Non-bank institutional investment behaviour in the South African market

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ABSTRACT

South Africa has a fairly large, well developed and sophisticated financial sector and system. The financial sector weathered the global financial crisis without any major disruptions. Nonetheless, the country has not been spared the regulatory changes that are being implemented at the global level. Globally, non-bank financial intermediaries or institutional investors have become increasingly important to policy makers and regulators given their role and relative size in the financial sector and the transmission of shocks to the real economy.

The paper looks at the non-bank institutional investment behaviour in the South African market over the period 1990 to 2010. It is established that the non-bank institutions have grown over the years and measured by total assets, are the largest in the financial sector. Within the non-bank sector, insurance companies are the biggest, followed by pension and provident funds and lastly mutual funds (unit trusts).

The asset allocation over the years has not displayed any dramatic shifts as it is still dominated by the traditional assets. Allocations to equities have on average remained above 40 per cent, whereas fixed-interest securities declined significantly from being dominant to roughly 20 per cent. Meanwhile, cash and deposits have increased. The observed trends are mainly on account of regulatory developments, asset-liability management strategies and the need to close funding gaps, which ultimately impact on the investment behaviour and strategies.

The paper concludes by proposing remedial statistical measures to close the identified loopholes in the tracking of financial behaviour. The proposed measures also aim to enhance the existing statistical collection framework and enrich it by proposing further dis-aggregation in an effort to improve quality in the measurement of risk behaviour.

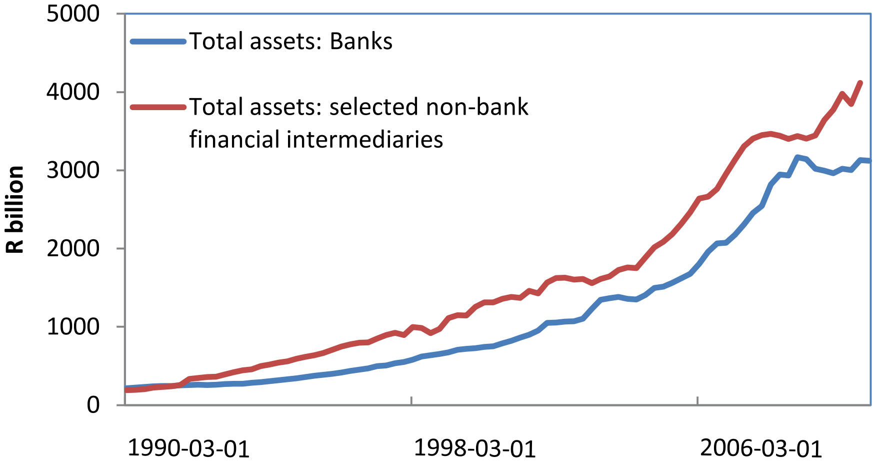
Introduction

Following the global financial crisis, non-bank financial institutions or investors[1] have become increasingly important in the global financial markets, to regulators and policy makers, particularly for monetary, financial and economic analysis. This paper analyses trends in the institutional investors' allocations in the South African financial market. In particular, the study looks at the key investment asset classes since 1990 and highlights some possible factors behind these trends.

Background on South African main institutional investors

In South Africa the main institutional investors comprise of pension and provident funds, insurers (long-term and short-term) and unit trusts. The size and importance of institutional investors has grown over the years as shown in figure 1.

Figure 1. South Africa: financial sector

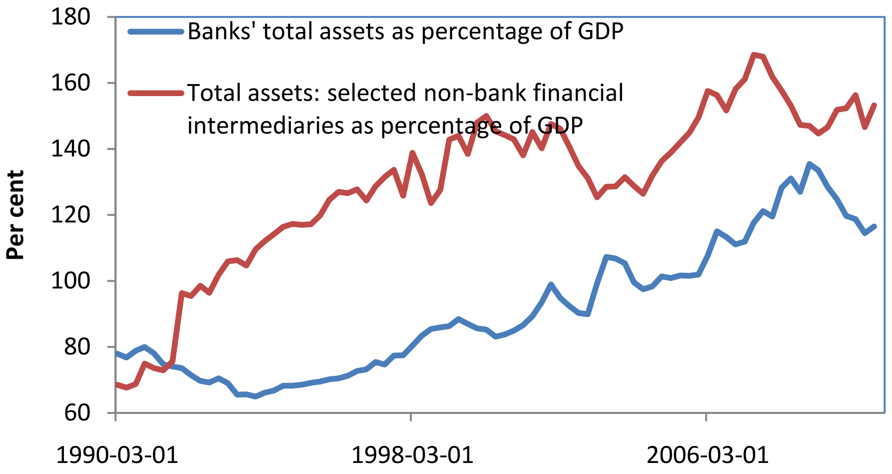


Measured by total assets in absolute levels and relative to the GDP (figure 2) and compared to banks, they are the largest in the financial sector.

Relative to GDP as shown in figure 2, institutional investors' assets account for levels above 140 per cent of the GDP whereas the banks are around 120 per cent of the GDP.

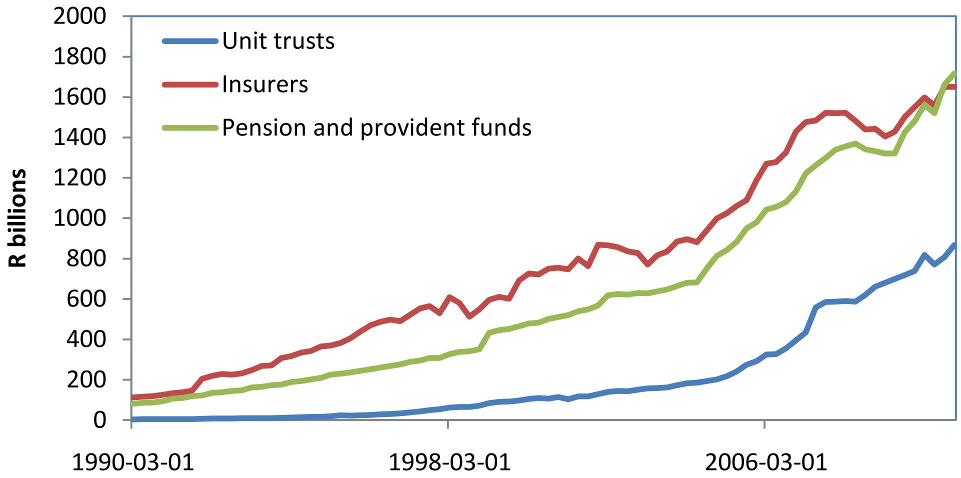
[1] In the paper, non-bank financial institutions or institutional investors are composed of pension and provident funds, insurers and unit trusts.

Figure 2. South Africa: financial sector relative to GDP



Within the non-bank sector, insurance companies are the biggest, and then followed by pension and provident funds and lastly unit trusts.

Figure 3. South Africa: total assets of selected non-bank institutions



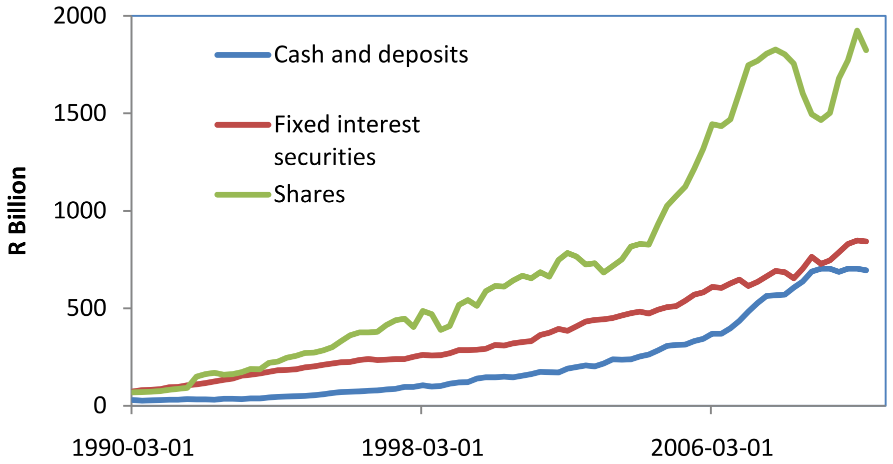
Institutional investors' asset allocation

Since the beginning of the 1990s, institutional investors globally have shown increased interest in alternative asset classes[2]. Nonetheless, in the South African

[2] An investment is considered alternative if it has a relatively limited investment history, is relatively uncommon in investment portfolios, is relatively illiquid, has different performance characteristics than traditional assets, is rarely traded in public markets and requires specialised skills on the part of the manager. Alternative investment classes for institutional investors are of a wide range but include major categories such as real estate, private equity, hedge funds and infrastructure.

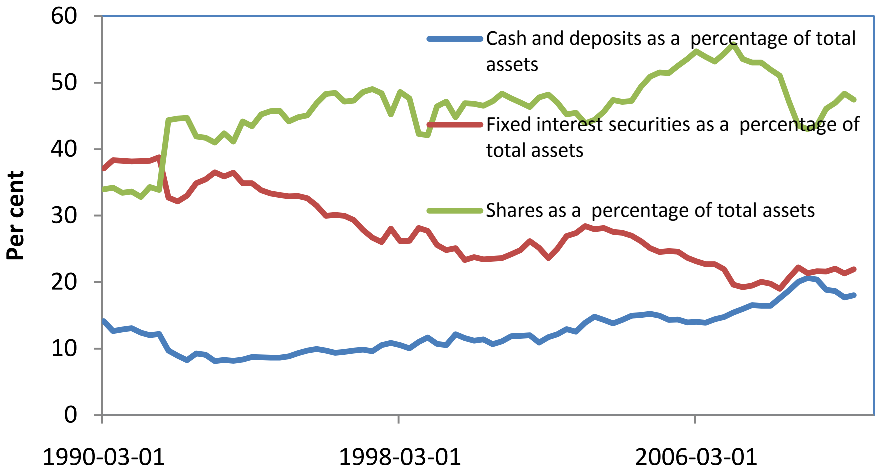
case, over the years as shown in figure 4, there has not been a dramatic shift in asset allocation as it is still dominated by the traditional assets[3].

Figure 4. Selected institutional investors: Asset allocation



Relative to total assets, as shown in figure 5, equities have on average remained above 40 per cent, whereas fixed interest securities declined significantly from dominant levels of around 40 per cent in the early 1990s to roughly 20 per cent. On the other hand, cash and deposits have increased from 10 per cent to levels around those of fixed interest securities.

Figure 5. Institutional investors: Asset allocation relative to total assets



The data also shows that South African institutional investors are driven largely by equity-oriented investment strategy, which is justified on the basis that such

[3] Traditional assets or investments are comprised of stocks, bonds and cash equivalents.

institutions have long-term investment horizons and this therefore allows them to tolerate additional risk in exchange for higher expected returns from equities relative to bonds and cash. Moreover, it is argued that equity investments (equity exposure) allow for better hedging of wage growth risks and lower expected plan contributions for the same level of benefits on the part of pension funds.

Within institutional investors, as mentioned earlier, insurance companies followed by pension and provident funds are the main recipients of the private sector assets and thus dominate the trends in asset allocations displayed in figures 3 and 4 (this aspect is discussed further in the section that deals with insurers and pension and provident funds). Moreover, asset allocation trends as observed have also been largely (directly and indirectly) influenced by regulatory policy reforms.

Trends in insurers'[4] asset allocation

As mentioned earlier insurers[5] are the largest group in the non-bank financial sector and within the category, the long-term insurance sector dominates mainly on account of the retirement savings market[6]. The South African insurance market is characterised by extensive interrelationships with banks through cross ownership and are amongst the main sources of funds for banks (this is mostly the case for short-term insurers and this is also evident in their asset allocation which is dominated by cash and deposits). Over and above, compared to agents and brokers, banks are mostly used as a major distribution channel for insurance products.

The risks underwritten by the insurance sector are predominantly for the domestic market (i.e. domestic customers) and mostly the retail level inclusive of group pensions and employee benefit schemes. In contrast to the global trends in the recent past, South African insurance companies are not involved in wholesale credit protection business such as credit default swaps[7], exposure to hard-to-value structured finance products was limited due to conservative approaches to risk, tight regulation on investments and the remaining exchange controls[8] credited for the sound performance of this sector during the financial crisis.

Figure 6, shows the asset allocation of the insurance sector. The observed trend is dominated by long-term insurers whose asset allocation is skewed towards equities. This is comparable to trends observed in asset allocation by Australian insurers who are dominant in equities as opposed to German insurers who are dominated by deposits and loans (BIS, 2007).

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[4] Insurance companies are divided between long-term insurance (comprising of life, health and disability insurance – these policies mainly pay out a benefit when the insured party dies, falls ill or becomes disabled) and short-term insurance (comprising of insurance for possessions that are owned by individuals and is mostly taken out on homes and/ or home contents, and cars or any other possessions).

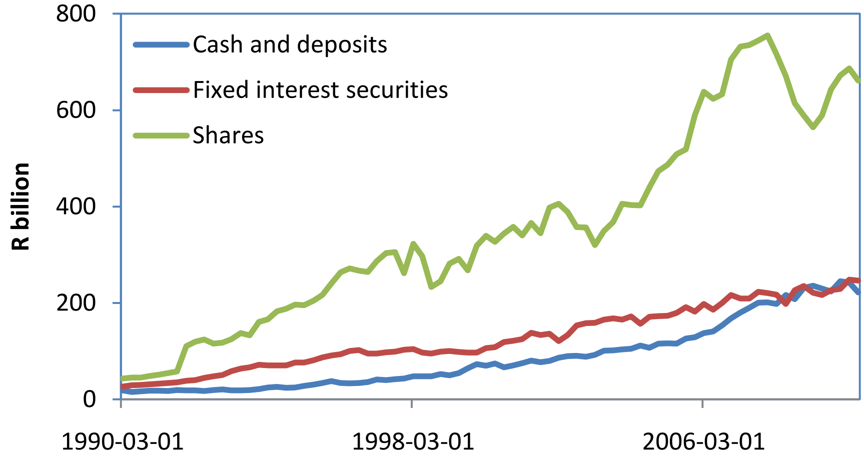
[5] This contrasts well with the dominance of insurance companies (in particular life insurance policies are the main form of retirement savings) in the Japan, Korea and most euro area countries as opposed to pension funds in countries such as Australia, Canada, the Netherlands, Switzerland and the United Kingdom as (BIS, 2007).

[6] For long-term insurers, the underwriting of retirement funds (retirement savings vehicles) account for the bulk of their business activity.

[7] As a result, no companies traded in credit default swaps.

[8] Exchange control requirements with respect to long-term insurers limit foreign assets backing retail business to 20 per cent of the total non-linked business and 30 per cent of the linked business.

Graph 6. Asset allocation of insurers



Based on asset allocation and the fact that over a prolonged period South African long-term insurers' business models were dominated by the selling of products with significant guarantees and promises based on equity-based returns, the resulting risks are structural exposure to equity markets (in particular, sustained declining episodes) and declines in interest rates as such phases increase the value of guarantees to policy holders. Over and above, dominance of the retirement savings market through annuities business increases their exposure to longevity risk. This risk is also not easily hedged and the matching of liabilities with appropriate assets is difficult given the shortage of long-term bonds in the domestic market (IMF, 2010).

The impact of equities markets on long-term insurers was evident during the financial crisis due to their large exposure to equities and the steep fall in their share prices in line with the insurance sector globally. Nonetheless, the losses from the performance of equities were cushioned by the bonus stabilisation reserves[9] built up in the strong markets that preceded the financial crisis which acted as a regulatory risk mitigating measure. Moreover, a large portion of the investment risk in the asset portfolios of insurers is directly borne by policy holders in their shares of investment and bonus reserves.

On the other hand, short-term insurers because their business is dominated by the motor and property insurance industry (which accounts for the bulk of gross premium income), are mostly exposed to accident related losses and motor theft and high replacement costs.

Nonetheless, both sectors are exposed to the impact of the recession and the recent developments in the real economy which have resulted in tight conditions in the labour market and fall in new business volumes coupled with higher policy lapses and surrenders. The sector is also exposed to the interest rate cycles and contagion

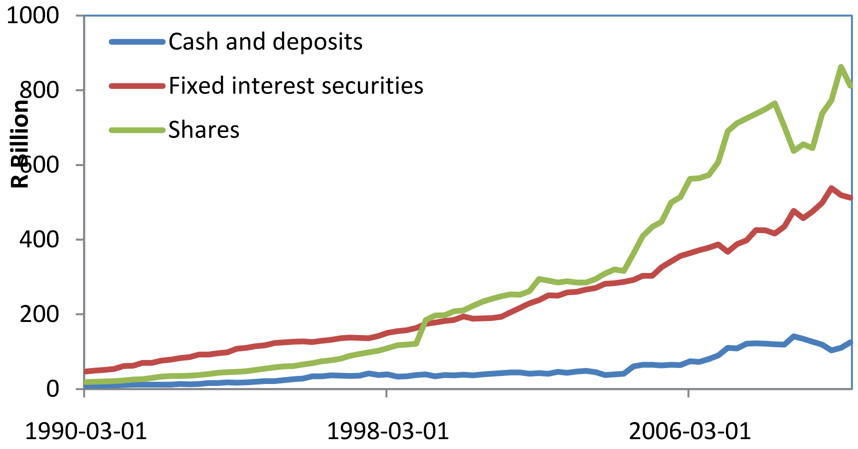
[9] Bonus Stabilisation Reserves are amounts withheld from investment returns that would otherwise be payable to policy holders in the form of bonuses during periods when returns are relatively high. Reserves are released during periods of low returns as a measure of avoiding the reductions in bonuses that would otherwise be necessary – investment and bonus reserves accelerated strongly during the recent bull- run in financial markets and offered a cushion on the impact of shocks (FSB, 2010).

risks in particular given the interrelationships between insurance and banking[10] and the fact that they are amongst main sources of wholesale funding for the baking sector.

Trends in pension and provident funds' asset allocation

The pension and provident funds sector has grown over the years with total assets comparable to those of the insurance sectors (as shown in figure 3). As shown in figure 7, asset allocation by the sector was previously dominated by fixed interest securities until the late 1990s, when equities became dominant.

Figure 7. Asset allocation of pension funds



The pension fund investment regulation (Regulation 28 to the Pension Funds Act[11]) governs the investment behaviour of the pension funds sector by empowering the Minister of Finance to define asset spreading requirement for pension funds. The regulations have over the years and currently impact on the asset allocation by this sector. Through setting the prudential limits on the asset allocations by pension funds, historically, Regulation 28 has restricted investments in unlisted equity and excluded allocations into derivatives (except to the extent that they fall within the 2,5 per cent for other assets), structured products and foreign investments into which there is no control on the part of the trustees in terms of the sectors in which foreign investment managers invest.

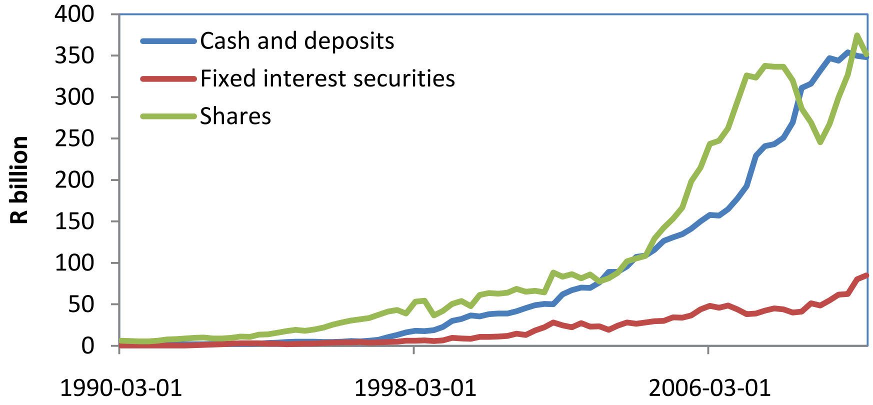
The regulations allowed up to 100 per cent to be invested in fixed interest stock, not more than 75 per cent in equities and a uniform approach towards fund managers. These have resulted in the dominance of asset classes such as equities, fixed interest securities and government stock. Exposure and risks to government stock have been justified on the basis that they carry a guarantee whereas for other fixed interest securities relative to equities the risks are more or less similar. Moreover, the regulations make the matching of liabilities and inflation hedging difficult.

[10] Four of the five largest insurance groups have ownership links to major banks.
[11] The Regulations have been revised and the new investment regulations become effective from 1 July 2011.

Trends in unit trusts' asset allocation

The unit trusts industry has grown considerably over the years and has become one of the most important investment vehicles for savings. As shown in figure 8, their asset allocation is dominated by both equities and cash and deposits. They are amongst the main sources of funding for the banking sector.

Figure 8. Asset allocation of unit trusts



Areas for improvement and closing some identified loopholes

The most embedded problem we face with South African data is a too large "other investments" item on institutions' reported balance sheets. This means that there is a need to dis-aggregate instruments further from the currently identified ones. In this instance there is a need to clearly identify derivatives and other alternative investments classified under other investments.

Furthermore, with the equities asset class, a sectoral split will enhance analysis and measurement of risks. The proposed split is as follows:

Of the listed shares or equities invested in, the proposed split includes:

(i) resource sector *of which: gold, platinum and other*;
(ii) industrial sector *of which: consumer services, consumer goods and other*;
(iii) financial sector *of which: banks, life insurance and other*.

Data analysis can be further enhanced by valuation adjustments, as the trends observed in the asset allocation are highly influenced by the fact that we do not adjust for movements in price or exchange rate or interest rates. In this regard, disaggregation in data as follows is suggested:

(i) Opening balance
(ii) Transactions (split into:purchases and sales)
(iii) Revaluations
    of which: price changes
    of which: interest rate changes
    of which: exchange rate changes
(iv) Other changes
(v) Closing balance

The distinction of investments between those that are *available for sale* and those *held to maturity* will also enhance the analysis of valuation changes given the fact that the manner in which investments are accounted for on the balance sheet makes a substantial difference to valuations (i.e. if instruments held on the balance sheets are on a hold-to-maturity basis they are affected differently to those on a mark-to-market basis).

Conclusion

The South African financial sector has grown over the years and the non-bank financial institutions are a force to be reckoned with; in particular insurers and pension and provident funds. The financial sector weathered the global financial crisis without any major disruptions. Asset allocation by various institutional investors is dominated by equities and fixed interest securities mainly on account of the investment regulations, asset-liability management strategies and the need to close funding gaps which ultimately impact on the investment behaviour and strategies. Their role in credit extension or loans is minimal although it has grown.

The performance of the sector has been dominated by buoyant economic and financial markets activity (which has resulted in the prolonged underwriting cycle upswing) and the low incidence of major losses. This exposes the sector to large macro-financial risks. Most retirement fund members belong to the defined contribution funds in which the investment risk in the asset portfolios is directly carried by policy holders in their shares of investment and bonus reserves. The analysis also shows that, although the insurers' (life insurance) and pension funds' activities are similar, their investment policies are different.

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