27FOUR INVESTMENT MANAGERS (PTY) LTD
SUBMISSION ON TRANSFORMATION IN THE FINANCIAL SECTOR
STANDING COMMITTEE ON FINANCE AND PORTFOLIO COMMITTEE ON TRADE AND INDUSTRY

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27four

INVESTMENT MANAGERS

CONTENTS

1. INTRODUCTION

Embedded in the attainment of political independence is the need for markets and transactional freedom. In fact, it is unarguable that the former cannot be complete without the latter. It goes without saying that the clamour for the re-examination of the financial sector is a corollary of an aspiration for a deeper entrenchment of economic freedom and parity through the elimination of barriers to competition in the highly concentrated sector. The perceived threat by government that any substantial change may result in the 'collapse' of a 'competitive, stable and efficient' financial system and thus requires incremental change remain flawed. Subsequently, the incentives for change remain tentative resulting in 'business as usual' with marginal adjustments (Financial Sector Charter Council, 2015).

This presentation is not premised on and in fact makes a departure from populist sentiment by providing solutions to the problem of the rooted anticompetitive environment. It is hoped that by articulating these suggestions, this paper will provide a few strategies aimed at aligning government's broad agenda designed to engender the attainment of economic equality.

This presentation is not a lobby for the removal of competition, rather it is a plea for the removal of dynamics that curtail competition and thus enhance Black firms' fragility.

2. THE PROBLEM OF CONCENTRATION RISK

It is inarguable from whichever angle one looks in South Africa, it is obvious that nearly every industry is concentrated into fewer and fewer hands. Despite the widely recognised phenomenon of scale economies, the majority of firms have always been small if not sub-optimal. This is especially so in the highly concentrated financial sector. In a sector dominated by a cartel of "a few big players" to which the government shows near-religious deference more than any other sector, calls for an urgent intervention aimed at addressing the asymmetric size distribution of financial benefits and the dismantling of this oligopoly have merit. The foundations of this lopsided and anti-competitive set up and the consequent dominancy – barriers to entry for newer firms (and therefore to economies of scale), collusion with political powers, among other factors, are common cause and need not be restated. For a country whose highly celebrated constitution, one which is premised on the need to ease economic participation, these oligopolistic features are not only sad but are an anachronism of the pre-1994 milieu. It undermines the economic welfare agenda upon which, among other objectives, the Constitution is built.

The South African situation defies the notion that markets operate in a competitive environment and that government should not interfere.

3. THE SAVINGS AND INVESTMENTS INDUSTRY

The financial services is a 'backbone' industrial sector with strong growth inducing downstream effects. Traditionally banks have played a critical role in financing industry and contributing to economic growth; in the last couple of decades the Asset Management subsector has increased its funding towards economic activities. It is expected to sharply intensify its role in financing industrial growth and infrastructure development projects in the decade ahead. In South Africa the savings and insurance companies manages roughly R9trillion of our nation's savings and investments (National Treasury, 2017). As such, the Asset Management subsector needs to be both competitive and inclusive.

Recent studies of the Asset Management subsector reveal that it is highly concentrated. The Top 20 firms manage roughly 80% of the overall industry's assets (Alexander Forbes, 2017). None of these firms can be classified as majority Black owned, managed and controlled. In relation to broad-based Black economic empowerment (B-BBEE) the picture is extremely bleak, with only 4.6% of AUM managed by Black companies (27four, 2016). In 2016, 41 B-BBEE Asset Management firms collectively managed R408.3billion; less than a third (13 companies) managed assets more than R5billion (27four, 2016). While, the picture of Black Asset Management appears more diverse and competitive; the small amounts that the majority of firms manages makes their long term sustainability tenuous.

In 2007, 27four Investment Managers established its 27four Black Asset Manager programme to diversify the subsector; with a key aim of assisting new Black entrants with gaining track records. 27four has to date seeded and supported a total of 27 Black emerging and start-up asset management firms and as a result have created in excess of 400 jobs within this skilled sector. **27four have proven that de-racialising the sector has led to diversification, employment growth, an increased tax base and broadened ownership, especially by Black women. De-racialisation therefore does contribute to a more inclusive and competitive financial sector.**

27four produces several research publications focused on providing solutions on how to transform the savings and investments sector. Our findings indicate that the outcomes of existing policy interventions are equivalent to 'trickle-down' economics and entrenching oligopoly - without disrupting the value chain. De-racialisation of the asset management sector necessitates 'pressure and support' at each of the links in the value chain.

This paper is based on tangible evidence as documented in the BEE.conomics Annual Transformation in Asset Management Surveys which has been published for the last 8 years by 27four. The findings are used by asset owners and other stakeholders to guide policy.

4. THE WAY OUT

As much as global standards can be of assistance in policy formulation help, what works in other jurisdictions might not be suitable for South Africa. It is important that country differentiation be undertaken. A number of solutions can be tendered:

Policies focussed on 'stability, efficiency and in integrity' are blunt without providing substantial support to strengthening Black talent and offering technical and financial assistance to Black entrants with compliance, product differentiation and distribution.

4.1. REFRAME THE POLICY DEBATE

Much of the debate has not comprehensively focused on the big business-Black new entrant firm debate. It is suggested that as part of this theme, the financial sector narrative be reassessed through the lens of firm inequality. In other words there is need for a radical re-assessment of the competitive nature of the financial sector, so far recent promulgated changes such as the highly anticipated twin peaks only deals with structural changes in the way the financial sector is regulated and supervised. What is still missing is a market oriented or focused approach that aims to bring parity among the firms.

4.2. POLICY INTERVENTIONS

New changes mooted under the proposed twin peaks framework only deal with prudential and market conduct interventions and not much in terms of meaningful transformation.

As such government still doesn't have a mechanism that serves to counter-weight the economic power of large financial firms. Governmental dalliance with big business is associated with the real risk that small firms might lose their belief in the State's normative regulatory underpinnings. It would lead to cynicism and a view that economic growth is achievable only by and through the largest players in the market. Because they lose confidence in government, small firms end up losing hope in the expected ability of being able to acquire just rewards through established frameworks such as regulations, they cease sowing. As such small firms cut investment in their own human capital. Alternatively, they end up aiming for short-term, opportunistic profiteering, among other economic ills.

One such solution to this problem is to utilise Corporate Law as a constraint. If the South African government is to reverse the inequality that big financial firms foment, it could craft laws that will spur competition by reducing the barriers to entry. Market concentration can be contained by limiting firm size or scope. Other jurisdictions have accomplished this by for instance, setting limits on registered capital, formation of subsidiaries through precise rules that do or do not offer flexibility or discretion on application. This could be complemented by a dedicated enforcement agency. South Africa could build on the framework of the Competition Commission. This could be a crucial weapon in averting market concentration.

4.3. AN ENABLING REGULATOR

Government setting high compliance requirements without the necessary support to new entrants contradicts all policy directives to enable de-racialisation of the FSS.

Example

- There are less than 4 Black hedge fund managers in South Africa.
- The recent migration from the unlisted environment to CISCA for hedge funds means that hedge funds could only be approved under an FSB approved hedge fund scheme.
- A Black player that submitted their applications to the FSB for approval were rejected with no guidance provided. This was done twice.
- This is an established and credible Black player who have in excess of 15 years experience in hedge fund management.
- Spent in excess of R2m or resources on the application.
- The success of the license would have allowed for business expansion and job creation.
- The result of this was that the pipeline of deal flow was then passed on to a white business with Black people once again being at the losing end.
- It is the view by many Black participants that the regulator is disabling to Black participants within the industry and is regarded as being anti-transformational.

4.4. APPRAISAL OF THE WHOLE FINANCIAL SECTOR

The magnitude of the market concentration has been a subject discourse. However what seems to be in the public domain is the dominancy of 'a few big players'. Concentration or emphasis on the life insurance and banking sector clouds the picture elsewhere in the financial sector. It has already been argued that there are structural and legislative impediments that foster anticompetitive behaviour.

In the absence of real data on sectors and links in the respective value chains it will be difficult to debunk the hypothesis of de-racialisation equals collapse of stability in the FSS.

- For a proper perspective to be gleaned and proper policy to be formulated, it is suggested that a holistic theoretical and empirical appraisal of the levels of concentration and competitiveness within the whole financial sector be undertaken. Such a professional diagnosis/assessment would be crucial as a guide to policy market assessments, regulatory formulation as well as its enforcement. Modes of analysis would need to be developed to identify where intervention is needed. That would be convenient as well in formulating entry/exit rules that engender contestable markets which would in turn assist in levelling the playing field across financial services providers and thus engendering effective intra-sectoral competition.
- Lessons could be learnt from countries such as Australia that have implemented explicit policies that limit the concentration in the banking industry. Among other restrictions the barring of mergers among the major banks was instituted until the authorities were content that there had been an increase in competition in lending to small businesses. Likewise, there are regulations that forbid the acquisition of shares or assets that would have the effect, or be likely to have the effect, of significantly reducing competition in a market. In like manner, the national interest test and the 'four pillars' policy Under the Financial Sector (Shareholdings) Act 1998, requires the authorisation of the Treasurer whenever a person wants to hold a stake of more than 15 per cent in a financial sector company. Approval is conditional upon the Treasurer being satisfied that the application is in the national interest.
- Such an appraisal would undoubtedly uncover historical disadvantages that small firms inherited from the time of apartheid. Likewise, it would also expose entrenched financial market practices that have helped to maintain the status quo. Governmental intervention is needed to level the playing field. Such intervention would not be unprecedented.

Big business benefitted from the protection they got from the apartheid government and it would only be fair if the democratic government did the same in the case of new Black entrants. Anything short of that will see Black firms stagnating, becoming smaller or even disappearing.

4.5. TOO DISCONNECTED TO SUCCEED

A factor that has contributed to the unfairness is rooted in the interdependence between big business and the government. Big Business through direct access and through their lobbyist groups enjoy unlimited access to the government and therefore enjoy government's coercive and allocative power in terms of regulation, policy and benefit from shaping financial sector governance and from the government's ambivalence towards addressing anticompetitive factors. Because big business have access to government they influence policy and the consequent large firm-centric outcomes. It has been shown that small firms are controlled by the markets and yet their larger compatriots shape both the markets and the government.

Hence the *status quo.* As much as post 1994 new Black entrants can be applauded for having the advantage of greater potential flexibility and proximity to the customer, by being disconnected from government these firms suffer from information asymmetry and as such cannot influence policy. This negatively impacts on their ability to enjoy economies of scale and scope. In other words the outlook is different for firms that fall outside the comforting embrace of the state. This inequality or economic exclusion creates a moral hazard characterised by big business enjoying a cosy relationship which smaller firms can only dream of.

To address this, we suggest that government and post 1994 established financial sector firms enter into strategic partnerships. A positive relationship between government and small firms would help towards addressing the needs of the firms and eventually, the government. Through alliances with the small firms government can extricate itself from the strong grip that larger firms have on the government and they effect through threats to pull their investments out of the country. It results in a dependency set up where firms think they control the government and the government fallaciously thinks it owns the financial sector. By giving audience to smaller firms policy distortions whose effect is to skew strategy towards larger firms would be minimised. Since political influence is intractably linked to the anti-competiveness problem, there is a need to minimise this by offering strategic tasks to smaller firms like for example advisory opportunities.

5. RECOMMENDATIONS BY 27FOUR

- ✓ **REGULATORY COMPLIANCE SHOULD BE MATCHED WITH SUPPORT TO NEW ENTRANTS:** Regulatory compliance can inadvertently serve to entrench existing market behaviour.

- ✓ **EXPAND THE FSC (FINANCIAL SECTOR CHARTER) TO INCLUDE PROCESS AND OUTCOME INDICATORS:** Inclusive growth relates to both process and outcomes. Expand the FSC to include variables that track process.

- ✓ **SANCTIONS FOR NONCOMPLIANCE OF B-BBEE SCORECARD:** Co-regulation is invaluable in reaching consensus, however without any penalties; it is toothless. A penalty regime should be included.

- ✓ **ENSURE EFFECTIVE MONITORING:** Measuring progress within the FSS and it subsectors in critical to making informed decisions, consequently resources should be allocated to gather quality data on rate and pattern of growth.

- ✓ **ALLOCATION OF RESOURCES TO DERACIALISE THE SECTOR:** Current government funding schemes for Black start-ups are skewed towards other sectors; namely construction, wholesale, mining and manufacturing. A dedicated fund for new entrants into the FSS should be established.

6. CONCLUSION

It is reasonable to claim that big business (not only in terms of balance-sheet, size, aggregated capital, power, and volume of business but also in terms of ability to extract benefits and exploit political mechanisms) have had it easy. This is mainly because of the preferential treatment they enjoy owing to among other factors, their ready access to the government. This is also because of the economic power that they have accumulated over the years with the protection of the then government as well as the current. Democracy and competition necessitate maintaining the interaction of many players rather than few large ones. By excluding smaller Black players from this charmed circle, their chances of influencing policy are limited and so they lose out to their larger counterparts.

The plea to government is for inclusion rather than exclusion. It is an exhortation not for government to piggy-back smaller financial actors, but rather, for the South African government to redress the entrenched anti-competitive environment so as to level the playing field. It is hoped that the above-cited recommendations would go a long way towards bringing parity in this sector.

7. APPENDIX: ABOUT 27FOUR INVESTMENT MANAGERS

27four is a leading, independent South African based investment consultant and a provider of discretionary multi-manager solutions. The company has been in the business of advising retirement funds on investment strategy, policy decision making, risk management and the selection of asset managers for 9.6 years. We are a business that prides itself on innovation and value-add through ongoing investment into research in different markets and the development of Black intellectual capital which has allowed us to position ourselves as pioneers in a number of areas.

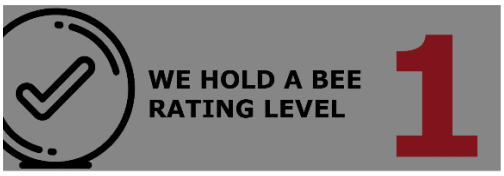
The 27four team is guided by a strong sense of values that always places the needs of our clients first. We provide unbiased recommendations and design world-class solutions based on the experience, breadth and quality of our team. This coupled with our innovative and modern investment approach that makes the best use of current financial engineering ensures that we can unlock value by implementing new approaches and ideas to fulfil the unique demands of our clients.

As South Africa's only majority Black woman owned, managed and controlled investment consultant we strive to promote inclusivity with a focus on transforming the retirement fund and investment value chain. This is evident from the composition of our team, being pioneers of Black asset manager incubation, producing dedicated research on de-racialisation of the financial sector and being active in shaping the national policy agenda.

The company has won numerous awards, including the Principal Officers Association "Manager of Managers of the Year" award, the Hedge News Africa Award for "Long-Term performance", a total of 6 Raging Bull awards between 2014 and 2016 as well as 4 Morningstar awards, 2 Africa Asset Management awards, 2 Minara Chamber of Commerce awards, 2 PMR.africa excellence awards. The company has also been recognised for its transformation efforts through the winning 4 ABSIP (Association of Black Securities and Investment Professionals) awards. Most recently the company was awarded the EY World Entrepreneur Southern Africa award.

8. APPENDIX: 27FOUR AND WHY TRANSFORMATION MAKES GOOD BUSINESS SENSE

Inclusive growth is now an ubiquitous part of our political discourse and policy lexicon to describe economic growth that ensures that the fruits are shared by all and that the growth process provides opportunities for all to participate productively in the economy. In other words inclusive growth is intrinsically about benefit-sharing and participation meaning that transformation is good for business. At 27four we believe that success can only be achieved through embracing the strength and diversity of our people. Hence our approach to transformation is founded on vigorous facilitation and implementation of transformational initiatives both within 27four, the financial services industry and within our broader society.



OUR ACTIVITIES

- **BlackRock, ABSIP and 27four Partnership:** The Association of Black Securities and Investment Professionals (ABSIP) together with BlackRock and 27four have partnered in a global skills development programme focused on providing South African investment professionals training and exposure in the management of global assets. As part of the initiative two Black individuals are selected annually to attend one of the BlackRock Education Academy's global training courses. Individuals are selected from the pool of winners of the annual ABSIP Financial Sector Awards and the 27four Black Emerging Asset Manager Programme.

- **Home of ABSIP:** 27four provides office space for 6 people, technology and infrastructure to ABSIP on pro bono basis. The ABSIP office is now housed on the same premises as the business of 27four.

- **Financial Sector Charter Council:** Through 27four's active participation in ABSIP (holds a seat at the Charter Council), 27four are able to influence policy making in relation to transformation targets within the financial services industry.

- **Established South Africa's First Black Manco under CISCA:** 27four have been awarded a Collective Investment Schemes (CIS) Manco license that allows us to provide 3rd party hosting solutions to asset managers seeking CIS funds. The Manco platform will allow successful Black asset managers to establish CIS portfolios which will further their ability to penetrate the retail market, grow brand, skills and distribution ultimately leading to levelling the playing fields in the CIS industry and diversifying the managers' client base. The success of this initiative will lead to the growth of Black Independent Financial Advisors and Black distribution platforms benefiting township communities. A step closer towards achieving inclusiveness of financial services in South Africa leading towards increased savings and education - a core component of the National Development Plan and the Financial Sector Codes.

- **Establishment of BEE-conomics.com (platform to distribute Black asset manager products to the retail market):** A first of its kind platform designed to showcase Black investment management talent within the retail sector thereby enhancing financial inclusivity within the South African savings and investment industry. The platform provides the retail market with access to:
    - Black financial planners; and
    - Unit Trusts managed by Black investment managers.

- This initiative was undertaken to enable Black investment managers to penetrate the retail market and diversify their client base and to provide retail investors with access to premium Black talent.

- **Progressive Fund Range:** In 2014 27four launched the Progressive Retirement Fund range which are multi-asset class multi-managed portfolios managed in accordance with Regulation 28 of the Pension Funds Act. The portfolios are designed to meet a range of risk-return preferences and are best suited for member investment choice or as life-stage portfolios within a Defined Contribution Fund. The portfolios mirror 27four's flagship retirement fund portfolio range: CPI+3% fund, CPI+5% fund, CPI+7% fund in terms of asset allocation. The Progressive Retirement Fund range however differs in that the underlying managers selected within the portfolios are all Black asset managers.

- **Annual and Monthly B-BBEE Asset Manager Surveys:** 27four have been producing these surveys since 2007. The surveys are continually enhanced to remain relevant and be the leading source of data to ably evaluate the sector. The use of the surveys is widespread amongst asset owners, fund managers, advisors, labour and government.

- **Black Asset Manager Incubation:** Since 2007 27four has managed a Black asset manager incubation programme which sources assets from retirement funds in South Africa and selects start-up Black asset managers to manage the assets. In so doing we have succeeded in allocating in excess of R20 Billion to over 20 start-up Black asset managers in an effort to build successful Black enterprises and grow Black skills within the industry. We have consistently picked winning teams to seed and have had no failures in our programme. All the managers that we seeded continue to grow their businesses and feul the economy through job creation and the delivery of above average investment performance. As 27four we will continue with our efforts to spearhead transformation in asset management until the playing fields in South Africa has levelled post democracy.

- **Growing skills within our organisation:** 27four is a progressive entrepreneurial organisation who strongly believe in the benefits and power of gender and race diversity. Our employment equity policy ensures that consistent opportunities are made available to women and Black individuals within all areas of our organisation. Individuals are also provided with the opportunity to gain academic qualifications, attend conferences, participate in industry forums and travel internationally.

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