charts reveal how advanced the South African economy is in terms of the role of institutional investors, particularly pension funds and insurance products.

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South Africa's institutional investors are a powerful base for cross-border financial service provision.

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The take-up of unit trusts is still fairly low (although growth in money market and other funds will, over time, close that gap). Given the central role played by institutions in international flows, this presents a solid base from which to develop key elements of a financial hub.

Reliance on private flows means, first and foremost, attracting institutional investors to the continent. This is a role a regional financial hub can play by providing the sophisticated trading and regulatory infrastructure required by institutional investors.

## ■ A new world for managers of systemic risk

The changes discussed in this chapter, together with the dramatic increase in cross-border flows, may in some circumstances add to the risks faced by the financial system as a whole. Three elements require close monitoring by regulators.

**BANK MARGINS AND FAILURES.** The reduction in bank margins, together with other factors, have led to banking sector weakness in a number of countries, culminating in banking crises in regions as diverse as North America, the Nordic countries, Latin America and Asia. In the near future, South African banks will face the competition and margin squeezes that have occurred in the advanced countries. In order to protect their returns, banks will be under pressure to assume more risk at the same time as their core business will be shifting. This creates additional challenges for managers and regulators who will need to ensure that early-warning systems are in place.

**CROSS-BORDER TRANSMISSION OF SHOCKS.** As Alan Greenspan has pointed out, the integration of world financial markets has, for all its benefits, created the capability of transmitting mistakes at a far faster pace throughout the financial system. Today's technology enables single individuals to initiate

massive transactions, and accumulate equally massive losses with very rapid execution. In some ways then, increasing global financial efficiency has increased the potential for systemic risk. During the Asian crisis, currency volatility revealed, and further exacerbated, widespread weaknesses in domestic banking sectors.

**NEW KINDS OF MONEY.** Non-traditional providers of payment services, using electronic means, may be creating new forms of money, with consequences for both monetary policy and the management of systemic risk that are not yet well understood.

## Implications for South Africa's WTO Offer

**Three main implications arising from these trends deserve consideration by South Africa's financial regulators and negotiators at the WTO.**

***First*, the optimal location of financial services is shifting as new technology and processes create new scale economies. In principle, South African and African firms and consumers should gain access to these efficiencies.**

***Second*, innovation is passed on along global networks within and among firms. It is important that South Africa's financial sector be plugged into these networks.**

***Third*, the Internet provides the technological means for hitherto unimagined access of South African consumers and firms to services offered by foreign firms with no physical presence in South Africa. This is the case around the world: therefore rules governing cross-border provision will be of great importance in the coming WTO rounds.**

# 3

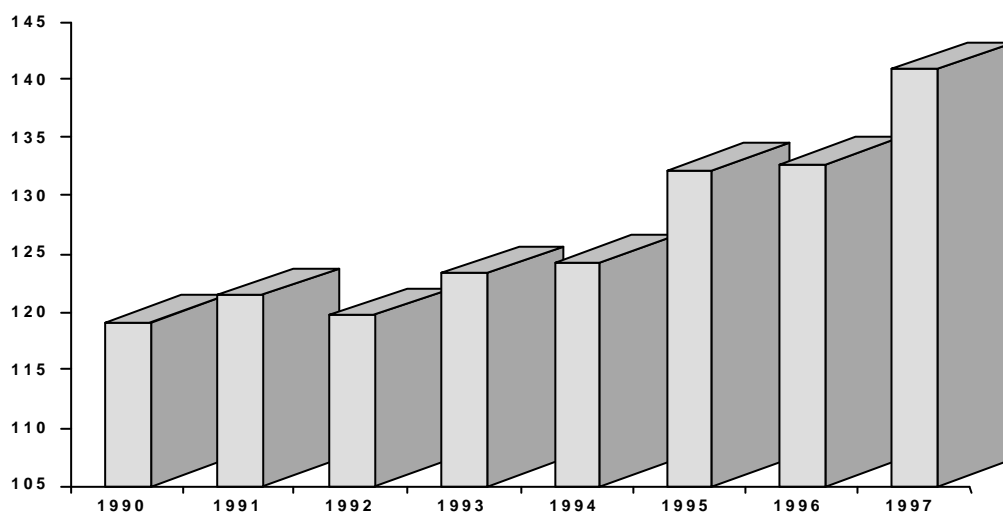
## The Banking Sector

An efficient and stable banking sector is critical for the efficient allocation of capital and management of risk in an economy. This chapter investigates this in the South African context.

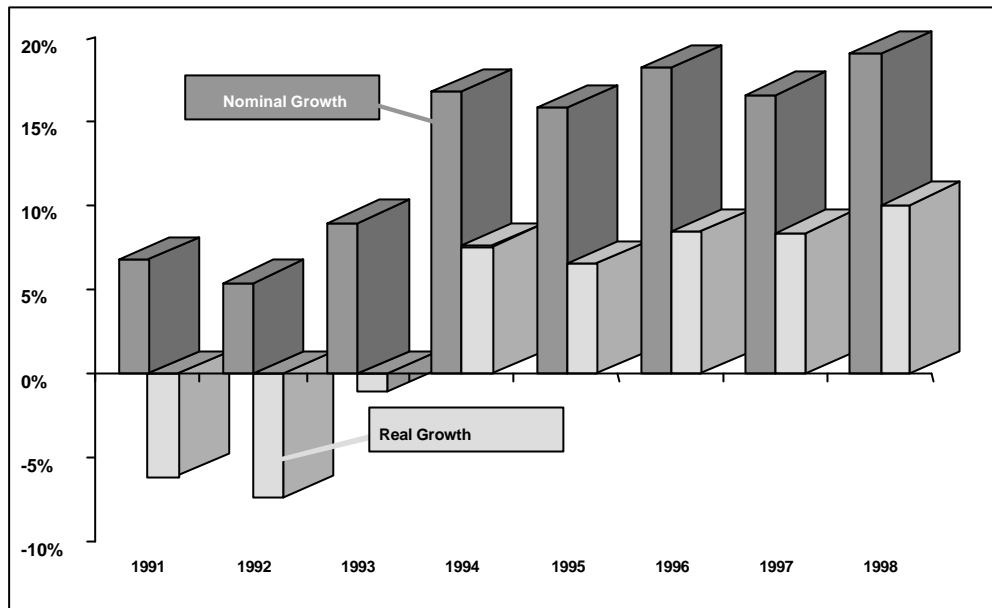
This chapter is divided into two main parts. The first part describes the domestic banking sector, highlighting performance, stability and foreign entry. Important trends are also identified. The second section examines the openness of the South African banking sector. The section draws together the present WTO commitments and the possible requests likely to be encountered the next round.

### Banking in South Africa

**Employment.** The figure below shows employment in the banking sector between 1990 and 1997, the latest year for which figures are available. Employment increased by 18 percent, or 22,000, over the period between 1990 and 1997, to a level of 141,000.



**Figure 15: Employment (000's)**  
*Source: SARB*

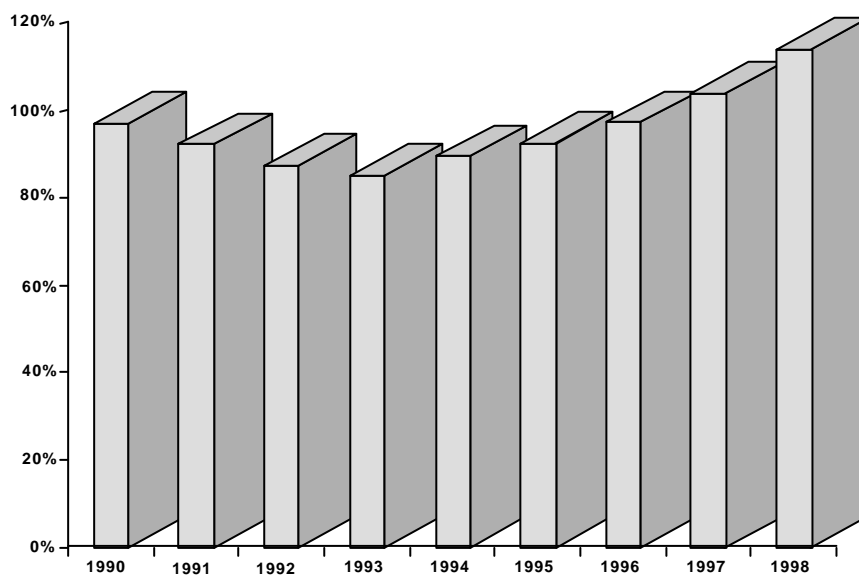


**Figure 16: Annual growth rate of total assets of the banking sector**

Source: SARB

**Assets.** At the end of 1998 assets of the banking sector totaled R654 billion, having grown at an average of 3 percent per year in real terms since 1990. All real growth occurred after 1994: in this latter period the annual real growth averaged 6.6 percent.

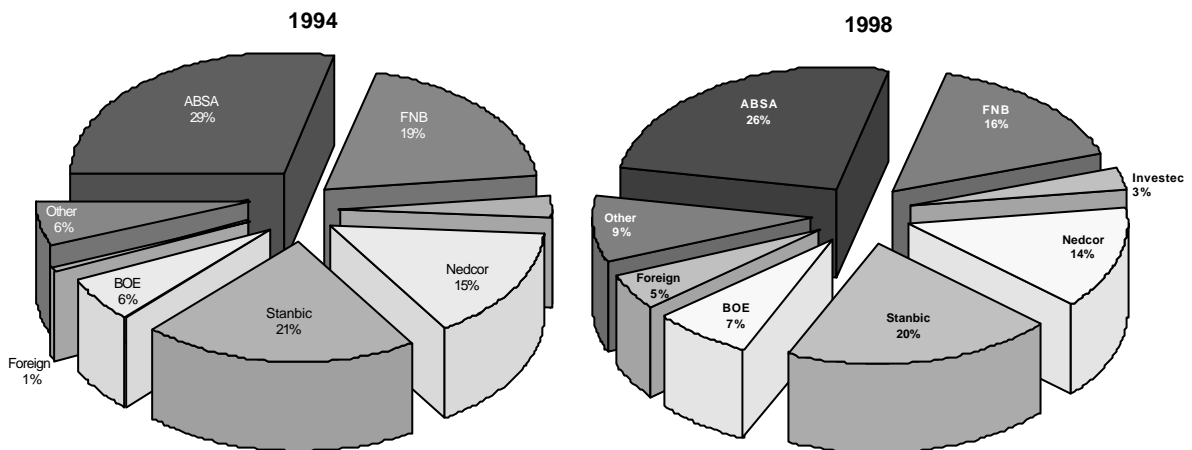
**Increasing depth.** Banking assets as a percentage of GDP measures the depth of the banking sector. Figure 3 below shows that banking sector depth has increased since 1994, breaking the 100 percent level in 1997. This increase implies that the banking sector growth has exceeded GDP growth since 1994.



**Figure 17: Depth of the banking sector (GDP/Assets)**

Source: SARB

**Concentration.** There were 43 registered banks and mutual banks in South Africa at the end of 1998. The five largest banks accounted for 83 percent of the total assets of the banking sector in 1998, a very high level of concentration. Compared to 1994, though, market share of the top five banks is down by 7 percentage points. Over half of this decline is accounted for by the increased market share of the foreign banking sector.



**Figure 18: Market share as a percentage of total assets**

Source: Banking Council of South Africa

**Stability.** One indicator of the health of the banking system is the ratio of capital to risk-weighted assets, as capital provides a safety net to depositors and other providers of loan finance against losses that a bank might incur. The lack of an adequately capitalised banking sector is illustrated by the widespread bank failures during the Asian crisis. In a recent report the IMF had this to say on the soundness of the South African banking system:

*Overall, the South African banking system was found to be generally sound – in sharp contrast to some in East Asia, whose flaws played a major role in triggering the present global crises. South African banks are well capitalised, well run and organised and, in general, have sophisticated risk management schemes and corporate governance systems in place.*

The average capital to risk-weighted asset ratio of the banking sector increased from 9.6 percent in 1994 to 10.7 percent in 1998.

In April 1998 Standard and Poor's noted in a bank industry risk analysis of South Africa that:

*“During a time when many emerging markets throughout the world have suffered the collapse of their financial services industry due to imprudent credit decision-making of funding mismatches, it is instructive to consider the resilience of the South African banking sector”*

In discussions with market players, many indicated that the South African banking system is perceived to be more credit worthy than the BB+ (stable) national rating from Standard and Poor's.

**National payments system.** South Africa's national payment system compares favourably with the best in the world. The large exposures among major participants in the financial markets and introduces systemic risk into the payments system. Default by one party could conceivably cause a chain reaction of defaults, ultimately affecting many banks. The South African Reserve Bank (SARB) monitors and manages the systemic risk in the national payments system. Over the past few years the SARB and the banking sector have developed a National Payments Strategy to ensure a secure, stable and efficient national payments system. A number of self-regulatory risk management strategies are being put into place within the framework of the National Payments System Act, passed in 1998. The critical high-value, low-volume, payments amounting to more than 90 percent of overall transaction value, are now settled on a real-time gross settlement basis. Banks' exposure to each other can be instantly monitored in the system.

**Technology.** South Africa's banking system has leading edge technology and communications systems. It has one of the best cheque-clearing systems world-wide, which forms part of the national payments system and works on a daily netting basis. In 1996, 1 million cheques were processed per day by the clearing system, which is approximately equivalent to 327 million cheques during the entire year. Overall, domestic banking technology and infrastructure are unmatched in Africa and compares favourably with other first world countries.

**Competitiveness.** In Africa, the competitiveness of the Southern African banking system is derived from its sophisticated corporate governance, high level of regulation and low private (external) debt.

**Legislation and supervision.** The Banks Act of 1990 regulates the banking sector. The Banking Supervision Department of the Reserve Bank issues regulations in terms of this Act and supervises the industry. The Banking Supervision Department has adopted the Basle Core Principles for Effective Banking Supervision and uses the principles as a benchmark for assessing the ongoing effectiveness of its supervisory process. Regulation dealing with foreign access is discussed in more detail below.

## Foreign entry in South African banking

The number of foreign banks active in South Africa has more than doubled since 1995. Growth in the foreign banking sector has been phenomenal.

Between 1994 and 1998 the market share of the foreign banking sector increased from 1 percent to 5 percent, with assets of R35 .4 billion by the end of 1998. It is expected that the inflow of foreign banks into South Africa will continue.

**Legal form of entry.** Banks can enter South Africa by establishing a representative office, a branch or a subsidiary, depending on their level of activity. Representative offices are not allowed to conduct banking business, but perform administrative, marketing and agency work for their parent.

Foreign banks need to establish a separately capitalised branch or subsidiary with a banking license to:

- To take deposits (subject to certain limitations)
- Become an authorised foreign exchange dealer and
- Become a primary dealer in government securities

Twelve foreign banks have branches, and 58 have representative offices, and there is one subsidiary.

Foreign banks prefer to obtain a South African banking license by establishing a branch as opposed to establishing a subsidiary. The reason is that a branch is given the same international rating as the parent bank. For example, the South African branch of Barclays Bank has the same rating as the parent in the UK, and can raise capital based on this rating. However, a subsidiary, as a locally incorporated entity, would at best be given the South African national rating. In the cases where this is lower than the rating of the parent, raising capital is more expensive.

**Reasons for setting up a representative office.** Representative offices are relationship managers, listening posts and marketing arms for services largely performed abroad. This is reflected in their small staff complements, on average around five and rarely exceeding ten. Although their value-added to the domestic economy is lower than that of branches and subsidiaries, they succeed in offering a wide range of international services, mainly to South African corporates and foreign corporates active in South Africa. In this way, representative offices facilitate the flow of foreign capital to and from South Africa. Representative offices also offer advisory services to the domestic market.

South African parastatals benefit from credit lines extended by these banks and some of these banks have close relationships with South African corporates.

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**The most important service areas for representative offices are:**

- Trade finance
- International commercial finance – SA government and parastatals are provided with foreign credit lines by the parent bank

- Project and structured finance and in most cases foreign capital which comes from the parent company bank is used.
- Corporate finance advisory services

Other service areas: private financing initiatives (PFI), structured products, correspondent banking, commercial and private banking, export credit.

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Representative offices can be a first stage to a larger presence. Many of the foreign banks with a branch presence in South Africa first operated here as representative offices. A number of banks had representative offices in South Africa prior to the sanctions era, pulled out in the late 1980s, re-entered the market through a representative office, and subsequently upgrading their operations to a full branch.

**Foreign bank branches.** At an average staff complement of 83 (and a maximum of 230), branches employ far more people in South Africa than representative offices, reflecting a wider and more complex set of services. The reasons for setting up a branch in South Africa are varied. Although some banks followed customers from their home jurisdictions, most consider an active presence in South Africa to be part of their global network. This country is also an ideal springboard into Africa. Domestic market opportunities are also important occasioned by privatisation and the restructuring of South African industry. Interestingly, some investment banks see their operations as a foothold for an eventual retail banking presence.

**Lending activities** are limited to major corporates and parastatals. Virtually no foreign bank has ventured into lending to smaller corporates, lending to individuals or mortgage lending. The lending areas where foreign banks are active are characterised by a high degree of competition and tight margins.

**Investment banking** There are major operations in investment banking, corporate finance, project, and trade and structured finance. In these operations teams of experts located in South Africa are used, assisted by specialists in foreign offices.

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**Foreign bank branches are prominent in four main service areas:**

- Lending products and loans. Mostly commercial loans and the arrangement of syndicated loans for larger corporates and parastatals.
  - Corporate finance advisory services
  - Foreign exchange dealers
  - Securities trading and relating services (and five of them play a special role in the bond market as a primary dealer in SA government bonds).
- 

**Securities businesses.** In some cases foreign banks have acquired local brokerages and built up extensive securities businesses. These may include agency and principal trading in equities and related derivatives, fixed income trading and OTC derivatives.



**Primary dealers.** In six cases, foreign banks have been appointed as primary dealers in South African government bonds, thus becoming major participants in both the activities and oversight of the Bond Exchange of South Africa. To be appointed a primary dealer by the Reserve Bank it is legally necessary to be a branch, which may have contributed to the decisions by some banks to upgrade to branch status.

**Where foreign banks are not active.** Foreign banks are notably absent from some of the most important banking services, such as individual banking services (deposits, lending, credit card and cheque services), lending to second tier corporates, and mortgage loans. Foreign bank branches are not allowed to take deposits of less than R1 million from natural persons, effectively barring branches from the retail banking market (subsidiaries do not have this constraint, but suffer, as has been discussed, other disadvantages).

**Impact of foreign entry on SA banking.** The orthodox view is that a financial system benefits from the entry of foreign banks. In particular<sup>2</sup>, foreign banks tend to:

- Improve the quality and availability of financial services and products in the domestic financial market by increasing bank competition, and facilitating the application of more modern banking skills and technology,
- serve to stimulate the development of the underlying bank supervisory and legal framework, and
- enhance a country's access to international capital<sup>3</sup>.

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### Examples of the benefits of foreign bank entry into South Africa

**New financial products.** Deutsche Bank pioneered the issuing of exchange-traded warrants in South Africa in October 1997. They have been at the forefront of new warrant products in South Africa and launched the first equity warrant, the first medium cap warrant and the first basket warrant. Of the four warrant issuers currently active in the South African market, three of them are large international banks.

**Regulatory improvement.** Most foreign banks have to adhere to strict internal money laundering rules. They have strongly supported the push by South Africa's authorities for stricter money laundering regulation.

**Access to foreign capital.** Telkom's forthcoming international bond issue will be facilitated by the local branch of a foreign bank, enhancing the access of this parastatal to international capital.

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According to the Banking Council of South Africa in their 1998 Review, commented that the arrival of foreign banks

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<sup>2</sup> Claessens, Demirgüç-Kunt and Huizinga, 1998

<sup>3</sup> Levine, 1996

*“has had a major impact on the domestic banking sector, which has responded by improving skills, developing more complex financial instruments, and introducing more sophisticated information technology and risk management systems.”*

## Trends in banking

There have been two main trends in the South African banking sector over the last four years, namely:

- High but declining cost levels
- Conglomeratisation

**High but declining cost levels.** Foreign banks cost to income ratios are estimated<sup>4</sup> at approximately 40-45 percent. Figure 5 shows that the average cost to income ratio of South African banks' is higher than those perceived for international banks, but declined slightly.

**Conglomeratisation.** In line with international trends, South African banks have diversified into non-banking financial activities such as insurance, unit trusts and other such financial services. This has taken the form of establishing conglomerates that comprise of separate business units each undertaking a separate activity. For example the Rand Merchant Bank Group comprises of unit trust, insurance and banking subsidiaries.



**Figure 19: Cost to income ratio of S.A. banks (percentage)**

*Source: Banking Council*

<sup>4</sup> Interviews with both domestic and foreign banks and the Reserve Bank all gave the same estimate on foreign banks' cost to income ratios.

Part of this trend is shown by the increase in registered controlling companies from 23 in 1994 to 34 by the end of 1998. It is under the umbrella of these holding companies that the unit trust, insurance and banks' operate as subsidiaries.

## 4

# Banking: Market Access and the WTO

How difficult is it for foreign banks to access South African customers? This chapter addresses this issue and is divided into four parts. The first identifies the regulatory requirements for doing banking business in South Africa. The second section examines the impact of regulation on the level of access of foreign banks. This is divided according to three types of access, namely: **cross-border supply**, **consumption abroad** and **commercial presence**. The third section outlines the existing commitments to the WTO and the final section looks at the potential for requests from other countries in the next round.

## Access to the South African Banking Market

***Requirements for doing banking business in South Africa.*** In South Africa only a public company that is registered as a bank with the Registrar of Banks is permitted to conduct banking business according to the Banks Act of 1990.

According to the Banks Act, "the business of a bank" means:

- Accepting deposits from the general public on a regular basis
- Soliciting of deposits
- Using money accepted by way of deposit to grant a loan or make an investment
- Repurchase agreements
- Any other activity the Registrar deems to be the business of a bank.

In addition only banks may be:

- Foreign exchange dealers
- Market makers for government bonds.

According to the definition above, the main criteria for conducting banking business are advertising for and accepting of deposits from the public. The aim of the regulation is ultimately the protection of depositors' interests by instituting entry requirements and prudential regulations. Entry requirements are aimed at preventing the establishment of banks that are not adequately capitalised as such banks face a higher risk of insolvency in the future. As the Asian experience shows vulnerable banks increase the systemic risk and reduce the stability of the banking sector. Prudential regulations are aimed at ensuring the financial soundness of banks by providing requirements for risk management, effective risk-weighted capital provisions and proper conduct of directors and management.

Section 18A of the Banks Act provides for the registration and operation of foreign banking branches in South Africa. The section empowers the Registrar of Banks to provide specific requirements that a foreign bank must comply with before it will be granted a banking license. The branch must also comply with all the regulations that apply to South African banks.

***Assessing the access channels.*** The openness of the banking sector is defined by the degree to which foreign banking institutions can access the local market. As is recognised by the negotiation methodology of the World Trade Organisation, there are three channels through which access can occur, namely:

- **Cross border supply** (mode 1). The cross-border supply of banking services occurs when a foreign supplier located abroad provides banking services to a consumer in South Africa. At the time the transaction is concluded the supplier is located in the foreign country while the consumer is present in South Africa.

The Banks Act, 1990 and the Banking Supervision Department of the Reserve Bank prohibit the cross-border supply of banking services to South Africa. This includes the advertising of foreign banking services in South Africa.

In addition to banking sector regulations, exchange controls restrict the amount of money that South African residents may transfer overseas. In the case of investment, residents are limited to R500 000 per lifetime and for travel R120 000 per annum. Exchange controls further control residents (individual and corporate) borrowing from overseas. The Reserve Bank in giving its approval examines the purpose, denomination, the interest rate and repayment structure of the loan. This is done on a case by case basis.

***Implications for the regulators.*** The Banks Act and the Banking Supervision Department of the Reserve Bank have no jurisdiction over foreign banks located in foreign countries. Unless foreign banks attempt to access the local market through direct methods such as advertising or promoting banking services in South Africa the regulator has no control over their activities.

The rise in popularity of the Internet is providing foreign banks a way of reaching South African consumers without directly advertising in South Africa. In this way foreign banks can circumvent the regulator. The Internet provides an access route both in terms of advertising online and actual transactions. Presently, exchange controls limits the potential for domestic consumers to transfer funds to foreign banks, but once the exchange controls are removed then unfettered access to South African clients through the Internet will be a reality.

- **Consumption abroad** (mode 2). Consumption abroad occurs when a South African consumer travels abroad and makes use of a foreign bank's services in a foreign country. In this case both consumer and foreign bank are located in the foreign country at the time the transaction takes place.

There are no banking regulations that prevent a person from consuming banking services in a foreign country. However, foreign banks located in a foreign country are prohibited from advertising or promoting their products in South Africa.

Exchange controls, once again, are the main limiting factor as discussed under cross-border supply above.

- **Commercial presence** (mode 3). Commercial presence requires the foreign supplier to have a local presence in South Africa. Furthermore, the transaction between the foreign supplier and domestic consumer takes place in South Africa.

The effect of regulation on foreign banks in South Africa has three dimensions. Firstly, differential regulation that restricts the entry of foreign banks into South Africa. Secondly, prudential regulation that, although applying equally to foreign and domestic banks constrains the operations of foreign entrants. Lastly, the effect of exchange controls.

***Differential regulation.*** There are two regulations in this category:

- (1) Before granting a banking license to a foreign branch the regulator requires the parent to have net assets worth at least \$1 billion and have a minimum investment grade rating from a rating agency recognised by the Reserve Bank. Moreover, the regulatory structure

of the home country must in the opinion of the Reserve Bank be of a comparable standard to South Africa's.

- (2) Foreign branches may not hold bank accounts for natural persons unless a minimum balance of R1 million is retained on the account at all times by the client. This regulation effectively bars foreign branches from the retail market. (Foreign banks could form a subsidiary in South Africa, which would not restrict them from the retail market. However, at this stage no foreign banks have elected to follow this route).

**Prudential regulation** The capital requirements as contained in the prudential regulations apply to all banks operating in South Africa. Some of these requirements form impediments to the activities of foreign branches. The capital requirements are divided into endowment and operating capital and liquidity requirements.

*Endowment capital* - A branch must bring in endowment capital to the value of R50 million (this is in the process of being increased to R250 million for new applications). The money must be transferred into Rands and held in South Africa.

*Operating capital* - All registered banks in South Africa have minimum capital requirements set according to the Basle principles. According to this requirement all banks must maintain a capital to risk-adjusted asset ratio of 8 percent. As with the endowment capital it must be located in South Africa.

*Liquidity requirements* - 2.5 per cent of liabilities must be deposited with the Reserve Bank and this earns no interest.

*Effects of regulation* – Some foreign branches object to this system, for two reasons. Firstly, the location of the capital (endowment and operating) in South Africa in rand introduces currency risk on the capital supplied by the parent. This increases the relative costs of the branch doing business in South Africa and reduces the branch's competitiveness. Secondly, branches believe that the value of their parental support meets prudential concerns. According to this argument, the value of the branch is the parental support. Therefore, the need for local capitalisation of a foreign branch falls away because a branch cannot effectively go into liquidation as it is still attached to the parent's balance sheet. The parent company can withdraw a branch but will not allow a branch to fail as this will damage the international credibility of the bank.

Liquidity requirements impact directly on the cost of financing from the parent, through the duplication of regulation. For example: foreign

branch takes out a loan from the parent. The parent has loaned that money from the home country economy (depositors) and according to those regulations needs to hold liquidity reserves. When the parent company loans the money to the branch, the branch has to put aside a liquidity requirement according to South African regulations. Thus both parent and branch are forced to hold liquidity against what is essentially a single loan from the home country depositors. In the case of a UK parent that has to hold 0.5 percent as liquidity and the South African branch that has to hold 2.5 percent, the effective liquidity requirement on the loan is 3 percent. This is a cost to both parent and branch because no interest is earned on these deposits, which puts pressure on the profit margins.

***Exchange controls.*** Exchange controls are not unique to the banking sector, but effect the entire financial services industry. Banks registered in South Africa cannot hold foreign exchange in excess of 15 percent of their endowment capital. The result is that foreign banks conduct most of their Rand foreign exchange trading in London. The result is that more rand foreign exchange is traded per day in London than in Johannesburg.

## South Africa's Existing WTO Commitments

### **Cross border supply (mode 1)**

#### ***Market access and National treatment***

South Africa has not made any commitments in the WTO to opening up access of the South African banking market through this channel.

### **Consumption abroad (mode 2)**

#### ***Market access and National treatment***

No commitments have been undertaken in the WTO except providing for the free transmission of financial information and financial data processing.

### **Commercial presence (mode 3)**

#### ***Market access***

- Dealings in foreign exchange in South Africa must be carried out through a dealer authorised by the SA Reserve Bank. This is limited to banks registered to operate in South Africa with the required minimum capital base, which must be registered with the Reserve Bank.
- Unit trust companies and any company providing custodial services for securities and financial instruments need to be incorporated as public companies in South Africa and registered with the supervisory authority.

#### ***National treatment***

- Branches of non-resident banks in South Africa must maintain a minimum balance of R 1 million on the deposit accounts of natural persons.

### **Presence of natural persons (mode 4)**

#### ***Market access and National treatment***

South Africa has not undertaken any commitments with regard to the presence of natural persons except for allowing the temporary presence of a natural person for a period of up to three years, unless otherwise specified, without requiring compliance with an economic needs test. The following categories of natural persons providing a service qualify:

- Services salesperson
- Intra-corporate Transferees
- Executives and managers
- Specialists and professionals
- Personnel engaged in establishment

This section relates to immigration of persons into South Africa where an 'economic needs test' must first be passed before residency is permitted. However, South Africa has exempted the above personnel from the needs test thus facilitating the flow of skilled personnel to South Africa.



Looking forward to the next round of negotiations in 2000 it is reasonable to expect that the requests from other countries will be, at the very least, reiterated.

The requests of the U.S. and the EU are detailed below and give a sense of what can be expected. The requests are as follows:

### ***US request***

- Guarantee foreign participants the ability to maintain existing ownership or control of local financial services firms, or to continue financial service activities in which they are engaged. ***South African banking access rules comply with this request***
- Non-prudential reserve or paid-in capital requirements that discriminates against foreign participants, including requirements that deny foreign branches the ability to include the capital of their head office in meeting capitalisation requirements. ***South African banking access rules do not comply with this request.***
- Local currency borrowing restrictions whereby majority foreign owned financial institutions and borrowings are determined by a different formula.

### ***European request***

- Eliminate or relax discriminatory capital requirements for foreign bank branches (R50 million), as well as minimum deposit requirement of R 1 million from natural person. Lending limits and restrictions on foreign currency positions on capital and reserves of
- the foreign branch. ***South African banking access rules do not comply with this request.***
- Relax foreign exchange controls to allow greater scope for foreign exchange dealing and review comprehensive approval requirements, e.g. for direct investment abroad and long-term borrowing abroad. ***South African banking access rules do not comply with this request.***

Any strategy for defending the current set of regulations will need to be built up in the context of these requests. However, it should be noted that the exchange control request is not part of the negotiating forum for financial services at the WTO.

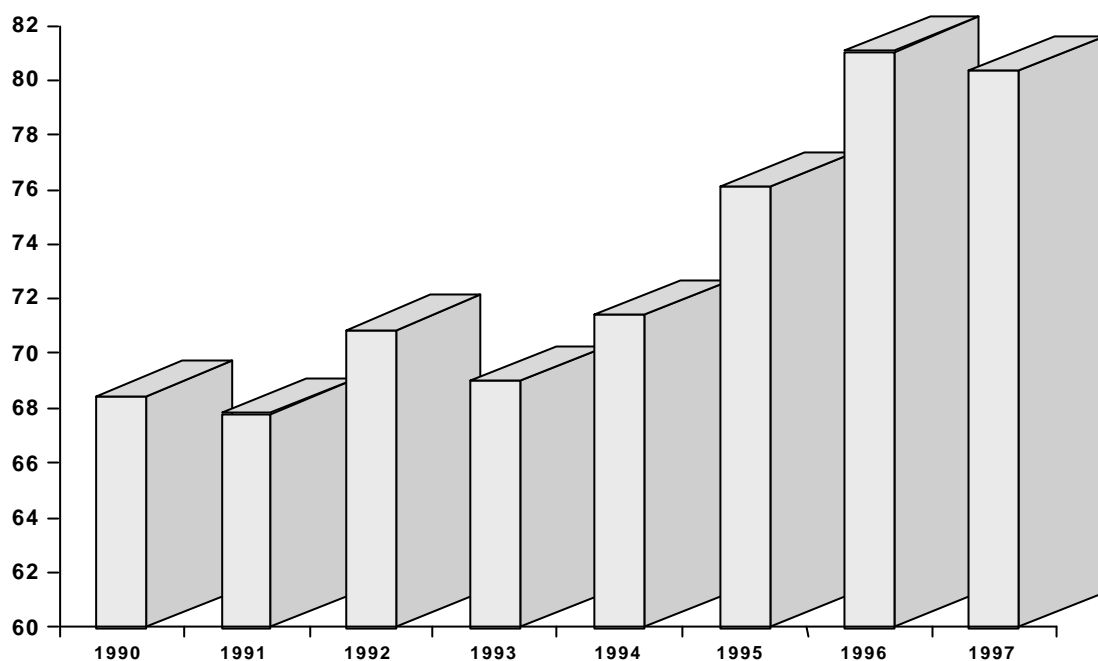
## 5 The Insurance Sector

Insurance in South Africa is very well developed and assets of this industry relative to GDP are high even by advanced economy standards. The role of the industry in the pooling of risk is self-evident. In addition life insurance companies have for long dominated long-term savings in this country, although that domination is now slipping the industry is a large employer, with employment increasing by almost a fifth during the 1990s, to 80 000. The insurance sector on the JSE accounts for 10 percent of the total market capitalisation or R 131 billion.

**Legislation and regulation.** The insurance industry falls under the auspices of two Acts:

- Short-Term Insurance Act No. 53 of 1998
- Long-Term Insurance Act No 52 of 1998

These Acts empower the respective registrars, who form part of the Financial



**Figure 20: Employment (000's)**

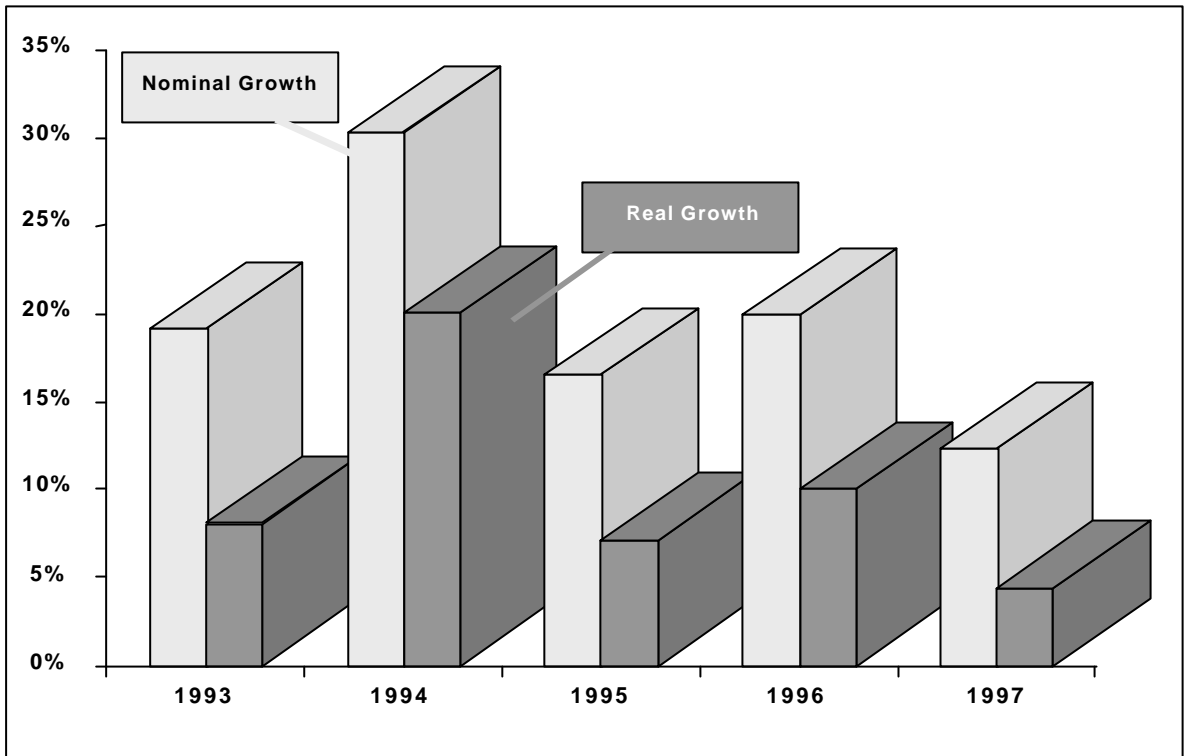
*Source: SSA*

Services Board, to administer the Acts and to regulate the insurance industries. The registrars set specific prudential limits issuing prescriptions regarding financial soundness, capital requirements and rules of conduct.

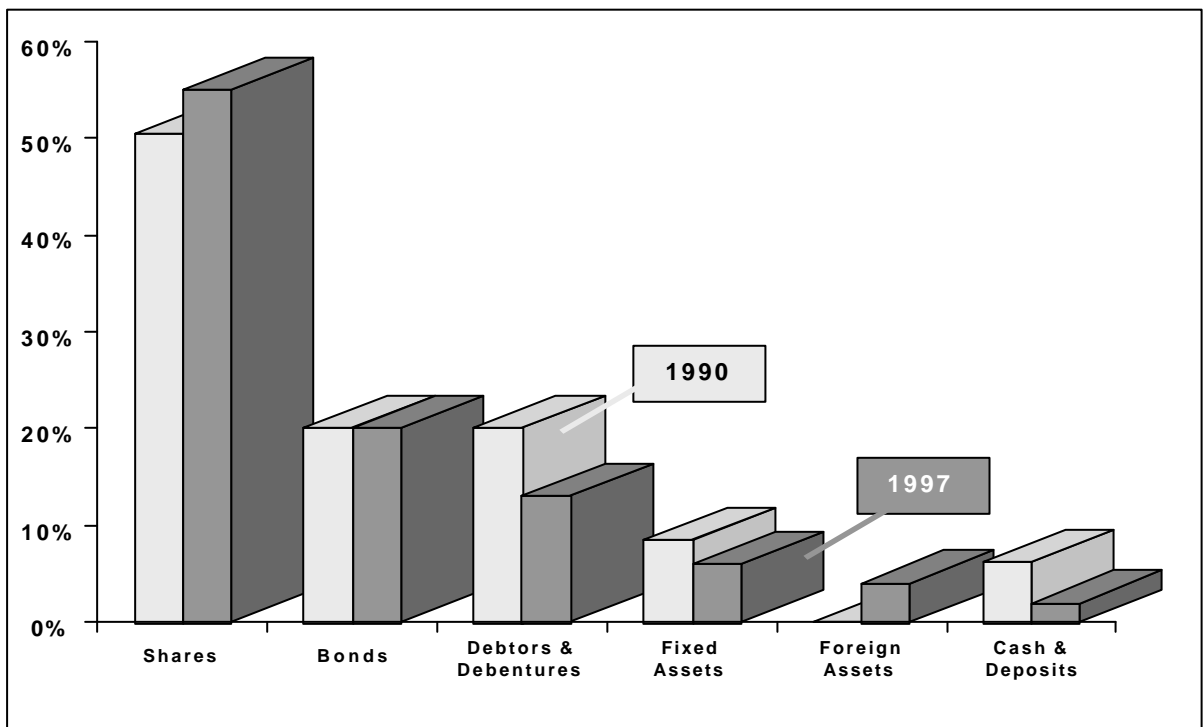
The first part of this chapter describes the domestic insurance sector, highlighting performance, structure and foreign entry. Important trends are also identified. The second section examines the openness of the South African insurance industry, drawing together the present WTO commitments and requests likely to be encountered the next round.

## Long-term insurance in South Africa

**Assets.** Assets of the long-term insurance industry totaled R498 billion by the end of 1997, having grown at an average of 9 percent per year in real terms. However, over this period liabilities grew faster than assets. During the 1990s investment has shifted from interest bearing assets to equities, with equities accounting for over half of the assets of the long-term insurance industry at the end of 1997. The relaxation of exchange controls has allowed an increase in foreign asset holding since 1990.

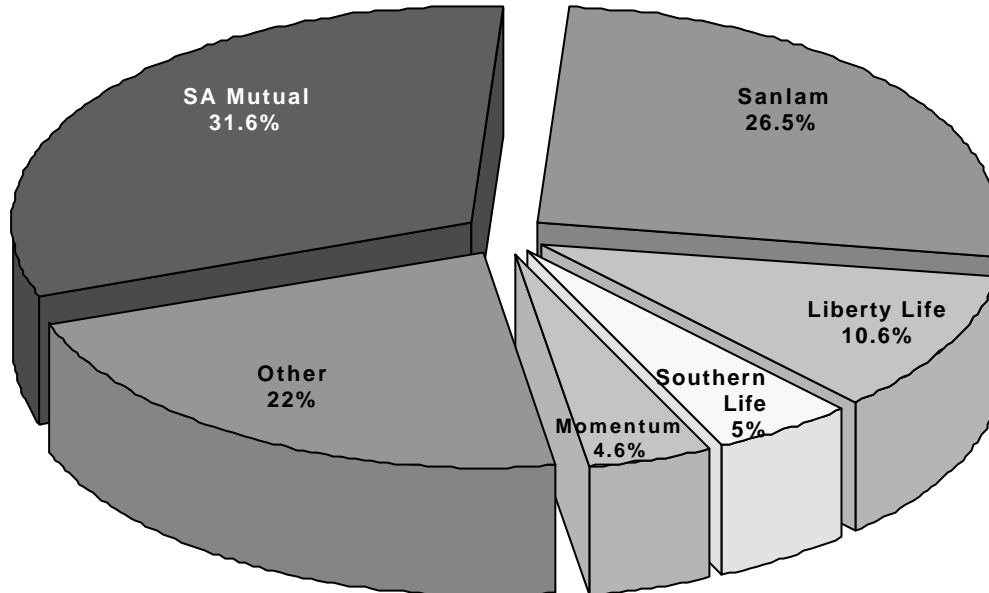


**Figure 21: Annual growth rates of total assets of the long-term insurance industry**  
 Source: FSB



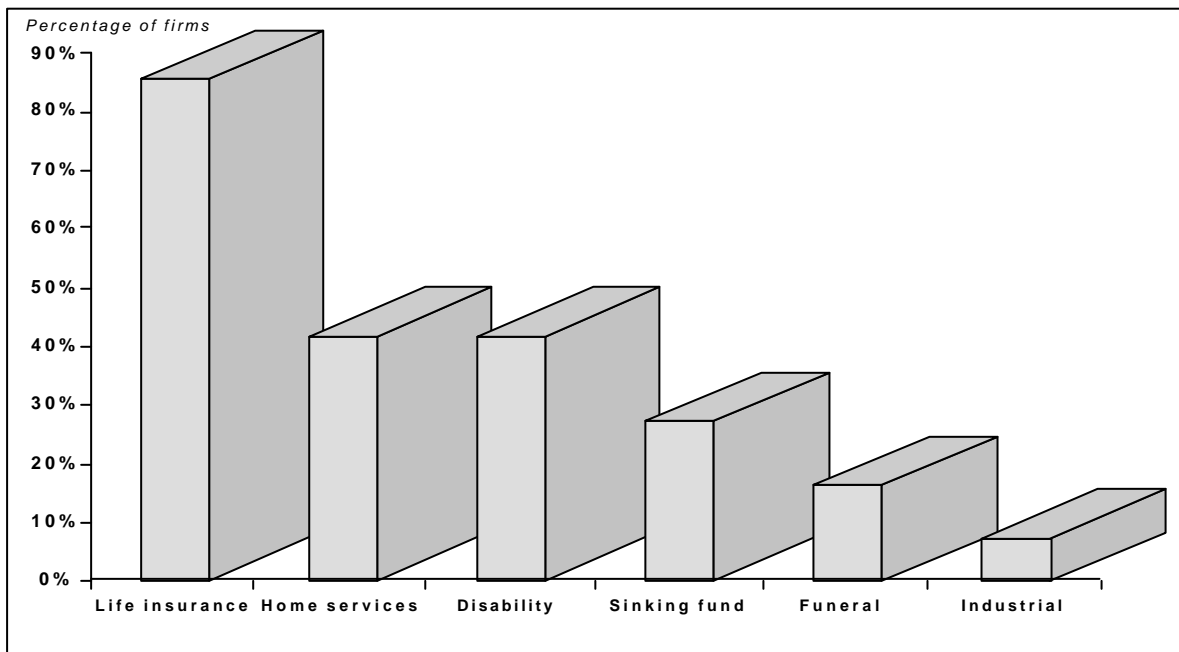
**Figure 22: Distribution of assets of the long-term insurance industry (percentage of total assets)**  
 Source: FSB

**Concentration.** At the end of June 1998 there were 57 long-term insurance companies registered with the Financial Services Board (FSB). The 5 largest long-term insurance companies accounted for 78 percent of the long-term insurance market measured as a percentage of industry gross premiums in 1997, down from 84 percent in 1994.



**Figure 23: Top five insurance companies' market share based on premiums, 1997**

Source: FSB



**Figure 24: Percentage of firms offering services in each category of business of long-term insurers (1998)**

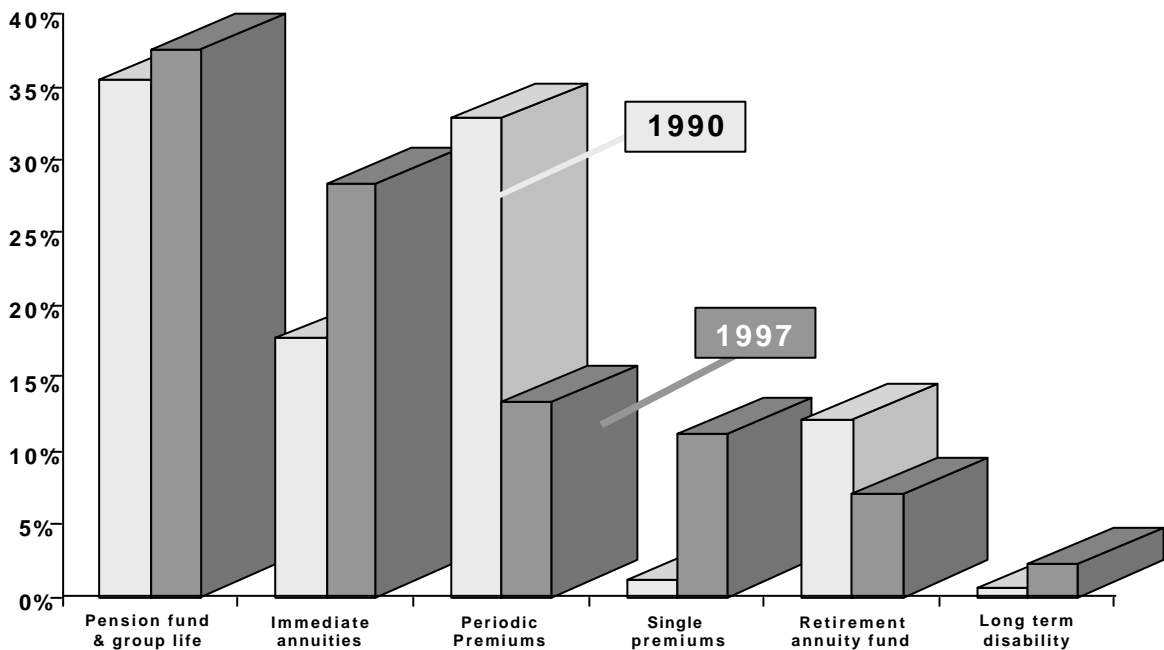
Source: FSB

**Products.** The figure below shows that most long-term insurance companies offer life insurance products, whereas less than half offer other product categories as well.

A long-term insurance policy has a contract life of at least five years. The products offered by long-term insurance companies are:

- Life insurance
- Assistance benefits, for example funeral cover
- Sinking funds, which are investment products for corporate bodies
- Fund business such as pension fund business, financial security business, medical schemes. These are called fund policies and have specific rules associated with them
- Home services, for example hospital policies where the policy pays out if the insured has to go to hospital under certain predefined circumstances, e.g. insured has a car accident
- Disability policies.

**Premiums.** Pension fund and group life account for one third of premium income and immediate annuities showed the most growth since 1990. Periodic premiums from basic life insurance policies, that traditionally formed the main alternative channel to the banking system for the investment of household savings, exhibited the largest decline since 1990.

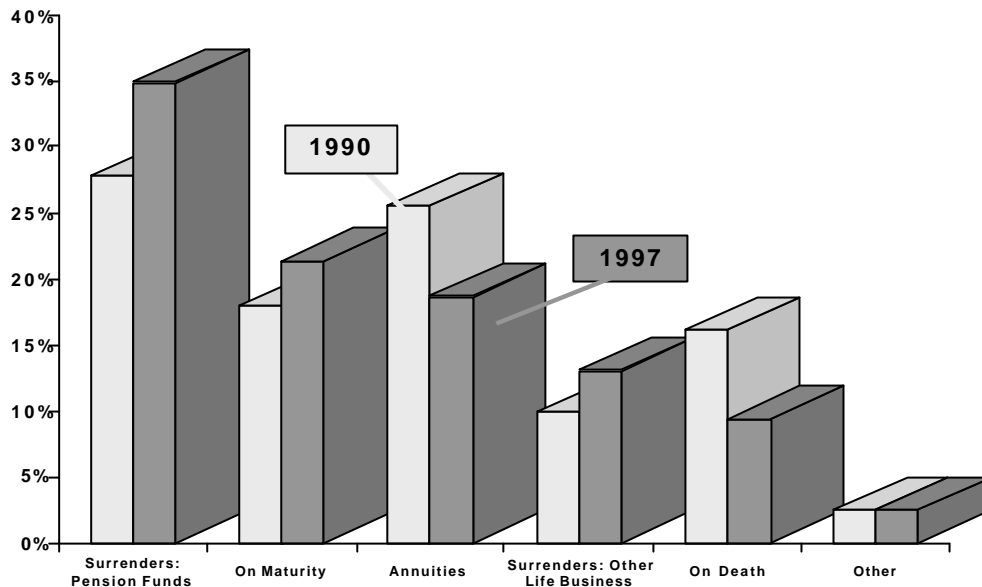


**Figure 25: Premium income of the long-term insurance industry (%)**

Source: FSB

**Benefits.** Surrenders of pension funds accounted for over one third of benefits paid out. This raises the question of what is happening to this money? At this

time there is no evidence available that points to why the increase in surrenders has taken place. The Financial Services Board is investigating this by means of a survey of people who surrender their pension funds. It is hoped that this will shed light on the cause of the increase and where the money is flowing.



**Figure 26: Distribution of benefits of long-term insurers**

Source: FSB

The increased surrender of life insurance policies is complimented by the decline in this class of premiums. The reason is a shift away from the traditional use of life insurance policies as a vehicle for savings towards unit trusts that offer a more transparent investment to consumers.

## Trends in long-term insurance

Trends in the long-term insurance industry can be divided into general trends and long-term insurance trends as follows:

### **General trends**

- Switch to investment in equities
- Product demarcations becoming blurred

### **Long-term insurance trends**

- Decline in life insurance policies
- Demarcation between long-term insurance, banking and unit trust products
- Surrender of pension fund policies

***A switch to investment in equities.*** Investment in equities by both long-term and short-term insurance companies has increased during the 1990's. By 1997, investments in equities accounted more than 50 percent of both short-term and long-term insurance assets.

***Product demarcations are becoming blurred.*** The demarcation between insurance products which long-term and short-term insurers offer has become less clear over the last few years. The short-term insurance industry has traditionally provided indemnity against the death of a person as a result of accidents. However, short-term insurers have begun to extend cover to include the death of a person as a result of sickness, which usually falls under a long-term insurance policy. In this case the long-term and short-term insurance industries are offering the same type of product.

***Decline in life insurance policies.*** During the last few years there has been decline in the use life insurance policies as an investment product as savings have moved to unit trust products offered by the asset management industry. The main drivers are higher levels of transparency and the development of linked products in the unit trust industry.

***Demarcation between long-term insurance, banking and unit trust products.*** According to the Bank Supervision Department of the Reserve Bank, a consensus has been reached on the demarcation between insurance and banking activities had been reached. The consensus has been formalised and the legislation is currently being drafted. The agreed solution is as follows:

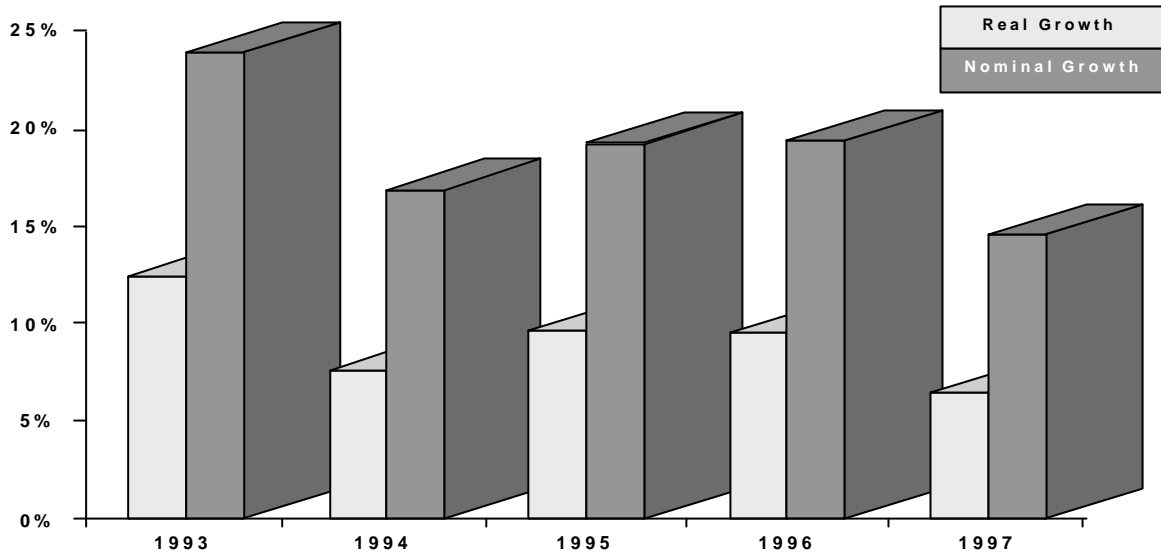
- Allow life insurers to issue products that are comparable to the products of unit trusts, thereby removing a competitive disadvantage for the life insurance industry.
- An adjustment to the prudential regulatory system of insurers in order to provide for the unforeseen risk that may arise as a result of mismatching.
- Preclude the life insurance industry from competing with banks through comparable products.
- Prevent the creation of regulatory arbitrage opportunities between the industries.
- Amendment to section 54 of the Long-term Insurance Act, 1998, which provides for a minimum term of five years for life insurance products.

The main aim of new legislation will be to eliminate the competitive advantage of unit trusts over long-term insurance companies resulting from the minimum duration condition of long-term insurance policies (currently set at five years).



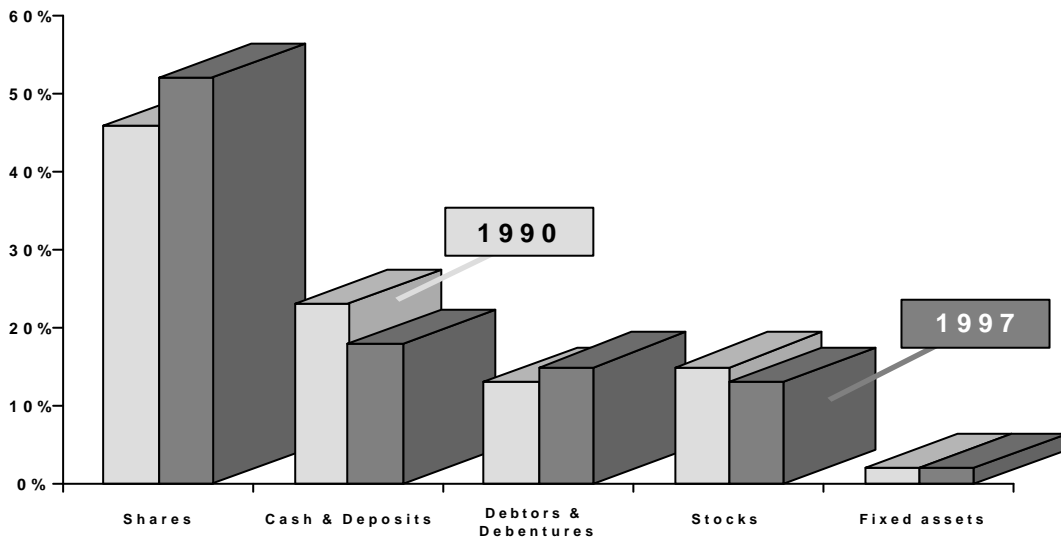
# Short-term insurance in South Africa

**Assets.** Assets of the short-term insurance industry totaled R36 billion at the end of 1997, having grown at an average of 8 percent in real terms since 1990.



**Figure 27: Annual growth rates of total assets of the short-term insurance industry**

Source: FSB



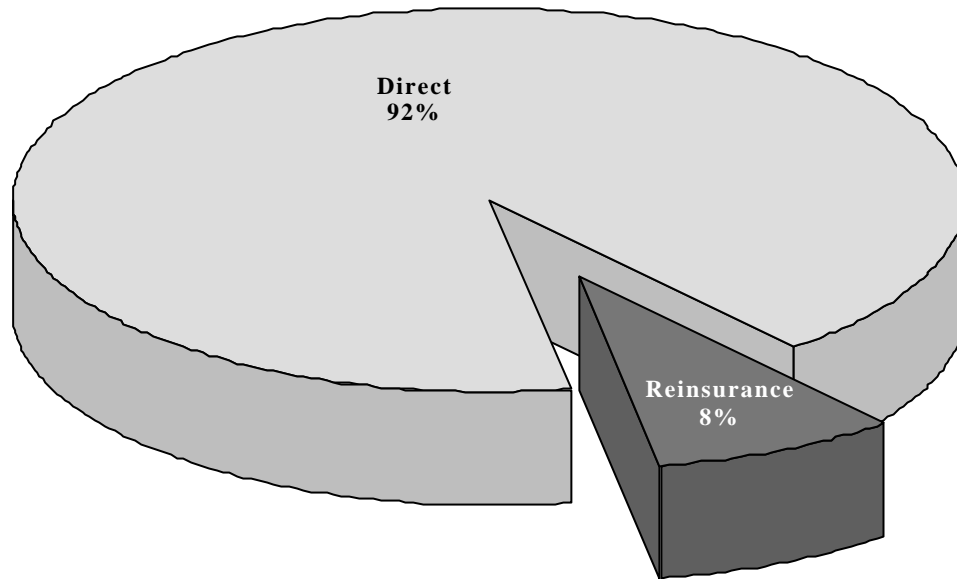
**Figure 28: Distribution of total assets of the short-term insurance industry (percent)**

Source: FSB

The figure above shows the composition of assets of the short-term insurance industry. Most noteworthy is the increase in investment in equities and the decline in liquid assets.

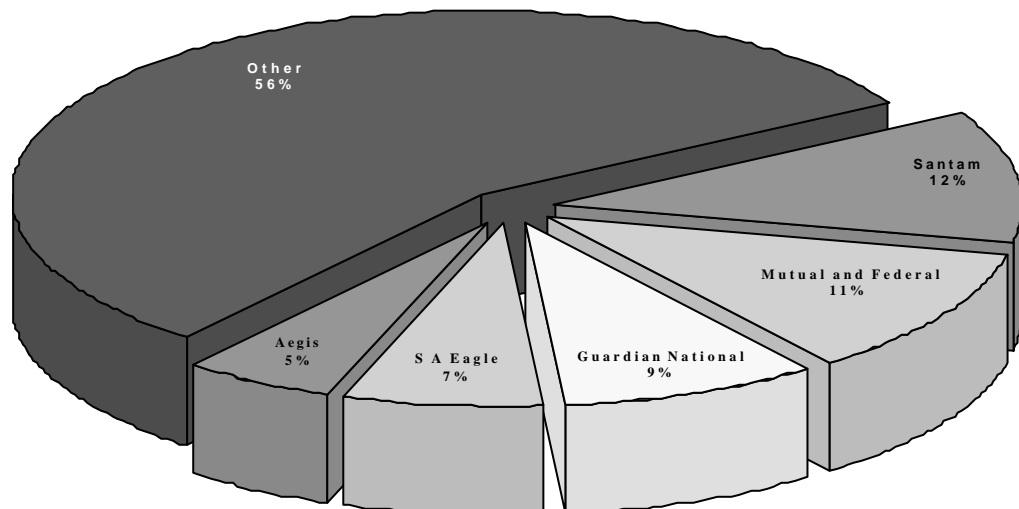
**Concentration.** There are 81 short-term insurance companies of which 4 offer both long-term and short-term insurance products. The short-term insurance industry is split into direct market and reinsurance, with the direct market being

the largest. In the direct market insurance products are sold to the public and in the reinsurance market insurance companies insure each other.



**Figure 29: Market distribution of the short-term insurance industry based on premium income (1997)**

Source: FSB



**Figure 30: Top five short-term insurance companies market share (% of total premiums, 1997)**

Source: FSB

The top five short-term insurance companies in the direct market have a combined market share of 44 percent. Relative to other financial product sectors, short-term insurance has a fairly low level of concentration.

Products offered by short-term insurance companies fall into one of six categories shown in the table1. The product coverage of most firms is

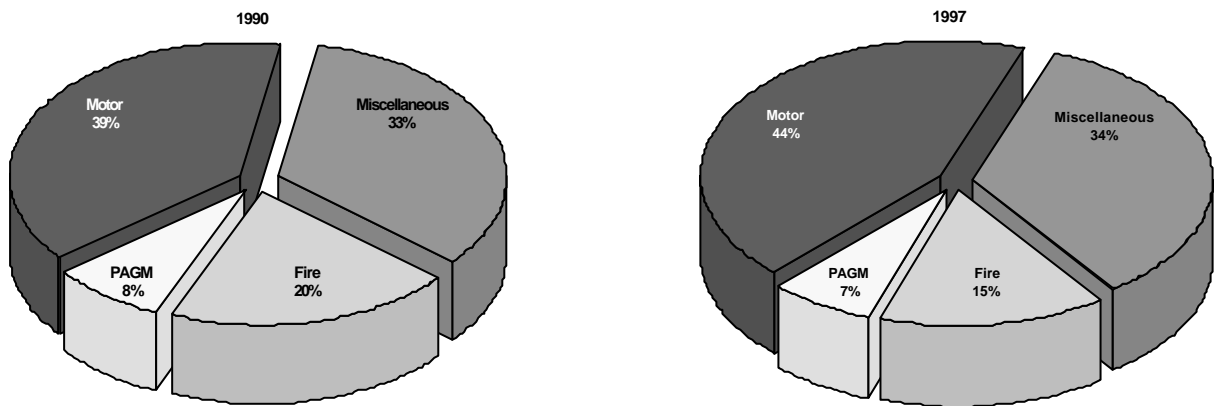
comprehensive. Combined with a low concentration, this indicates a high level of competition in the industry.

**Premiums.** Premium income in the 1990's shifted towards motor insurance away from fire. This shift is possibly reflecting changing crime patterns in South Africa.

Product	Percentage of Firms
Fire	79.5
Marine	72.6
Motor	79.5
Personal Accident	89.9
Guarantee	76.7
Miscellaneous	93.2

**Table 1: Proportion of short-term insurers offering stated product, (% , 1997)**

Source: FSB



**Figure 31: Distribution of premiums (percentage of total premiums)**

Source: FSB

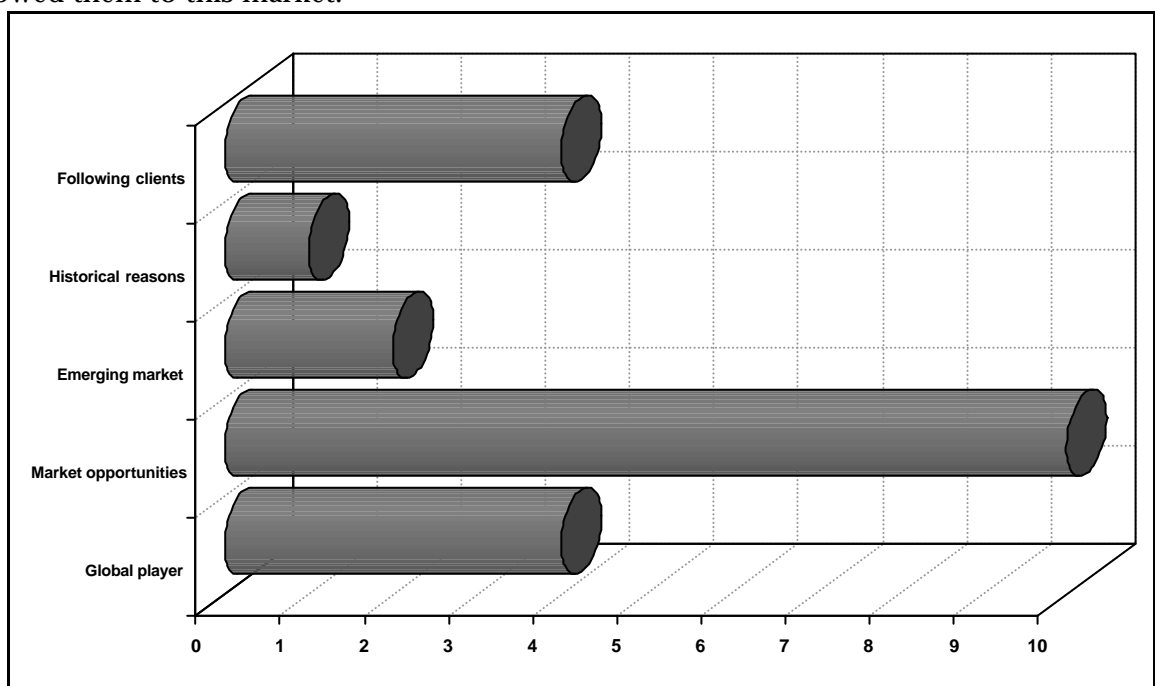
## Foreign Participation in insurance

More than 25 foreign insurance companies have South African subsidiaries 19 of which are short-term insurance companies and 5 are reinsurers. All but

seven of these firms are wholly-owned subsidiaries. Only separately capitalised South African registered companies may conduct insurance business and no branches are permitted. The bifurcation seen with banks is repeated here, with about a quarter of the firms operating here for four decades or more, and about half entering since 1994. Foreign owned insurance companies employ on average about 89 people, but the range is from 2 to about 300. Over 40 percent of foreign owned insurance companies employ in excess of 120 people.

**Market share.** Foreign insurance companies (including those with partial foreign ownership) had a market share of just under 38 percent of the short-term insurance market in terms of gross premiums written in 1997. In the direct market four of the six largest companies are at least partly foreign-owned. Foreign wholly owned insurance companies, dominate the reinsurance market, with virtually 100 percent market share.

Insurance companies are mainly based in South Africa to pursue opportunities offered in the domestic market while at the same time maintaining a world-wide presence in order to service multinational clients. Since 1994 many multinationals have located in South Africa and the insurers from their home jurisdictions have followed them to this market.



**Figure 32: What motivates your presence in South Africa? Why did you choose to come here? (Insurers)**

Source: Genesis Analytics interviews

Expectations of growth in this country, interest in emerging markets and the formerly disadvantaged communities as well as optimism after the 1994 elections are also reasons given for locating in South Africa.

**Services offered by foreign insurance companies operating in South Africa:**

- Short-term insurance for individuals
  - Commercial and corporate short-term insurance
  - Creditor insurance
  - All classes of reinsurance
- 

### ***Impact of foreign insurers in South Africa***

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#### **The consequences of the entry of foreign insurance firms in South Africa:**

- Increased price competition
  - Increased demand for insurance skills
  - Product innovation
  - International standards of market conduct
- 

***Competition.*** According to industry sources, competition from foreign insurance companies locating here has “stirred up” the market. New short-term insurance entrants from abroad are able to offer more favourable rates. For example, in areas such as property insurance, foreign companies have kept rates low, forcing the local companies to do the same.

***Staffing.*** Foreign insurance companies draw staff and expertise from the local market. The additional demand from foreign firms for staff has pushed up the salaries of skilled insurance staff.

***Product and service innovation.*** Foreign insurance companies have offered niche products new to the South African market. One such area is alternative risk transfer. Alternative risk transfer entails companies finding ways other than traditional insurance to transfer and manage risk. An example is the use of ‘captives’, whereby firms partly insure themselves through a subsidiary. This has certain financial and tax advantages. Market participants believe that the standards of service have improved as domestic firms work to match and exceed the services offered by foreign insurers.

***Market conduct.*** Foreign firms subject to stricter legislation in their home jurisdictions continue to apply these rules in South Africa thereby improving the levels of conduct within the domestic insurance industry.

***Future expansion.*** Most foreign of insurance companies believe that South Africa is a growth area for their business. However, future expansion depends on market growth, the strength of the rand, levels of crime, and whether exchange controls are abolished.

## Trends in short-term insurance

Trends in the short-term insurance industry are divided into general trends and short-term insurance trends as follows:

### **General trends**

- Switch to investment in equities
- Product demarcations becoming blurred

### **Short-term insurance trends**

- Increase in captives
- Price competition has heated up

**A switch to investment in equities.** Investment in equities by both long-term and short-term insurance companies has increased during the 1990's. By 1997, investments in equities accounted more than 50 percent of both short-term and long-term insurance assets.

**Product demarcations are becoming blurred.** The demarcation between insurance products which long-term and short-term insurers offer has become less clear over the last few years. The short-term insurance industry has traditionally provided indemnity against the death of a person as a result of accidents. However, short-term insurers have begun to extend cover to include the death of a person as a result of sickness, which usually falls under a long-term insurance policy. In this case the long-term and short-term insurance industries are offering the same type of product.

**Captives.** There has been a trend towards the self-provision of short-term insurance in the last few years. This trend is assisted by the globalisation of financial markets, which offers the means for diversifying risk through an array of financial instruments and strategies. The self-provision is taken on in the form of a 'captive', whereby a company forms a subsidiary company with the purpose of providing provision for losses. In South Africa the number of captives doubled in the year ending 31 June 1998. This trend is likely to continue.

**Price competition has heated up.** Price and product competition has been sharpened by the foreign entry in the South African market. By bringing more innovative products into the market, global players have increased the capacity of the industry. It has been difficult for local insurers to increase the levels of premiums and rates.

# 6

## Insurance: Market Access and the WTO

How difficult is it for foreign insurance companies to access South African customers? In this chapter we identify the regulatory requirements for doing insurance business in South Africa. The second section examines the impact of regulation on the level of access of foreign insurance companies. This is divided according to three types of access, namely: **cross-border supply**, **consumption abroad** and **commercial presence**. The third section outlines the existing commitments to the WTO and the final section looks at the potential for requests from other countries in the next round.

### Access to the South African Insurance Market

#### ***Requirements for establishing an insurance company***

Long-term Insurance Act and Short-term Insurance Act require insurers operating in South Africa be a public company domiciled in South Africa and duly registered with the Registrar of Insurance

Long-term insurance business is defined as the business of providing or undertaking to provide policy benefits under long-term insurance policies. The following types of policies are classified as long-term insurance policies:

- Assistance policy
- Disability policy
- Fund policy
- Health policy
- Life policy or sinking fund policy

Short-term insurance business is defined as the business of providing or undertaking to provide policy benefits under short-term insurance policies. The following types of policies are classified as short-term insurance policies:

- Engineering policy
- Guarantee policy
- Liability policy
- Miscellaneous policy
- Motor policy

- Accident and health policy
- Property policy or transportation policy

A foreign entrant has no additional requirements for establishment over and above those that apply to domestic insurance companies. All domestically registered insurance companies are deemed to be South African insurance companies.

**Assessing the access channels.** The openness of the insurance sector is defined by the degree to which foreign insurance institutions can access the local market. As is recognised by the negotiation methodology of the World Trade Organisation, there are three channels through which access can occur. We look at each in turn.

- **Cross border supply** (mode 1). The cross-border supply of insurance products occurs when a foreign supplier located abroad sells an insurance policy to a consumer in South Africa. At the time the transaction is concluded the supplier is located in the foreign country while the consumer is present in South Africa.

Cross border supply is restricted in both Acts and by the regulators. A foreign insurance company cannot advertise insurance products or collect premiums in South Africa. No restrictions apply to reinsurance between South African insurance companies and foreign insurance companies.

The Reserve Bank through exchange controls restricts insurance contracts between residents and foreign insurance companies. However, they do acknowledge that in certain instances the limited scope and capacity of the local insurance market warrants the use of international insurance products. Examples are marine insurance and assets denominated in a foreign currency. In this case an application must be made to the Reserve Bank.

**Implications for the regulator.** The Insurance Acts and the Financial Services Board have no jurisdiction over foreign insurance companies located in foreign countries. Unless foreign insurance companies attempt to access the local market through direct methods such as advertising or promoting insurance products in South Africa the regulator has no control over their activities.

The rise in popularity of the Internet is providing foreign insurance companies a way of reaching South African consumers without directly advertising in South Africa. In this way foreign insurance companies can circumvent the regulator. The Internet provides an access route both in terms of advertising online and actual transactions. Presently, exchange controls limits the potential for domestic consumers to access foreign insurance companies. Once the exchange controls are removed then unfettered access to South African clients through the Internet will be a reality.



- **Consumption abroad** (mode 2). Consumption abroad occurs when a South African consumer travels abroad and makes use of a foreign bank's services in a foreign country. In this case both the consumer and the foreign insurer are located in the foreign country at the time the transaction takes place.

Exchange control that limit the amount of money that South African residents may transfer overseas restrict this access.

- **Commercial presence** (mode 3). Commercial presence requires the foreign supplier to have a local presence in South Africa, and the transaction takes place in South Africa.

The effect of regulation on foreign insurance companies in South Africa has three dimensions. Firstly, differential regulation that restricts the foreign entry into South Africa. Secondly, prudential regulation that, although applying equally to foreign and domestic insurance companies, constrains the operations of foreign entrants. Finally, the effect of exchange controls.

***Differential regulation.*** There are two regulations in this category.

- (1) No branches of foreign insurance companies are permitted to operate in South Africa except in the special case of Lloyd's agents. This precludes the possibility of trading off the strength of the parent's balance sheet and confines the strength of the subsidiary to its local balance sheet in terms of capital, liquidity and ability to raise finance.
- (2) Section 3(1)f of the exchange control regulations limits the amount of finance a local insurance company controlled by non-residents can raise in the South Africa. A higher degree of foreign ownership penalises the insurance company by limiting the amount of finance it can raise domestically.

***Prudential regulation.*** The capital and investment requirements as contained in the prudential regulations apply to all insurance companies operating in South Africa. Some of these requirements form impediments to the activities of foreign owned insurance companies.

*Local capitalisation.* All insurance companies require local capitalisation. Long-term insurers need a minimum of R10 million (as set by the Registrar). Short-term insurers are evaluated on their business plans and, if a subsidiary, on the strength of their parent company balance sheet. In this case the capital requirement is at the discretion of the Registrar. Domestic capitalisation introduces currency risk for the parent, which makes entry into the domestic insurance market more costly.

*Investments.* The Financial Service Board restricts the foreign investment of insurance companies to selected foreign stock exchanges where it can invest its assets and have them recognised as deemed assets used to match against its liabilities. The Registrar of Insurance limits investment abroad to 15 percent of total South African assets.

*Ownership.* According to both Insurance Acts permission has to be obtained from the Registrar before a person can acquire a controlling interest in an insurance company. Furthermore, insurance company officers and actuaries are required to be South African residents. This precludes foreign control of insurance company's from offshore locations. For example: a parent company cannot run or administer a subsidiary from its home country.

### **Cross border supply (mode 1)**

#### ***Market access and National treatment***

South Africa has not made any commitments in the WTO to opening up access of the South African insurance industry through this channel.

### **Consumption abroad (mode 2)**

#### ***Market access and National treatment***

No limitations have been placed on this mode of access. This means that South Africa has committed itself to not placing any restrictions in the way of consumption abroad of insurance.

### **Commercial presence (mode 3)**

#### ***Market access and National Treatment***

- All insurers/reinsurers (and insurers on whose behalf policies are sold) need to be incorporated as a public company in South Africa and registered with the supervisory authority to carry on insurance business in South Africa.
- The acquisition of shares or any other interest (by a resident or non-resident) in a registered insurer resulting in the holding of 25 percent or more of the value of all shares or other interests in that business, requires written approval of the Registrar of Insurance.
- The executive chairman, public officer and the majority of the directors must be residents in South Africa.
- Life insurance actuaries must also be resident in South Africa.

### **Presence of natural persons (mode 4)**

#### ***Market access and National treatment***

South Africa has not undertaken any commitments with regard to the presence of natural persons except for allowing the temporary presence of a natural person for a period of up to three years, unless otherwise specified, without requiring compliance with an economic needs test. The following categories of natural persons providing a service qualify:

- Services salesperson
- Intra-corporate Transferees
- Executives
- Managers
- Specialists
- Professionals
- Personnel engaged in establishment

This section relates to immigration of persons into South Africa where an 'economic needs test' must first be passed before residency is permitted. However, South Africa has exempted the above personnel from the needs test thus facilitating the flow of skilled personnel to South Africa.

Looking forward to the next round of negotiations in 2000 it is reasonable to expect that the requests from other countries will be, at the very least, reiterated.

The requests of the U.S. and the EU are detailed below and give a sense of what can be expected. The requests are as follows:

#### ***U.S. request***

- Allow cross-border market and consumption abroad for the provision of all insurance services. ***The South African insurance industry access rules do not comply with this request.***
- Complete market access to foreign insurance branches. ***South African insurance industry access rules do not comply with this request.***

#### ***European request***

- Allow the establishment of foreign insurance branches. ***The South African insurance industry access rules do not comply with this request.***
- Undertake commitment on cross-border MAT insurance (mode 1 and 2) and in reinsurance (mode 2). ***The South African insurance industry access rules do not comply with this request.***
- Eliminate or substantially reduce discriminatory condition for the authorisation of shareholding over 25 percent in insurance companies incorporated in South Africa. ***The South African insurance industry access rules do not comply with this request.***

Any strategy for defending the current set of regulations will need to be built up in the context of these requests. However, it should be noted that the exchange control request is not part of the negotiating forum for financial services at the WTO.

# 7

## Asset Management: Pension Funds and Unit Trusts

Given the rise of institutional investors as long-term investment alternative to the banking sector, asset managers play an increasingly important role in the allocation of capital. The speed with which this sector adopts sophisticated investment techniques, risk management methods and flexible and attractive products, affects the efficiency with which savings are intermediated in the economy and the financial security of the retirees of the future.

The first part of this chapter describes the domestic asset management and pension fund industries. Important trends are also identified. The second section examines the openness of the industry, drawing together the present WTO commitments and requests likely to be encountered the Seattle round.

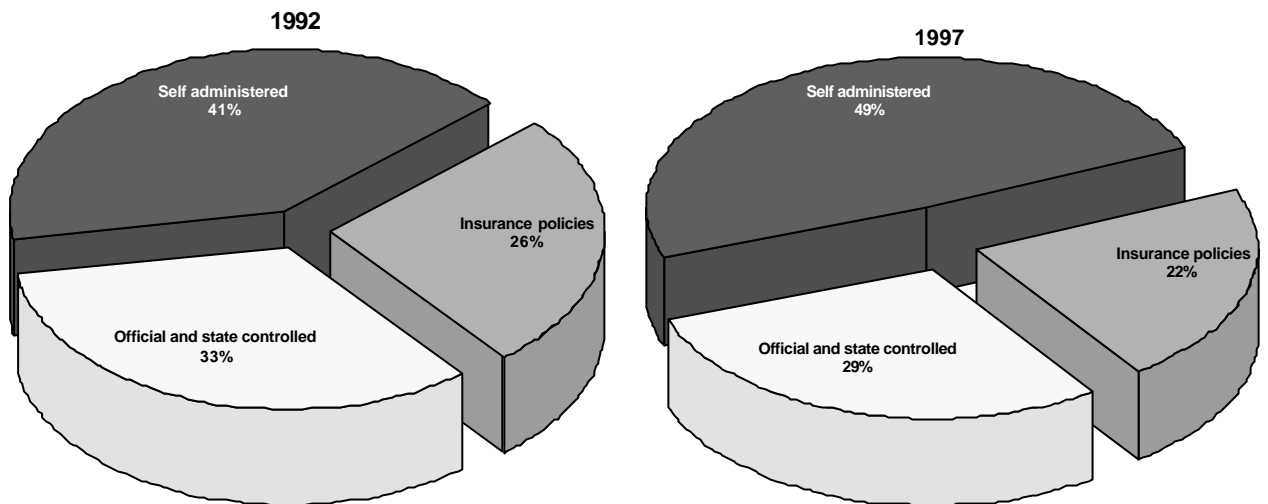
### Pension Funds in South Africa

Pension funds are the dominant form of long-term savings in South Africa. Assets of the pension fund industry totaled R543 billion at the end of 1997, having grown at an average of 9 percent per year since 1992. Membership of pension funds has grown at an average of 2 percent per year during the 1990s reaching just over 10 million by the end of 1998. 8.6 million members are active and still making contributions, the remainder being pensioners

**Categories of pension fund.** There are three categories of pension fund,:

- **Self administered** pension funds that are under the control of independent administrators.
- **Life insurance** pension fund products. These are insurance policies issued by a registered long-term insurer.
- **Official** Pension funds run by the various local authorities, government departments and parastatals.

At the end of 1997 there were 172 pension fund administrators comprising of asset management companies, long-term insurance companies and private professional administration companies. Self-administered funds exhibited the highest growth rate of 23 percent per year. Around half of pension fund assets are in self-administered pension funds having increased their share by 7 percentage points from 1992.



**Figure 33: Distribution total pension fund assets**

Source: FSB

Pension fund investments have shifted from interest bearing assets to equities, unit trusts and foreign assets. The three fold growth in foreign investments since 1995 is the result of the Reserve Bank allowing pension funds to invest up to 15 percent of their assets abroad.

**Legislation and regulation.** The pension fund industry is regulated by the Registrar of Pension Funds in term of the Pension Funds Act of 1956.

Type of Assets	1993	1994	1995	1996	1997
Immovable property	4.9	4.8	4.3	2.9	4.1
Shares in companies	26.5	40.5	47.7	45.5	43.0
Unit trusts	1.1	1.4	1.5	1.8	2.9
Debt instruments	1.0	1.1	1.0	1.0	1.0
Bills, bonds, securities	19.2	14.0	12.6	13.8	14.8
Deposits and Kruger rands	8.2	9.3	7.5	6.5	5.4
Insurance policies	29.6	26.8	24.6	26.8	26.2
Foreign	0.0	0.0	0.1	0.8	2.3

**Table 2: composition of assets of self administered pension funds (percentage of total)**

Source: FSB

## Trends in pension funds

The main trends in the pension fund industry are:

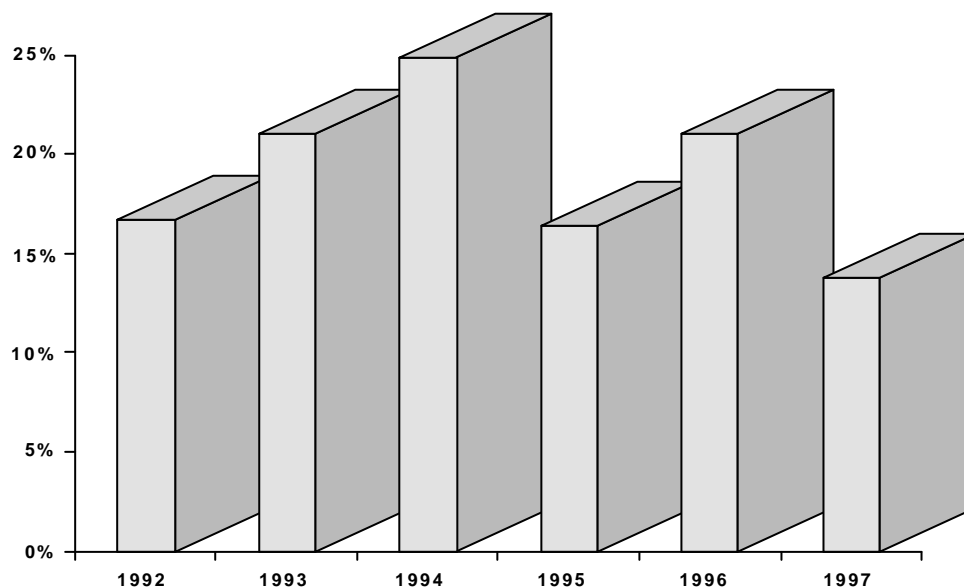
- Shift to defined contribution funds
- Increase in investment in equities
- Returns on investment have been declining
- Growth in contributions

**Shift to defined contribution funds.** Pension funds in South Africa consist of defined benefit and defined contribution funds, broadly known as pension and provident funds, retirement annuity, umbrella and preservation funds. There has been a shift from defined benefit to defined contribution funds due to employers trying to reduce their liability under defined benefit funds. With defined benefit funds the employer pays in any shortfall between the benefit paid by the fund and the contracted benefit to the employee. Defined contribution funds, on the other hand, contract the payment of a specific amount into the fund by the employee, and the amount of benefits paid out is determined by the performance of the fund.

**Increase in investment in equities.** Over the last few years investments of pension fund assets have been increasingly directed towards the equities market.

**Returns on investments have been declining.** Income from investments is the main source of income for pension funds, although returns on investments have been declining since 1994.

**Growth in contributions.** Contributions have grown at 16% per year since 1992.



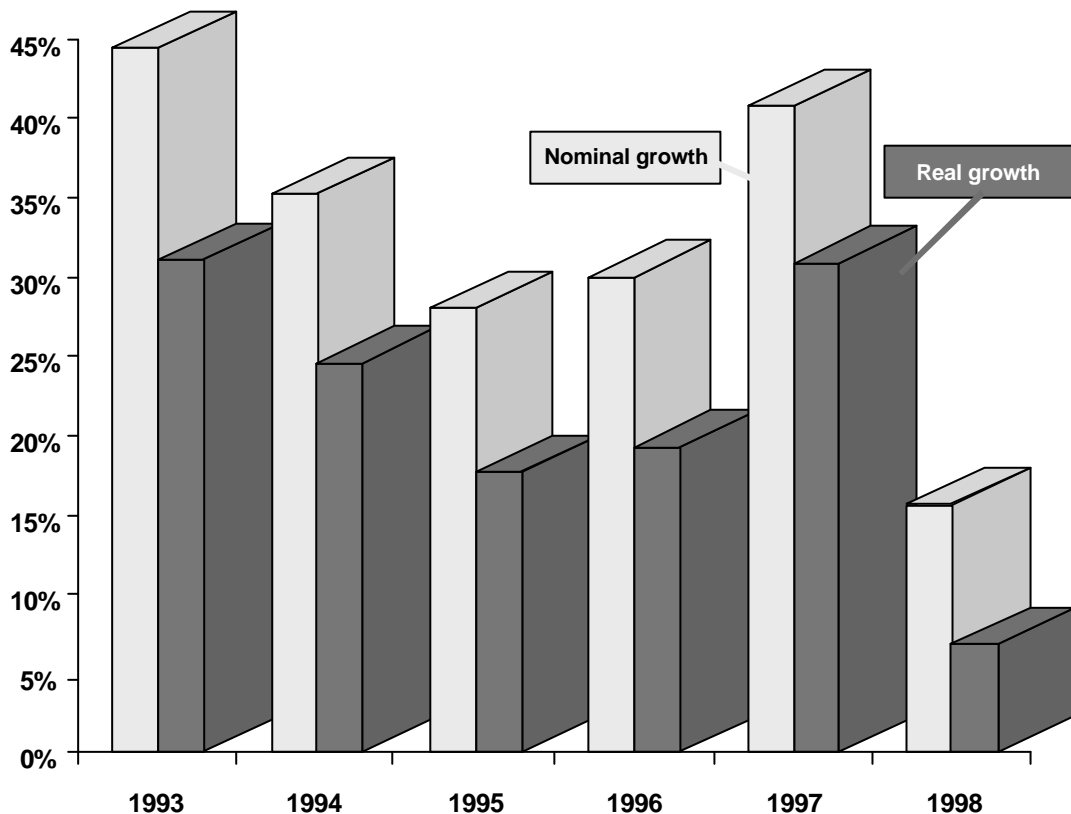
**Figure 34: Returns on investments of the pension fund industry**

Source: FSB

## Unit trusts in South Africa

Total assets of the unit trust industry amounted to R90 billion at the end of 1998, having increased more than ten fold since 1990. There were 204 funds run by 28 management companies at the end of 1998. Five years ago there were 57 funds, ten years ago there were only 30. The five largest assets management companies control 61 percent of the assets under management in the unit trust industry.

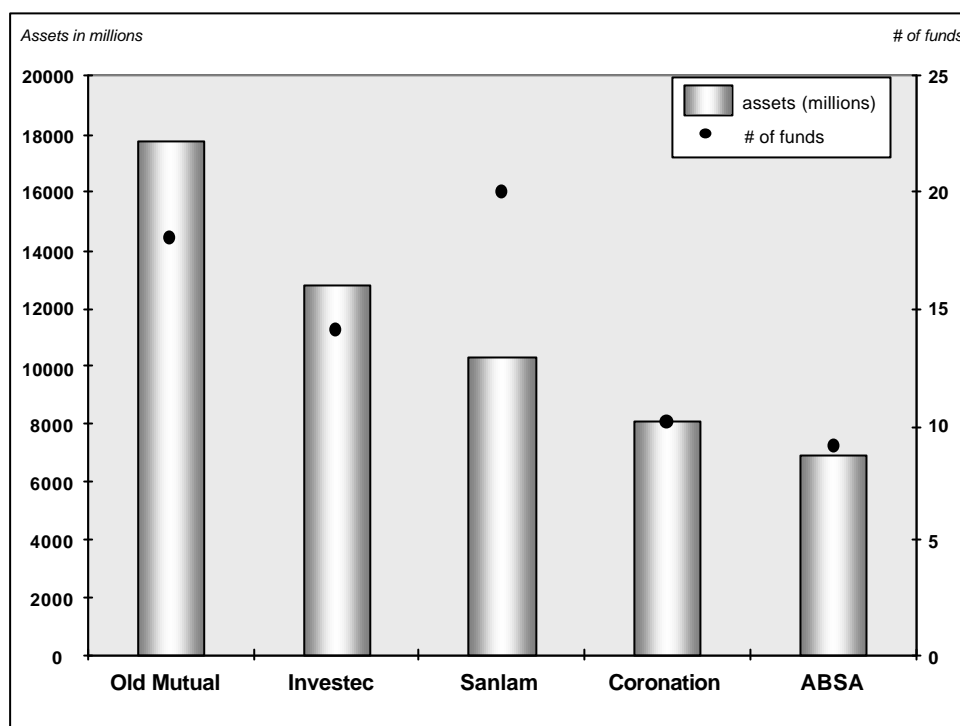
Unit trust assets account for 3.4 percent of total JSE market capitalisation, up from 1.8 percent five years ago. In the US this figure is closer to 25 percent, which suggests plenty of room for future growth in SA.



**Figure 35: Growth rate of total unit trust assets**

Source: FSB





**Figure 36: Top five unit trust companies in term of assets under management (1999)**

Source: AOU

**Competition for deposits.** In 1997 money market funds were launched and by the end of 1998 there were 10 money market funds managing assets of R12.2 billion or 17 percent of total industry assets.

**Types of funds.** The variety of funds has increased rapidly with growing sophistication of the investing public. There are five broad categories into which the 204 funds are divided as shown in table 3:

Categories	# of funds	Further divided into	# of funds
General equity funds	41		
Specialist equity sector*	85		
Managed funds	32	Prudential Flexible	24 8
Fund of funds	17		
Fixed interest funds	41	Income funds Bond funds Money market funds	15 15 11

**Table 3: Types of unit trust products available (1997)**

Source: FSB

\*Specialist equity sector includes gold, global, industrial, mining & resources, smaller companies, and specific equity.

**Legislation and regulation.** The unit trust industry is legislated by the Unit Trust Control Act of 1981 and the Participation Bonds Act 1981. This Act was amended in 1998 by the Unit Trust Control Amendment Act of 1998. The Registrar of Unit Trusts regulates and enforces the Unit Trust Control Act.

## Trends in pension funds

The main trends in the unit trust industry are:

- A massive increase in funds flowing to unit trusts
- The rise of money market unit trusts as competition for banks
- The rise of the linked product providers (LPPs) as an important force in distribution

**Massive increase in funds flowing into unit trusts.** Sales of unit trusts have increased from R2 billion in 1990 to almost R64 billion in 1998. The net inflows, sales minus repurchases, increased almost thirteen fold since 1990 and by 1998 totalled R13 billion.

**The Rise in money market unit trusts as competition for banks.** In 1997 money market funds were launched and by the end of 1998 there were 10 money market funds managing assets of R12.2 billion or 17 percent of total industry assets. In the US almost a third of total mutual fund assets are in money market funds, and South Africa is expected to follow this trend.

**The rise of the LPPs as an important force in distribution.** Unit trust products have become increasingly popular as a vehicle for discretionary savings, especially in the case of linked retirement products. "Linked products" have played a major role in enhancing flows from the retirement and discretionary investment industry into unit trusts. Higher returns and increased transparency have been the main contributing factors.

# 8

## Asset Management: Market Access and the WTO

How difficult is it for foreign asset management companies to access South African customers? In this chapter we identify the regulatory requirements for entry into the South African unit trust market. The second section examines the impact of regulation on the level of access of foreign asset management companies. This is divided according to three types of access, namely: **cross-border supply**, **consumption abroad** and **commercial presence**. The third section outlines the existing commitments to the WTO and the final section looks at the potential for requests from other countries in the next round.

### ***Requirements for establishing an asset management company***

A South African unit trust company is required to be a separately capitalised public company registered with the Registrar of Unit Trusts. A foreign unit trust company can establish a representative office in South Africa providing it is locally capitalised and registered with the registrar. No branch operations are permitted.

## Access to the Asset Management Industry

The openness of the insurance sector is defined by the degree to which foreign asset management companies can access the local market. As is recognised by the negotiation methodology of the World Trade Organisation, there are three channels through which access can occur. We look at each in turn.

- **Cross border supply** (mode 1). The cross-border supply of unit trusts occurs when a foreign supplier located abroad sells a unit trust product to a consumer in South Africa. At the time the transaction is concluded the supplier is located in the foreign country while the consumer is present in South Africa.

A foreign based firm may sell unit trusts in South Africa without maintaining a local presence provided a representative agreement is signed with a local management company and the scheme must be approved and registered with the Registrar of Unit Trusts.

The registration is conditional on the following:

- (1) The scheme must be carried on in a regulatory environment at least of the same standing as the South African regulatory environment.
- (2) The applicant must satisfy the Registrar that the investment scheme has a risk profile which is not significantly higher when compared to

the risk profile of similar investments in units offered for sale in the Republic by management companies registered under the Unit Trust Control Act, 1981.

- (3) The scheme may not be different from those already offered for sale in South Africa by a management company registered in South Africa under the Unit Trust Control Act, 1981.

Foreign schemes are also required to comply with the Code of Advertising for Unit Trusts and full disclosure of marketing information and material must be made to the Registrar.

Exchange control restricts the amount of money South Africans may take out of South Africa to R 500 000 per person per lifetime. In the case of a travel allowance, persons are limited to R120 000 per annum, but the unspent travel allowance must be brought back to the country with them.

- **Consumption abroad** (mode 2). Consumption abroad occurs when a South African consumer travels abroad and purchases unit trusts in a foreign country. In this case both consumer and foreign asset management company are located in the foreign country at the time the transaction takes place.

Exchange controls are the main restriction as explained above.

- **Commercial presence** (mode 3). Commercial presence requires the foreign supplier to have a local presence in South Africa. Furthermore, the transaction between the foreign supplier and domestic consumer takes place in South Africa.

The effect of regulation on foreign unit trust companies in South Africa has two dimensions. Firstly, differential regulation that restricts the entry of foreign asset management companies into South Africa. Secondly, prudential regulation that, although applying equally to foreign and domestic asset management companies constrains the operations of foreign entrants.

**Differential.** No branches of foreign asset management companies are permitted entry into the South African market.

**Prudential.** The capital requirements as contained in the prudential regulations apply to all unit trust companies operating in South Africa. Representative offices must have and maintain a paid-up share capital and reserves of not less than R2 million. Furthermore, these assets must at all times be invested in liquid assets. This introduces exchange rate risk for the representative office, which would otherwise trade off the parent's balance sheet. Given the fairly modest amount it is not clear that this requirement hinders access.



## South Africa's Existing WTO Commitments

### **Cross border supply (mode 1)**

#### ***Market access and National treatment***

South Africa has not made any commitments in the WTO to opening up access of the South African unit trust market through this channel.

### **Consumption abroad (mode 2)**

#### ***Market access and National treatment***

No commitments have been undertaken in the WTO except providing for the free transmission of financial information and financial data processing.

### **Commercial presence (mode 3)**

#### ***Market access and National treatment***

Unit trust companies and any company providing custodial services for securities and financial instruments need to be incorporated as public companies in South Africa and registered with the supervisory authority.

### **Presence of natural persons (mode 4)**

#### ***Market access and National treatment***

South Africa has not undertaken any commitments with regard to the presence of natural persons except for allowing the temporary presence of a natural person for a period of up to three years, unless otherwise specified, without requiring compliance with an economic needs test. The following categories of natural persons providing a service qualify:

- Services salesperson
- Intra-corporate Transferees
- Executives
- Managers
- Specialists
- Professionals
- Personnel engaged in establishment

This section relates to immigration of persons into South Africa where an 'economic needs test' must first be passed before residency is permitted. However, South Africa has exempted the above personnel from the needs test thus facilitating the flow of skilled personnel to South Africa.

Looking forward to the next round of negotiations in 2000 it is reasonable to expect that the requests from other countries will be, at the very least, reiterated.

The requests of the U.S. and the EU are detailed below and give a sense of what can be expected. The requests are as follows:

### ***U.S. Request***

- Guarantee foreign participants the ability to maintain existing ownership or control of local financial services firms, or to continue financial service activities in which they are engaged. ***South Africa unit trust industry access rules comply with this request***
- Non-prudential reserve or paid-in capital requirements that discriminates against foreign participants, including requirements that deny foreign branches the ability to include the capital of their head office in meeting capitalisation requirements. ***The South Africa unit trust industry access rules do not comply with this request***

### ***Europe Request***

- Relax foreign exchange controls to allow greater scope for foreign exchange dealing and review comprehensive approval requirements, e.g. for direct investment abroad and long-term borrowing abroad. ***The South Africa unit trust industry access rules do not comply with this request***

Any strategy for defending the current set of regulations will need to be built up in the context of these requests. However, it should be noted that the exchange control request is not part of the negotiating forum for financial services at the WTO.

# 9

## Securities Exchanges and Brokerages

The rise of institutional investors discussed in previous chapters requires liquid, sophisticated and efficient securities markets.. The more liquid, sophisticated and efficient these markets are the better is the level of risk management and capital allocation. Efficient capital markets are also a prerequisite for many providers of foreign capital

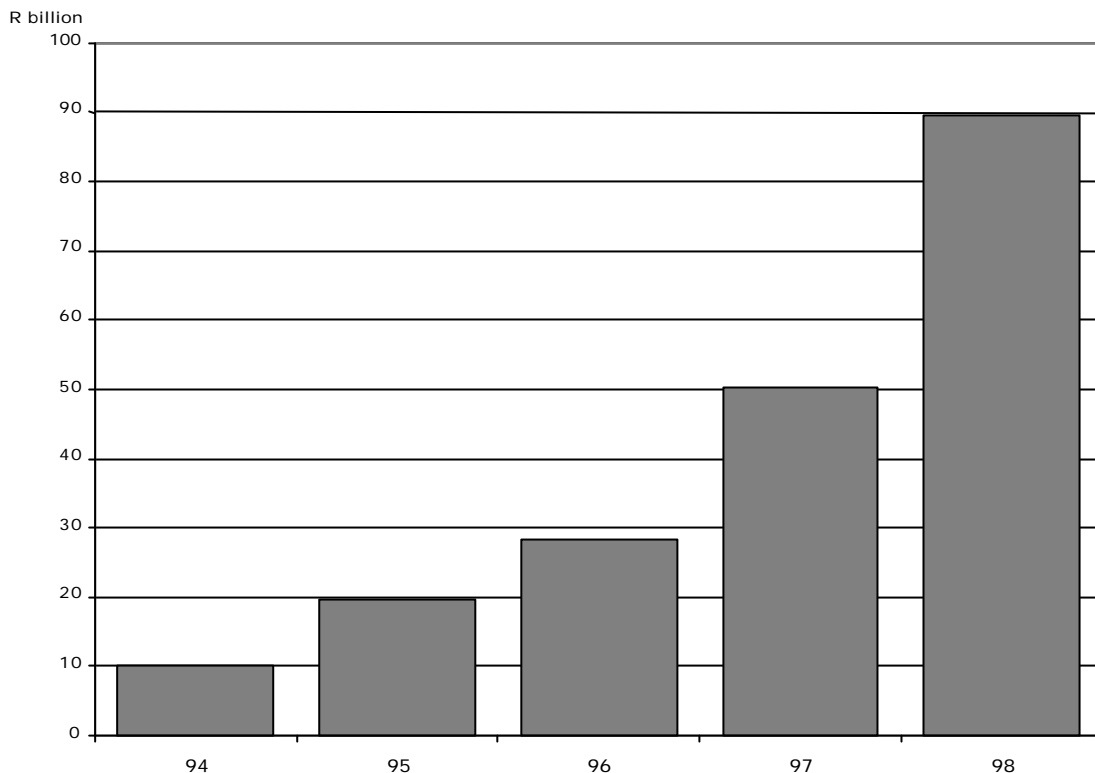
The first part of this chapter describes the Johannesburg Stock Exchange, Bond Exchange of South Africa and the South African Futures Exchange, highlighting performance, structure and foreign entry. Important trends are also identified. The second section examines the openness of these markets in South Africa, drawing together the present WTO commitments and requests likely to be encountered the next round.

### Equities: The Johannesburg Stock Exchange

The JSE embraced the challenge by deregulating the traditional stockbroking environment previously protected from international competition. The 'Big Bang' of 1995 introduced negotiated commissions, corporate ownership (mainly local and foreign banks), and principal dealing (member firms dealing directly with their clients) to the market. The effect has been increased turnover, more competitive rates and services for investors.

Market capitalisation of the JSE at the end of June 1999 totalled R1, 360 billion. Liquidity, measured by the fraction of annual trade over market capitalisation, in 1998 stood at 27 percent up from 5 percent in 1992. During that period new capital raised annually increased by almost nine times to R89.5 billion. Foreign trading on the JSE has shown a dramatic increase in the last 3 years with net purchases increasing seven fold to R42 billion in 1998 from R 5.2 billion in 1996.





**Figure 37: New capital raised on the JSE**

*Source: JSE*

### Debt: The Bond Exchange of South Africa

On 30 June 1998 the Bond Exchange listed 243 bonds issued by 23 borrowers with a nominal value of R380 billion, 80 percent are government bonds. Total turnover since 1997 has increased three fold to R7 048 billion and new capital raised totaled R6.5 billion. Since 1994 liquidity has more than doubled to 22 times.

Securities listed by the Bond Exchange are categorised as follows

- Fixed interest-bearing bonds with a single redemption date
- Fixed interest-bearing bonds with multiple redemption dates
- Zero coupon bonds
- Variable interest rate bonds

At present there are eleven market makers in government bonds. Only registered banks holding at least R1 billion in unimpaired capital that are members of the Bond Exchange may become market makers in government bonds. In the year ended 30 June 1998 foreigners accounted for R 2 361 billion or 33 percent of the nominal trading value on the Exchange.

### Futures: The South African Futures Exchange

Turnover of futures and options totaled 14 million contracts in the year ended 30 June 1998, having increased by 38.5 percent on the preceding year. This is compared to world volumes which increased by only 10 percent. Turnover as a percentage of trade on the JSE declined to 163 percent from a high of 336 percent in 1996.

In the Washington based Futures Industry Association's 1997 table of the World's Futures Exchanges, Safex improved its position from 25th to 22nd and finds itself in the distinguished company of the exchanges of countries such as the Netherlands and Switzerland. Safex's benchmark AlsI40 contract is recognised as the world's fifth most successful contracts of its kind. Open interest grew during the year to a new record of 1 822 982 contracts on 19 March 1998.

### Trading: Brokerages

*Broking members.* The table below shows the increase in broking members (51 percent) during the 90's.

	<b>Broking Memebers</b>	<b>Non- Broking</b>	<b>Firms</b>
1990	288	83	43
1991	307	85	47
1992	320	95	53
1993	322	108	53
1994	335	119	47
1995	354	118	46
1996	402	102	46
1997	449	121	49
1998	435	174	60

**Table 4: Broking members of the JSE**

*Source: JSE*

### Legislation and regulation

The Stock Exchange Control Act 1985 regulates the JSE. The Financial Markets Control Act 1989 regulates financial institutions. Both cover the activities of brokerages and were amended in 1998 to provide for the regulation of the cross-border supply of collective investment schemes and behaviour of investment managers.

The Bond Exchange of South Africa falls within the framework of the Financial Markets Control Act and a set of Rules and Directives approved by the Registrar of Financial Markets. The Bond Exchange is self-regulatory and is further charged with regulating the bond market in South Africa.

The South African Futures Exchange falls under the financial Markets control Act and the Registrar of Financial Markets.

## The entry of foreign brokerages

Before November 1995, no foreign brokerages operated on the Johannesburg Stock Exchange. This was due to a combination of political circumstances and JSE rules limiting membership to individual persons. The JSE rules up until November 1995 stipulated that only private individuals were members of the JSE. These individuals were shareholders and directors of their firms. After the adoption of corporate membership by the JSE in 1995, the picture changed dramatically. Six of the ten largest brokerages on the JSE are now foreign owned.

**Market share of foreign brokerages.** Foreign owned firms have also carved out a large slice of the futures market. Informed sources estimate that 40 percent of the trade done on the South African Futures Exchange is done by foreign owned firms. On the Bond Exchange of South Africa foreign firms also play a significant role. During 1999 (till mid June) 27 percent of trade on the BONDEX has been with non-residents. Another 23 percent have been offshore trade between non-residents. During 1998 21 percent of the trade on the Bond Exchange was offshore trade and 32 percent was with non-residents.

Most of the foreign owned brokerages in this country have gained access to the South African market by buying a share in a South African brokerage, as this is an easy entry point. Those brokerages that went this route generally bought about 50 percent of a local South African brokerage in the early 1990's and then after the JSE was deregulated in 1995, the rest of the South African business was purchased.

The foreign broking firms in this country are involved in a whole range of activities. These include:

- Principal and agency securities trading, including equity, fixed income and derivatives
- Equity and fixed income research
- Private client investment advice
- Corporate finance and distribution

The foreign brokerages in this country are generally part of a large investment bank. The reasons for locating in South Africa are as follows:

- Maintaining a global presence
- South Africa is an established emerging market and it is necessary to service global clients with an emerging markets interest.

- Relationships with large South African corporates

**Impact on the South African financial sector.** Apart from the dramatic inroads by acquisition in market share, foreign brokerages have had an impact on the market in a number of qualitative ways:

- Quality of research
- Market conduct
- Product innovation
- Demand for, and salaries of, high-level skilled personnel.

The **quality of research and analysis** available to investors has improved significantly during the 1990s. In large part this is due to the participation in the market of the foreign brokerages, and the competition that they bring. Clients of South African subsidiaries now have access to the international research capabilities of the global securities houses. This feeds through in various ways. Analysis of the impact of international financial developments improves; analysts in some houses participate in global sector teams, allowing them to collate international information about an industry; and new analytical tools and standards disseminate more quickly to South African analysts. The research edge of foreign firms is reflected in the annual Financial Mail rankings of analysts and the research capabilities of firms. In the latest rankings the top four positions were occupied by Deutsche Morgan Grenfell, Merrill Lynch, Fleming Martin and HSBC Simpson Mckie, all of which are foreign-owned brokerages. Of the thirty-one winners in individual analyst categories, nineteen came from foreign-owned brokerages. The entry of foreign firms has not left domestic firms behind, but led to an improvement in their competitiveness.

**Market conduct and risk management.** As in other areas, the major foreign financial institutions in broking have 'imported' the regulatory requirements and standards of market conduct required in their home jurisdictions. All foreign broking firms surveyed pointed out that the rules imposed on them by their parent companies are in some respects more stringent than South African regulation and that compliance is closely monitored.

**Product innovation.** Foreign-owned brokerages, and the banks that own them, have access to very large balance sheets, as well as expertise located in the global financial centres. This has enabled these conglomerates to offer new products in the securities fields, such as warrants on individual equities and a large number of customised derivative products traded over-the-counter.

**Demand for skills.** The entry of foreign ownership in brokerages in the mid-1990s dramatically increased demand for skilled staff, with a commensurate increase in remuneration and tax revenues.

## Trends

The main trends in the securities markets have been:

- Innovation
- Mergers
- Increased competition for trading companies
- Updating clearing systems
- Capital raising boom

**Innovation.** Access to a larger balance sheet and pool of funds has enabled foreign financial firms to construct more complex products. This has increased the level of sophistication in the local market.

**Merger of exchanges.** In line with the international trend towards integrated or merged markets the S.A. Futures Exchange, the Bond Exchange and JSE have agreed in principle to a merger.

**Increased competition for trading companies.** Foreign brokerages have increased the level of competition in the South African market over the last four years in term of price and range of products.

**Updating clearing systems.** Introduction of STRATE, a central securities depository, in mid to late 1999 facilitating the move to a paperless system.

**Capital raising boom.** New capital raised on the JSE has increased dramatically from R10 billion in 1994 to almost R90 billion in 1998.

## 10

### Securities: Market Access and the WTO

How difficult is it for foreign brokerage companies to access South African customers? In this chapter we identify the regulatory requirements for establishing a brokerage in South Africa. The second section examines the impact of regulation on the level of access of foreign insurance companies. This is divided according to three types of access, namely: **cross-border supply, consumption abroad** and **commercial presence**. The third section outlines the existing commitments to the WTO and the final section looks at the potential for requests from other countries in the next round.

## Exchange services

An exchange provides for the listing, trading, clearing and settlement of financial instruments such as bonds, equities or futures.

### ***Requirements to operate an exchange in South Africa***

In order to establish an exchange ten or more persons must form an association to carry on the business of a financial market and an application must be made to the Registrar of Financial Markets for a certificate authorising the Receiver of Revenue issue a license. The license specifies the place at which or the trading method or facility by means of which the business of the financial market be carried on, and that business shall not be carried on at any other place or in any other manner without the prior approval of the Registrar.

The openness South Africa for foreign exchanges is defined by the degree to which these companies can access the local market. As is recognised by the negotiation methodology of the World Trade Organisation, there are three channels through which access can occur. We look at each in turn.

- **Cross border supply** (mode 1). Special permission for foreign primary listings must be applied for to Minister of Finance. Applications for secondary listings must be submitted to the Reserve Bank, which makes its decision based on the particular circumstance of that listing.
- **Consumption abroad** (mode 2). The conditions for foreign primary and secondary listing are given above.
- **Commercial presence** (mode 3). There are no restrictions contained in the Act regarding the nationality of who is allowed to establish an exchange. As long as the predetermined procedures are adhered to and the investor protection requirements are met there are no restrictions on the establishment of an exchange.

## Brokerages

***Requirements to operate a brokerage.*** A brokerage must be a separately capitalised public company, registered with the Financial Markets Board and a member of the relevant exchange. Foreign brokerages are allowed to trade on the JSE if they are already members of an approved foreign exchange. Also foreign firms are permitted to list on the JSE.

The openness of South African capital markets is defined by the degree to which foreign brokerages can access the local market. As is recognised by the negotiation methodology of the World Trade Organisation, there are three channels through which access can occur. We look at each in turn.

- **Cross border supply** (mode 1). Under section 39 of the Stock Exchange Control Act, the only way for a foreign based firm to provide stock broking services without locating to South Africa is to be a member of a foreign stock exchange recognised by the Registrar. Under no circumstance can a broker from a non-recognised foreign stock exchange directly or indirectly advertise or canvass for any business relating to the buying and selling of securities on that exchange. Furthermore, even if the broker is a member of a recognised foreign stock exchange the marketing and advertising for business is subject to special requirements laid down by the registrar and the broker has to be registered with the Registrar. This has implications for the potential for remote membership of the JSE

Exchange controls as discussed in previous chapters also restrict the cross border supply of brokerage services.

- **Consumption abroad** (mode 2). The primary binding constrain on South African consumers is exchange control limits which restrict the amount of money they may take out of South Africa to R 500 000 per person per lifetime. In the case of a travel allowance, persons are limited to R120 000 per annum, but the unspent travel allowance must be brought back to the country with them.

Exchange controls as above.

- **Commercial presence** (mode 3). The effect of regulation on foreign brokerages in South Africa has three dimensions. Firstly, differential regulation that restricts the foreign entry into South Africa. Secondly, prudential regulation that, although applying equally to foreign and domestic insurance companies, constrains the operations of foreign entrants. Finally, the effect of exchange controls.

**Differential.** No branches are permitted.

**Prudential.** Brokerages are required to be separately capitalised companies and are also subject to thin capitalisation rule imposed by the Receiver of Revenue. This rule states that all business has to be capitalised locally and limits the amount of debt relative to capital that can be raised, especially from the parent. The reason behind this is to stop brokerages using parent funding entirely in the form of debt, which reduces taxable income. The Receiver of Revenue allows a debt equity ratio of between 35 and 40 percent. This has two effects: Firstly, it reduces the firm's ability to raise debt finance, internationally and locally. Secondly, the amount capital invested and held locally opens the local concern up to exchange rate risk which reducing the willingness of the

parent to capitalise the brokerage and thus limits access to the parent balance sheet.

***Exchange controls.*** Restricts foreign brokerages access to domestic and international finance as well as providing controls on non-resident holdings of shares.

## South Africa's Existing WTO Commitments

### **Cross border supply (mode 1)**

#### ***Market access and National treatment***

South Africa has not made any commitments in the WTO to opening up access of the South African banking market through this channel.

### **Consumption abroad (mode 2)**

#### ***Market access and National treatment***

No commitments have been undertaken in the WTO except providing for the free transmission of financial information and financial data processing.

### **Commercial presence (mode 3)**

#### ***Market access and National treatment***

Unit trust companies and any company providing custodial services for securities and financial instruments need to be incorporated as public companies in South Africa and registered with the supervisory authority.

### **Presence of natural persons (mode 4)**

#### ***Market access and National treatment***

South Africa has not undertaken any commitments with regard to the presence of natural persons except for allowing the temporary presence of a natural person for a period of up to three years, unless otherwise specified, without requiring compliance with an economic needs test. The following categories of natural persons providing a service qualify:

- Services salesperson
- Intra-corporate Transferees
- Executives
- Managers
- Specialists
- Professionals



Looking forward to the next round of negotiations in 2000 it is reasonable to expect that the requests from other countries will be, at the very least, reiterated.

The requests of the U.S. and the EU are detailed below and give a sense of what can be expected. The requests are as follows:

***US request***

- Guarantee foreign participants the ability to maintain existing ownership or control of local financial services firms, or to continue financial service activities in which they are engaged. ***The South African securities market access rules comply with this request.***
- Non-prudential reserve or paid-in capital requirements that discriminates against foreign participants, including requirements that deny foreign branches the ability to include the capital of their head office in meeting capitalisation requirements. ***The South African securities market access rules do not comply with this request.***
- Local currency borrowing restrictions whereby majority foreign owned financial institutions and borrowings are determined by a different formula. ***The South African securities markets do not comply with this requirement.***

Any strategy for defending the current set of regulations will need to be built up in the context of these requests. However, it should be noted that the exchange control request is not part of the negotiating forum for financial services at the WTO.

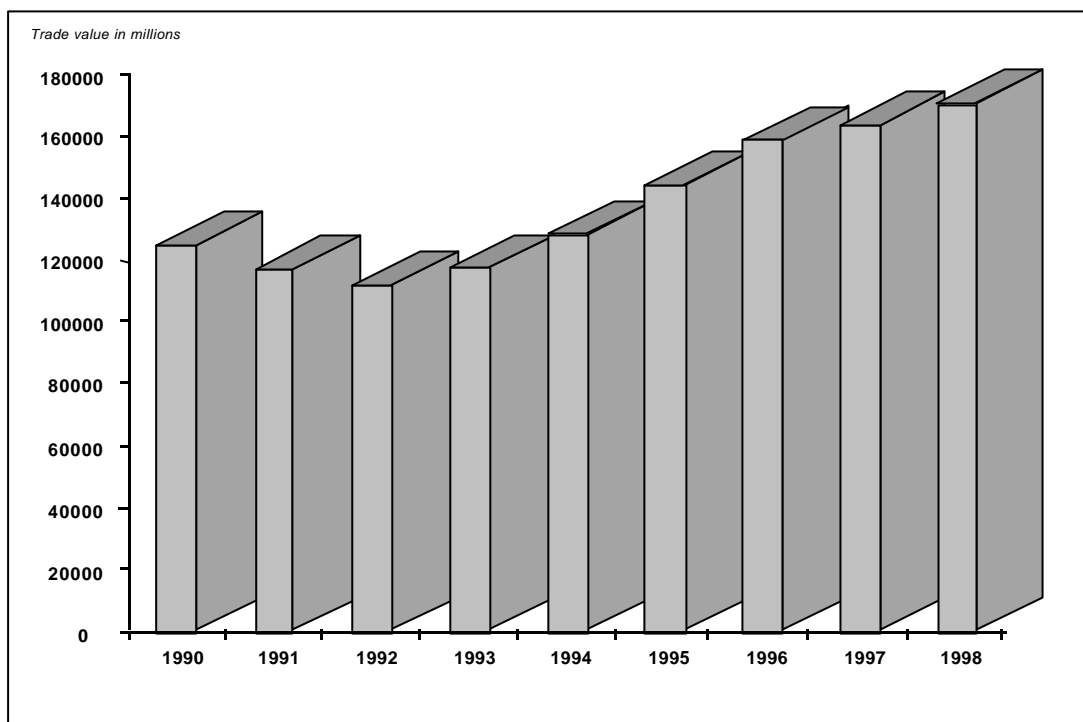
# 11

## Financial Services Exports from South Africa

This chapter provides a brief overview of exports and foreign operations of financial services firms using South Africa as a base. Although data is extremely sketchy, available information indicates that such activities have increased dramatically since 1994. We then point, in turn, to policies and circumstances in recipient countries, and in South Africa, that impede the growth of financial services exports.

**Trade finance.** The expansion of regional trade in the 1990s has led to a greater demand for trade finance and associated services in South Africa and the rest of Africa. South African trade increased by 37 percent over the period, which gives an indication of the increase in the need for trade finance. Competition in other African countries is tough in as much as there are other foreign banks present in that market.

Trade finance can be arranged for both exports to other countries and imports to South Africa. The service can be provided through cross border supply or through a local presence in other countries.



**Figure 38: Value of Trade**

Source: SSA

Export finance mostly relies in some form on the creditworthiness of foreign counterparties, entailing considerations of sovereign and corporate risk in the region. For example, the provision of trade finance is often backed by letters of credit from approved banks in other countries. Trade finance considerations are linked to the expansion of South African banking networks into Africa (see below): a bank maximises trade finance earnings by being located at both ends of a trade transaction.

**Local market banking services.** South African banks are expanding offshore through the establishment of branches, subsidiaries and acquisition. For example, Standard Bank controls 28 –30 subsidiaries and maintains an extensive branch network in 14 African countries. They employ approximately 3500 staff and generate after tax earnings of about R300 million. Although Standard Bank leads in this field, ABSA, First National Bank and NBS/Boland have all made strategic moves into the African market or announced initiatives.

**Finance companies.** Some South African banks have established finance companies offshore to aid domestic client's international expansion. Finance companies do not take part in traditional banking in the foreign country, but provide specialised banking services such as corporate structuring and raising finance from local banking systems or international capital markets. This type of international expansion has mainly occurred in the corporate banking market, and markets are entered as dictated by the needs of existing clients. The advantage of this strategy is that the finance company does not use its own

balance sheet and hence does not incur the associated risk, while still earning the service fees.

**Alliances.** The other predominant strategy is to purchase foreign companies with strong positions in niche markets, such as trust fund management. Often the strategy is directed at forming non-competitive alliances and strategic partnerships with other firms. The South African firms would commonly contribute product innovation, while the foreign partner firm provides market access and a client base. The relationship established with the partner firm is an important spin-off, as it may result in reciprocity when the partner's clients seek financial services upon entry into South Africa.

**Two-thirds of foreign banks in SA export services to Africa.** Although most business conducted by foreign bank branches and representative offices in South Africa is generated internally, two-thirds use the country as a base from which to export financial services to other African countries. South Africa is an exporting base for 73 percent of representative offices and 45 percent of branches and subsidiaries.

**Regional headquarters in SA.** In a number of instances foreign banks operating in Africa have elected to use Johannesburg their regional headquarters. In one case, a British investment bank has significant interests in Africa, including joint ventures in Namibia, Botswana, Mauritius and Malawi. This bank views its South African operation as a hub through which all of

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#### Services exported to Africa by foreign banks in South Africa

- International commercial finance
- Trade finance and export credit services
- Project finance
- Advisory and general investment banking services.

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these operations are controlled. However, where foreign banks have retail operations in other African countries, the headquarters for these interests tend to be in the home country of the bank concerned.

In most cases financial services are exported to the whole SADC region, but some banks cover only Mozambique, Zambia, Namibia and Botswana. North Africa is generally not serviced from Johannesburg.

There are a number of cases where services are not exported to other African countries, but are provided from their home office or London. The choice of location is influenced by two factors, namely the relative scarcity in South Africa of qualified staff and regulatory constraints, which mostly have to do with exchange control.

**Insurance.** South Africa is roughly estimated to account for around three-quarters of the insurance market in Sub-Saharan Africa. Therefore insurers, attracted by the South African market, have chosen to locate here, and only

over time develop other African activities, using South Africa as a base. At this point 57 percent of foreign owned insurers that operate in South Africa export their services to other parts of Africa. Markets covered are usually the SADC region, but in some cases include Nigeria, Cameroon, Uganda, Ghana and Kenya.

Some companies provide only marketing links and advisory services to other African countries while others provide a full range of reinsurance or short term insurance services. Some of the insurers have subsidiaries or branches in other SADC countries. In some cases a client of an international insurer with a South African subsidiary will get insurance from a local company and the local company will in turn be reinsured by the client's international insurer.

In the majority of cases where the parent company has other African interests and South Africa is used as an export base, the headquarters for the other African interests is the South African office. However some business is also done out of London.

**Brokerages.** Brokerages serve mainly the SADC countries, but some serve West Africa. Corporate finance, advisory services and research are some of the services conducted in other African countries. Two-thirds of the foreign brokerages in South Africa export services to other African countries.

**Johannesburg Stock Exchange.** In February 1998 the JSE offered the usage of its JET system at cost to the other exchanges in the SADC. The Namibian stock exchange (NSX) was the first to take advantage of this offer, and the system was installed in November 1998. As yet no other exchanges have taken up the offer. Foreign companies are now permitted to list on the JSE, but the exchange has not yet been used to raise capital by non South African companies active in Africa.

**The SADC committee of stock exchanges** was formed in January 1997 as a private sector initiative within the SADC framework. Members thus far: South Africa, Namibia, Botswana, Mauritius, Swaziland, Tanzania, Zambia and Zimbabwe. The aim is the promotion of cross border investment, the introduction of depository receipts and the facilitation of dual listings. The strategy of the SADC Committee of Stock Exchanges aims to keep national markets autonomous and to find ways of using technology, dual listings, skills sharing and cross border investment within the SADC to combine forces and speed development of the regions exchanges.

**Asset management.** Foreign take-up of South African unit trusts and pension funds is not widespread, the main market being expatriates who have blocked funds still in the country. However, three quarters of foreign asset management firms active in South Africa do serve other African countries from here. In other cases the firms have other asset management businesses in the region. Some South African asset management firms, such as Old Mutual and Investec Guinness Flight, have been able to successfully enter foreign

markets. These firms have operations in a number of African countries as well as mid-sized operations based in the United Kingdom.

## Foreign Country Restrictions on SA Financial Exports

Restrictions imposed by foreign countries on the access of South African financial institutions to foreign markets take two forms.

- **Specific regulation** that limits the access of South African banks to the foreign country's consumers. Direct limitations may take the form of direct restriction on the offering of products to the foreign consumer or may take the form of specific requirements placed on the branch or subsidiary that leaves it at a competitive disadvantage.
- **The general business environment** such as the lack of infrastructure, inefficient bureaucracy, political inconsistency and risk.

In discussing these barriers, we focus on banking and insurance which are the largest exporting sectors.

### **Specific regulation constraining banks**

**Ownership.** Limitations on foreign ownership in African countries can pose difficulties. For example, in Zimbabwe there is a limitation of the percentage of local firms that foreigners can own. This has been relaxed to 35 percent from an outright ban on foreign ownership a few years ago. Thus to establish a subsidiary the foreign entrant must find a local partner who will control 65 percent of the subsidiary.

**Liquidity requirements.** In some cases the central bank sets these requirements in order to ensure its own liquidity. In some cases (such as Zambia) the central banks require that 40 per cent of the branches capital be deposited with it as a liquidity requirement. This puts pressure on profit margins.

**Red tape.** A common way of limiting access is through the use of extensive application procedures for bank licenses for foreign entities.

**Subsidisation of local competitors.** The local legislation can make it difficult for branches to expand. For example, in Nigeria, local legislation coupled with subsidisation of domestic banks makes expansion for foreign banks difficult.

**Limits on expatriate employment.** Branches in the African countries are also bound by other indirect regulations such as employment laws. In some cases they compel the branches to employ a certain percentage of nationals, which is usually defined as a ratio of the number of expatriate personnel employed in the branch.

**Foreign exchange.** Foreign exchange shortages and foreign exchange controls restrict banks trading in foreign exchange by restricting the level of foreign exchange holdings. In some cases the central bank may require all foreign exchange to be deposited with it. The central bank may choose not to pay interest on those deposits and may also limit access to those deposits as it sees fit.

**Discriminatory application of regulation** South African banks in the foreign countries have to obey the rules as laid down. However, there is a perception in some countries that local banks face no consequences for disobeying regulations.

**Specific regulation constraining insurers.** Insurance markets in Africa are characterised by higher capital and liquidity requirements. These translate into higher costs in two ways

**Costlier float.** Increased capital and liquidity requirements leaves less funds available for investment and the payment of claims. In this case the premiums need to be higher to earn a particular level of profit.

**Exchange rate risk.** Higher capitalisation, which usually needs to be held locally, increases the potential losses on that capital to the parent from exchange rate fluctuations.

**Reinsurance.** In some African countries a predetermined percentage of reinsurance has to be placed with the government reinsurer. This limits the capacity to use the parent for reinsurance. The use of the parent for reinsurance is a common practice worldwide. This restriction reduces the profitability of the market concerned.

**Business environment** This section examines the impact of poor infrastructure and institutional culture on foreign banks and insurers in the African region.

**Infrastructure.** Infrastructure problems in telephones, roads, public transport make operations in African countries difficult. Services are generally poor. The poor infrastructure increases the process time of transactions and increases costs.

**Legal system.** In some cases legal systems have broken down and in many cases commercial law is underdeveloped and contracts cannot be properly enforced. This creates a level of legal risk which is difficult to assess from

the outside and virtually impossible to lay off – but is potentially very costly.

***Institutional culture.*** In a number of countries there is a perception that one needs to know the right people and have the right political connections to get applications for banking licenses approved timeously.

***Policy uncertainty.*** Volatility in terms of government policies and their direction can be problematic. Governments can change policies and regulations at any time without warning and with no regard for the consequences for foreign firms with sunk costs.

***Limited customer base.*** The main customers tend to be government agencies, although the private sector is gaining ground. The limited size and customer base increases the risks associated with doing business in Africa

## SA Restrictions on Financial Services Exports

Exchange controls are the main South African restriction on the export of financial services.

***Exchange controls on insurers.*** The Exchange Control Act prohibits insurance companies from holding foreign exchange. This limits the domestic insurer's capacity to match foreign liabilities with foreign assets as well as introducing currency risk on to the domestic company's balance sheet. The restrictions have two effects. Firstly, the competitiveness of local insurers is reduced in foreign markets in terms of cross-border access. Secondly, there is a loss of business from local firms that are expanding internationally and require their foreign assets be insured in a foreign currency.

***Exchange controls on banks.*** South African banks are not permitted to make loans to foreign clients using their domestic South African funds and balance sheet. The only way for them to do this is by using their offshore funds. This limits the capacity of South African banks to compete in the international markets, as most of the assets are on-shore. South Africa's large banks have surplus capital on-shore which they cannot utilise in the domestic market.

***Capital markets.*** The ability to raise debt on the international market is constrained by exchange control regulations about the nature and form of finance as well as the source.

### Need for bilateral policy co-ordination

There are two considerations here:

***Liquidity.*** Duplication of regulation especially with reference to liquidity requirements.



**Double taxation**, where companies are taxed on the same profits in the foreign country and in South Africa.

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