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Prudential regulation of foreign exposure for South African institutional investors

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PRUDENTIAL REGULATION OF FOREIGN EXPOSURE FOR SOUTH AFRICAN INSTITUTIONAL INVESTORS

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Executive Summary

Introduction

The impact of the global financial crisis on growth and employment has given impetus to the debate on the sustainability of the external position in South Africa and the structural and policy mechanisms needed to manage the macroeconomic impact of external shocks. Moreover, these events have demonstrated that the most developed financial systems are not immune to systemic crises and that cross-border linkages mean that such crises can be rapidly transmitted across countries.

Exchange controls have provided one instrument for managing the macroeconomic risks arising from capital flows but the approach has had important disadvantages. The exchange control system has also contributed to related objectives through supporting prudential regulation of financial institutions, protecting the tax base, and assisting the prevention of financial crime. The gradual reform of controls on cross-border transactions has enabled policy makers to assess the extent to which alternative – and better targeted - regulations are needed in support of these varied objectives. The sequencing of reform has also sought to address the distortions created by controls while strengthening the domestic financial system.

The policy objective of reform for institutional investors has been to shift from a system of currency-based exchange controls on transactions towards an approach based on the prudential regulation of foreign exposure, in line with international practice. Building on earlier reforms, the pre-application process that had defined exchange controls was replaced in 2008 by a system of reporting and monitoring of foreign exposures, representing a decisive move from transactions-based controls to a risk-based prudential approach. Further reforms to finalise the prudential regulation of foreign exposure should now aim to achieve greater consistency with the broader framework for the regulation of risk in institutional portfolios. Not only is this essential to the overall effectiveness of the supervision of foreign risk exposures but it should also work to minimise the costs of compliance and supervision.

Foreign asset holdings of institutional investors

The gradual reform of foreign investment by institutional investors has enabled substantial portfolio rebalancing while limiting risks to the balance of payments. An important issue for the sustainability of the external position is whether this portfolio rebalancing is now largely complete or, conversely, whether there remains a significant pent-up demand for foreign assets that could imply large capital outflows under a new regulatory framework. This paper analyses the foreign exposures of institutional investors using Financial Surveillance data for December 2009. Foreign asset limits at this time did not constrain foreign investment for the industry as a whole, although restrictions were binding on many individual institutions.

Most of the assets in the retirement fund and non-linked insurance sectors are held by institutions that reported foreign exposures below the limit of 20 percent at December 2009. Less than one-fifth of total private retirement assets (excluding the Government Employees Pension Fund) were held by funds reporting foreign exposures within two percentage points of the 20 percent limit. Moreover, increases in foreign exposures in 2007 and 2008 were in large part driven by exchange rate valuation changes, rather than an aggressive strategy of externalisation of assets, and a reduction in the value of foreign asset holdings was evident as the rand strengthened in 2009. The

retirement fund and insurance industry has not automatically moved to increase foreign asset holdings to the maximum extent possible over time. Thus, while the foreign asset limit constrains a number of individual funds, there is little evidence of remaining pent-up demand for foreign assets in the sector as a whole.

There is even less evidence of pent-up demand among the retail clients of investment managers and CIS companies, most of which reported foreign exposures below 15 percent, compared to the limit of 30 percent at December 2009. The foreign exposures of investment-linked insurance policies tend to be higher than for investment managers, CIS companies, or the non-linked portfolios of long-term insurance companies, but the volume of retail assets held in linked policies is low relative to other forms of institutional investment.

Objectives of prudential portfolio regulation

The principal objective of exchange control was to limit outflows of capital. Prudential regulation is instead concerned with the financial soundness of individual institutions and the broader objective of systemic stability, as part of the overall framework for supporting macroeconomic stability. Foreign asset limits in South Africa can thus be viewed as having both micro and macro- prudential objectives:

Micro-prudential regulation: supporting financial stability through the financial soundness of individual institutions

- To promote the benefits of foreign diversification in institutional portfolios, while recognising that foreign investment exposes institutions to new forms of risk
- To provide a limit on the overall foreign risk exposure of institutions, complementing the existing rules-based framework for regulation of risk

Macro-prudential regulation: managing the macroeconomic risks associated with cross-border capital flows and exposures of institutional investors

- To limit the volatility of capital flows in periods of macroeconomic instability
- To limit the contagion of international crises
- To avoid excess reliance on costly and volatile foreign capital to fund domestic investment

Alternative approaches to prudential portfolio regulation

In South Africa, the prudential regulation of retirement funds and long-term insurance companies includes quantitative portfolio regulations that set ceilings on holdings of certain classes of assets, including foreign assets. A similar approach is used in a number of other emerging and developed economies. The rationale is that financial soundness requires that assets are sufficiently diversified to limit the risk that an institution is unable to meet its (explicit or implicit) liabilities to fund members or policy holders. An alternative approach of relying on internal risk management subject to supervisory surveillance - the ‘prudent person’ approach - has grown in importance over time but even in these models, some quantitative restrictions often apply. A rapid move towards a ‘pure’ prudent person approach to regulating foreign exposure would seem inadvisable for South Africa as the development of sufficient specialised capacity in the supervision of foreign risk - together with appropriate governance and incentive structures in financial institutions - would be a crucial pre-requisite for major reform. We therefore take as our starting point in this paper that a prudential foreign asset limit will remain in place in South Africa as part of the broader framework for prudential regulation of financial institutions.

Institutions subject to prudential portfolio regulations

Retirement funds are subject to quantitative portfolio regulation in South Africa in order to protect the future income of pensioners and dependents, in a context where

the resulting liabilities may be longer-term and less volatile than the relevant assets. Portfolio limits are set out in Regulation 28 under the Pension Fund Act and revisions to this framework are currently under review.

Long-term insurance companies are also subject to prudential portfolio regulation in the form of spreading requirements set out in the Long-Term Insurance Act. Quantitative portfolio limits are applied to the assets backing *non-linked policies* in order to ensure sufficient diversification and liquidity in the context of liabilities that expose the insurer to risk. South African insurers also offer *investment-linked policies* but here quantitative spreading requirements are not applied because liabilities to policy holders are defined in terms of the assets held.

CIS companies and other investment managers are not typically subject to the prudential portfolio regulation of aggregate asset classes. As with the investment-linked policies of insurance companies, their liabilities to investors are defined in terms of the assets held on behalf of clients. Other forms of investment regulation of the individual *products* sold by these institutions are, however, important from the perspective of consumer protection and sound market conduct.

Foreign asset limits in prudential portfolio regulation

The implementation of a foreign exposure limit as part of prudential portfolio regulation recognises that foreign assets form a distinct risk class for institutions. While international investment is important for portfolio diversification and for stabilising real consumption levels in retirement, it also exposes institutions to new risks including the impact of exchange rate volatility and the transmission of international crises. For developing countries, the macroeconomic risks associated with volatile cross-border investment and the loss of domestic capital in the context of balance of payments constraints have provided a further rationale for such limits.

An aggregate foreign asset limit does not, however, differentiate between the varied country and currency risks associated with specific assets within this class. As the broader set of prudential portfolio rules administered by the FSB provides the appropriate framework for differentiating these risks, there is a strong case for harmonisation of the macro-prudential surveillance of foreign exposure with micro-prudential portfolio regulations. Harmonisation should not only strengthen financial regulation but also reduce the administrative costs of compliance and supervision.

Retirement funds and non-linked long term insurance

The current foreign asset limit for long-term insurance companies applies to the assets backing policies held by retail clients and not to the assets backing policies held by other institutional investors, in particular retirement funds. For retirement funds, the foreign asset limit has correspondingly applied on a full look-through basis such that funds invested with a long-term insurer are disaggregated into the underlying assets held by the insurer.

The emphasis on financial soundness under prudential regulation implies that the foreign exposure limit for long-term insurers should apply to the assets backing all *non-linked* policies, regardless of the nature of policy holders. This wider application of the limit would be more consistent with the existing spreading requirements in the Long-Term Insurance Act. This change would therefore support greater harmonisation with the broader framework for prudential portfolio regulation. Consistency with the spreading requirements raises further questions about the appropriate basis for the limit, in particular whether the limit should be based on total assets (as under exchange control) or on the value of policy liabilities plus the capital adequacy requirement (as under the Long Term Insurance Act).

The prudential foreign asset limit for retirement funds would need to reflect an equivalent distinction between non-linked and linked insurance policies held as assets by retirement funds. While look-through is appropriate for monitoring the exposures

associated with *investment-linked* policies, a consistent approach would require the particular benefits specified in *non-linked* policies to be taken into account. A major challenge in developing consistent definitions in this area will be to assess the investment and guarantee elements of non-linked policies in order to identify the true risk profile from the perspective of retirement funds. One solution could be for non-linked policies to be excluded from the calculation of the foreign asset limit for the retirement fund, provided that the investment mandate for the policy is consistent with the limit. Reform should also take into account the treatment of linked and non-linked insurance policies under the revised Regulation 28.

Investment managers, CIS companies, investment-linked insurance

The current foreign asset limit for investment managers, CIS companies and investment-linked insurance is applied at an aggregate level to the total retail assets managed by the institution. These institutions are able to offer investment products that provide up to 100 percent foreign exposure for their retail clients as long as they also manage domestic assets of sufficient size to generate the foreign asset allowance required for these international investments. The foreign asset limit thus operates purely at a 'macro-prudential' level for this group of institutions.

The foreign exposures of most CIS companies and investment managers remain considerably below the existing foreign asset limit, raising the question of whether limits are necessary for these institutions. However, the volatile external environment facing South Africa will continue to pose challenges for maintaining financial and macroeconomic stability and promoting growth. In this context, a long-term macro-prudential limit on foreign investment by these institutions can be seen as complementing the prudential foreign asset limit for retirement funds and non-linked insurance in managing the macroeconomic risks associated with capital flows.

A higher macro-prudential foreign asset limit could apply to the retail asset base of these institutions, with retirement funds and other institutions reporting their exposure to these investment products on a look-through basis. A higher limit is proposed as its role would be limited to underpinning macroeconomic stability, especially in periods of external shocks. A higher limit would also support the ability of these institutions to compete as providers of locally-based vehicles for foreign diversification in the context where private individuals have increased access to offshore investment under exchange control allowances.

Classification of foreign assets under prudential regulation

The reforms implemented in 2003 marked a shift away from currency-based exchange controls on transactions towards a prudential approach of measuring exposure to foreign risk. This approach recognises the increasing role of domestic intermediaries and markets as a channel for foreign exposure.

A consistent classification principle has not been fully applied in the case of foreign securities that are traded on the JSE, however. From 2004, institutional investment in new non-resident listings has been subject to the foreign asset limits (including the African allowance). However several non-resident firms with earlier listings continue to be categorised as domestic assets, reflecting the historical currency basis of exchange control. For South Africa, the classification of foreign securities traded on the local stock exchange is an important issue because several of the largest companies listed on the JSE are non-resident on the basis of registered headquarters or country of incorporation. In part, this follows from the changes in domicile and primary listings of large South African multinationals between 1997 and 1999, including BHP Billiton, Anglo American, SABMiller and Old Mutual. It also includes listings reflecting earlier unbundling and re-domiciling of international assets, such as Swiss-based Compagnie Financière Richemont.

The presence of large non-resident companies in the local equity market means that the classification of assets has significant implications for the robustness of regulation

of foreign exposure, from both micro and macro-prudential perspectives. At the same time, the importance of these companies for the JSE and for institutional equity portfolios implies that any changes to existing classifications would create substantial transitional challenges. Holdings of non-resident equities with a domestic classification amount to around 6 percent of the total assets of institutional investors.

Two options for the classification of foreign assets listed on the JSE are set out in this paper. Both options take as their starting point that the most practical and consistent basis for classification is the *domicile* of the listed entity (i.e., foreign or South African), but with an exemption for non-resident companies that have substantial operations in South Africa or the rest of Africa. Under both options, it is proposed that the existing limit for African securities be removed.

Option 1: Foreign classification with 'partial' grandfathering

The first option is to apply a new framework for classification to all future non-resident listings on the JSE but to maintain the current classification for all existing non-resident listings, whether foreign, African or domestic.

New non-resident listings would be classified as 'foreign' or 'African', with African entities defined as domiciled in Africa or the majority of activities located in Africa (as is current practice). All non-resident listings classified as 'foreign' would be subject to the prudential foreign asset limits. All non-resident listings classified as 'domestic' (i.e., the 'grandfathered' older non-resident listings) or 'African' would be exempt from prudential foreign asset limits. The grandfathering of domestic classification would apply only to the relevant companies in their current form. Any new non-resident listing that emerges from a future restructuring of the company would be subject to the new framework for classification.

The principal benefit of the partial grandfathering approach is that it establishes a transparent framework for foreign classification in the longer term, building on the 2003 reforms, while avoiding the significant transitional costs that would arise from any reclassification of existing non-resident listings. This must be weighed against the costs of maintaining an anomalous treatment of a small group of large non-resident firms with varying degrees of exposure to South Africa. This treatment works to undermine the overall integrity of micro and macro-prudential regulation.

Option 2: Foreign classification with exempt status

The second option is to apply the new framework for classification to all non-resident listings on the JSE (new and existing) but to apply a more generous threshold for exempt status. The threshold would incorporate large multinational companies that have maintained a substantial centre of operations in South Africa or the rest of Africa but who would not necessarily satisfy an exemption condition based on the *majority* of economic activities in Africa.

All non-resident listings would be classified as either 'foreign' or 'exempt'. Non-resident listings classified as 'foreign' would be subject to prudential foreign asset limits; 'exempt' non-resident listings would be treated as domestic assets.

The principal benefit of this approach would be to support prudential regulation by aligning the classification of non-resident listings more closely with the underlying foreign and domestic risk exposures. However, it would create significant transitional challenges as some of the existing non-resident listings would be re-classified from domestic to foreign assets. Several related reforms would therefore be needed. First, any reclassification would need to be accompanied by a recalibration of the foreign asset limit in order to accommodate existing holdings of the affected equities. Second, the implications of reclassification for the composition of the FTSE/JSE indices would need to be considered and reforms to the benchmark indices may be required. Finally, a new framework for classification of assets may also require revisions to the structure of mandates governing institutional investment.

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In 2008, the Minister of Finance announced the removal of exchange controls on South African institutional investors and the implementation of prudential regulation of foreign exposures. The controls on foreign currency transactions that had previously defined the exchange control regime were replaced by a system of reporting and monitoring of foreign exposures, as part of a broader framework for risk-based financial regulation and supervision. The Minister raised the prudential foreign asset limits as an interim measure and signalled that further work would be conducted to finalise these limits. Subsequent announcements in the Budget of 2010 reiterated the Government's policy of prudential management of foreign risk exposures aimed at supporting macroeconomic and financial stability.

This paper has been commissioned by the National Treasury in order to inform the consultation process on final foreign exposure limits for institutional investors. The objectives of the paper are:

- To provide an analysis of the impact of exchange control reform on the foreign exposure of institutional investors
- To identify issues for discussion in establishing a framework for prudential regulation of foreign exposures that is consistent with the goals of macroeconomic and financial stability.

1. Introduction

A central feature of exchange control reform is the expected path of the external position and the implications for the strategy on increasing growth. Volatility in the composition and level of global capital flows means that South Africa will remain exposed to external shocks in the form of surges, slumps and even reversals in foreign inflows. Indeed, in recent years, the contagion experienced as a result of the international financial crisis and subsequent deep recessions in high-income economies has underscored South Africa's continued vulnerability to shocks and especially their impact on growth and employment.

A key challenge for economic policy is to strengthen the framework for managing the macroeconomic risks associated with external shocks. This implies a need for broad-based policies that can reduce the likelihood of shocks and also policies that can limit the impact of shocks, in particular, the effects on the poor who are least able to protect themselves against hardship in periods of economic instability. The traditional tools of macroeconomic management - in the form of fiscal, monetary and exchange rate policies - are clearly crucial. But other policy areas are also important, such as financial sector policy in promoting efficient and liquid markets and sound institutions; trade and industrial policy in encouraging the diversification of production and exports; and social policy in creating safety nets to protect the poor. In the past, exchange controls have provided one policy instrument for managing macroeconomic risks through restricting the legal channels for capital outflows, especially during periods of financial instability. However, the historical approach of exchange control - based on restricting cross-border transactions - has been costly and distortionary. It has required extensive administrative capacity for enforcement, reduced liquidity in the foreign exchange market and affected a wide range of economic decisions by

individuals and firms. Moreover, exchange controls have been far less than fully effective in preventing (illegal) outflows in the past. For these reasons, the continuing risks associated with volatile foreign capital flows are not a convincing reason to abandon the reform of exchange controls on cross-border transactions, especially where the agenda for reform entails the implementation of more appropriate instruments for the supervision and regulation of cross-border risks.

While the principal objective of exchange controls has been to limit capital outflows, the system has also contributed to policy objectives in several related areas. These include protecting systemic stability and supporting the prudential regulation of financial institutions; protecting the tax base; and supporting anti-money laundering and related strategies in the prevention of financial crime. The gradual reform of exchange controls on South African residents since the mid-1990s has enabled policy makers to consider these varied objectives and to assess the extent to which alternative – and better targeted - regulatory structures are needed as controls on transactions are removed. The gradual strategy has also focused on reducing the distortions created by controls on transactions and, in particular, on removing the barriers to two-way flows of capital, for instance by removing the formal application process for cross-border transactions by institutional investors. Finally, the gradual strategy has enabled a sequencing of reforms to take into account the interaction between institutions and individuals. The strong policy preference for encouraging outward diversification by individuals through domestic financial institutions has worked to strengthen the financial system while supporting increased choice and competition.

At the heart of the reforms for institutional investors is a shift to risk-based regulation and supervision of foreign exposure, in line with international practice. The prudential regulation of risk in institutional portfolios is also incorporated in the broader investment regulations applied to institutional investors - through Regulation 28 under the Pension Fund Act and through spreading requirements set out in the Long-Term Insurance Act. The approach to finalising the regulation of foreign exposure should contribute to an effective *overall* framework for the regulation and supervision of risk in retirement funds and insurance companies. The aim should be to ensure consistency across elements of the regulatory framework while minimising the administrative burden on institutions and the supervisory agencies. Moreover, reforms should take into account the broader macroeconomic risks created by cross-border capital flows and the role of regulation of the local investment industry in limiting vulnerability to shocks.

The principal conclusions of this paper are as follows:

- the main emphasis of exchange control reform has been a shift from distortionary transactions-based exchange controls to prudential regulation of foreign exposures, which focuses on the underlying risk rather than the currency of transactions.
- the reforms to exchange control have enabled institutions to rebalance their portfolios; while there are a number of individual institutions with foreign exposures at the current limit, there is little evidence of pent-up demand for foreign assets at the level of the industry as a whole.
- the shift from exchange controls to prudential regulation reflects a change in objectives, from limiting and sequencing outflows of domestic capital to supporting the financial soundness of institutions and the stability of the financial system as a whole.
- international evidence shows that a significant number of countries use foreign asset restrictions as part of a risk-based regulatory framework, including major emerging market countries as well as some developed countries.
- further reforms could strengthen the broader framework of prudential regulation for retirement funds and long-term insurance companies through harmonising the regulation of foreign exposure with other prudential portfolio rules.

- the vulnerability of small open economies like South Africa to cross-border contagion of financial stress highlights the importance of regulating foreign exposures, suggesting the need for a macro-prudential framework that extends to all institutional investors.
- finally, the shift to risk-based prudential regulation requires a definition of foreign assets that captures the foreign risk exposures of institutions and takes into account the different ways in which institutional investors can acquire foreign exposure, including through local markets; it must also be practical to administer for both supervisors and institutions.

The paper begins in section 2 by providing an overview of the history of exchange control reform for institutional investors, with a particular emphasis on the reforms that have defined the shift from the transactions-based approach of exchange control to a new risk-based prudential approach based on foreign asset positions. Section 3 presents new data on the foreign exposures of institutional investors. The role of foreign asset limits in the framework of prudential regulation is explored both within the South African context in section 4 and in terms of international experience in section 5. Sections 6 to 8 set out issues to be considered in finalising the prudential regulation of foreign exposures. Section 6 explores the implementation of a prudential foreign asset limit for retirement funds and the assets backing the non-linked liabilities of long-term insurers. Section 7 considers the potential role for a macro-prudential foreign asset limit for investment managers, collective investment scheme companies, and the investment-linked business of long-term insurers. Section 8 highlights the classification of foreign assets under prudential regulation and, in particular, the need to address uncertainty over the classification of the growing number of foreign assets traded on the JSE.

2. History of reforms for institutional investors

The following review draws on the National Treasury *Budget Review* and *Medium Term Budget Policy Statement* and the South African Reserve Bank *Exchange Control Manual*. Given the complex nature of controls and the liberalisation process, the following description is necessarily selective. We review the reform process in terms of the different instruments or limits that have been implemented under the shift to prudential regulation. An alternative chronology of reforms is provided in Box 1.

2.1 The asset swap mechanism

The gradual liberalisation of exchange controls on South African institutional investors began in 1995 with the introduction of the asset swap mechanism. This mechanism enabled long-term insurers, retirement funds, and collective investment scheme (CIS) managers to invest a portion of total assets offshore by way of a swap of domestic assets for foreign assets with non-resident investors. The dispensation was extended to regulated investment managers in 1997. The rationale for asset swaps was to allow the rapid diversification of portfolios while safeguarding the balance of payments, with an intended lock-in period for non-resident investment.

The initial foreign asset limit was set at 5 percent of total assets, increased to 10 percent in 1996 and to 15 percent in 1998. A further increase to 20 percent was implemented for CIS companies in 2000, enabling domestic CIS to compete more effectively with foreign-registered CIS, as the foreign investment allowance for private individuals created new competition between products.

By 2001, the level of foreign diversification of institutional investors had increased significantly. The asset swap mechanism achieved the aim of facilitating significant portfolio rebalancing but there were concerns regarding the transparency of this instrument and its role as a means of protecting the balance of payments in the longer term. The asset swap mechanism was removed early in 2001, although a cash flow allowance for foreign investment initially remained in place (see below).

2.2 The cash flow allowance

From 1996, a cash flow allowance enabled institutions to invest abroad a percentage of the net inflow of funds in the previous year, subject to the overall foreign asset limit applied to asset swaps. The cash flow allowance was initially set at 3 percent of the net inflow of funds and increased over time to 10 percent in 2000.

While the cash flow allowance continued to provide a channel for limited foreign investment following the removal of the asset swap mechanism, it was not generally consistent with the proposed shift to prudential financial supervision (see below). At the end of 2001, the allowance was not renewed.

2.3 The shift to prudential regulation

The long-term objective of moving to a system of prudential financial supervision was indicated in the Budget of 1997, forming the basis of the strategy for exchange control reform for institutional investors. A major shift towards prudential regulation occurred in February 2003 when institutional investors were permitted to invest abroad up to the existing foreign asset limits, without further requirements in the form of asset swaps or cash flow allowances.

The foreign asset limits now applied only to assets managed on behalf of retail clients, referred to as *retail assets*. Assets managed on behalf of other institutional investors (*institutional* clients) could be invested abroad subject to the specific investment mandate of the client, with the originating institution (the client) retaining responsibility for ensuring that their overall foreign exposure complied with exchange control requirements. This dispensation remained subject to an application process for undertaking foreign transactions and so retained an important element of the previous exchange control regime. Under this transitional system, foreign asset limits remained at 15 percent for long-term insurers and retirement funds but increased to 25 percent for CIS companies and investment managers in 2005. An additional 5 percent limit for investment in African securities was introduced in 2004, in support of the initiative to build South Africa's role as a financial centre for African investment.

An important aspect of reform in 2003 was the introduction of new reporting requirements for institutional investors and a revised definition of foreign assets that broadened the focus of regulation to foreign risk exposures in line with a prudential approach. Prior to 2003, the exchange control limit on foreign assets was defined in terms of directly-held foreign currency assets; from 2003, the definition was extended to include foreign assets held indirectly through another domestic intermediary - for instance, through a rand-denominated CIS product backed mainly or in part by foreign assets. These new requirements facilitated a considerable step towards prudential regulation and supervision of foreign exposure. At the same time, the new reporting system achieved a marked improvement in the quality of data on asset allocations available to policy makers, supporting the development of further reforms to exchange controls.

The final implementation of prudential regulation was announced by the Minister of Finance in February 2008. The pre-application process that had defined exchange controls was replaced by a system of reporting and monitoring of foreign exposures, representing a decisive move from transactions-based controls to a prudential approach. At this time, the Minister signalled that further work on the final prudential foreign exposure limits for institutional investors would take place. As an interim measure, the existing foreign asset limits were raised to 20 percent for retirement funds and for the assets backing the non-linked policies of long-term insurers and 30 percent for CIS companies, investment managers and the assets backing investment-linked insurance policies. In December 2010, these limits were further increased to 25 percent and 35 percent respectively.

Box 1: Chronology of main exchange control reforms for South African institutional investors

June 1995: Introduction of the asset swap mechanism: long-term insurers, retirement funds and collective investment scheme (CIS) companies permitted to exchange up to 5 percent of total assets for foreign assets in approved swap arrangements with foreign counterparties, with non-resident investment in domestic securities maintained for at least two years.

June 1996: Foreign asset limit for asset swaps increased to 10 percent of total assets. Introduction of cash flow allowance: institutions permitted to transfer abroad up to 3 percent of the net inflow of funds in 1995, subject to the foreign asset limit of 10 percent. Allowance is available to long-term insurers, retirement funds and CIS companies.

June to July 1997: Cash flow allowance renewed: up to 3 percent of net inflow of funds in 1996. Introduction of an additional cash flow allowance: institutions permitted to invest up to 2 percent of net inflow of funds in 1996 in stock exchanges in the rest of SADC, subject to overall foreign asset limit of 10 percent. Asset swap mechanism extended to investment managers regulated by the Financial Services Board and to approved stock-broking firms.

March 1998: Increase in the foreign asset limit for asset swaps: 15 percent of total assets. Increase in the cash flow allowance: up to 10 percent of net inflow of funds in 1997 for investment in the rest of SADC; up to 5 percent of net inflow of funds for investment in the rest of the world. Both allowances subject to the 15 percent foreign asset limit.

February 1999: Cash flow allowances renewed: up to 10 percent of the net inflow of funds in 1998 for investment in the rest of SADC; up to 5 percent of the net inflow of funds for investment in the rest of the world.

February 2000: Increase in the foreign asset limit for CIS companies to 20 percent; no change for other institutional investors. This supports competition with foreign collective investment schemes. Increase in the cash flow allowance: up to 10 percent of net inflow of funds in 1999, subject to the foreign asset limits of 15 percent and 20 percent. No further distinction between SADC and the rest of the world.

February 2001: Asset swap mechanism removed. Cash flow allowances renewed: up to 10 percent of the net inflow of funds in 2000, subject to the foreign asset limits of 15 percent and 20 percent.

February 2003: Introduction of new foreign asset limits: long-term insurers, retirement funds and investment managers can invest abroad up to 15 percent of total (retail) assets and up to 20 percent for CIS companies (with no asset swap or cash flow based restrictions). New reporting system and definitions implemented in move towards prudential regulation of foreign exposure.

March 2004: Introduction of an additional foreign asset limit: up to 5 percent of total retail assets can be invested in African securities listed on the JSE or BESA, implemented as part of the strategy to promote South Africa as a financial centre for Africa. Extended to include all portfolio investment in Africa in 2006.

October 2005: Increase in the foreign asset limit for CIS companies and investment managers to 25 percent.

February 2008: Final shift to prudential regulation of foreign exposure announced. Foreign asset limits increase to 20 percent for retirement funds and the non-linked policies of long-term insurers and 30 percent for CIS companies, investment managers and the investment-linked policies of long-term insurers. Reporting systems remain but the pre-application process is removed.

December 2010: Foreign asset limits increase to 25 percent for retirement funds and the non-linked policies of long-term insurers and 30 percent for CIS companies, investment managers and the investment-linked policies of long-term insurers.

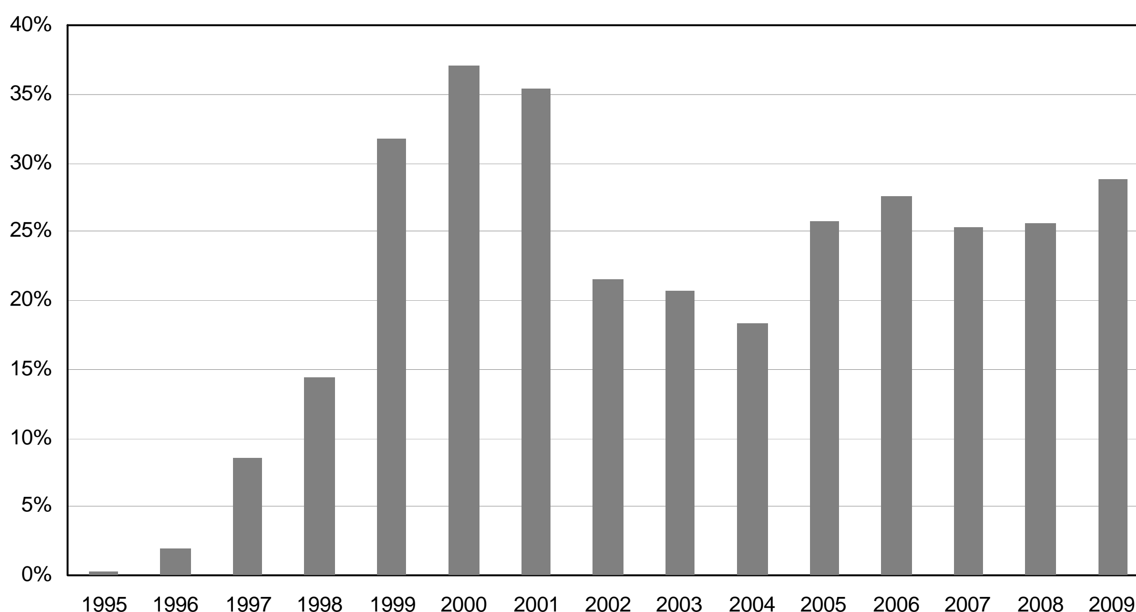
Notes: This chronology draws on the National Treasury *Budget Review* and *Medium Term Budget Policy Statement* and the South African Reserve Bank *Exchange Control Manual*. The dates reflect the timing of announcements by the Minister of Finance, typically as part of the Budget or the Medium Term Budget Policy Statement.

3. Foreign asset holdings of institutional investors

The gradual approach to reform of foreign investment by institutional investors has enabled substantial portfolio rebalancing while limiting risks to the balance of payments and financial stability. Prior to the introduction of the asset swap mechanism in 1995, the stock of foreign portfolio investment held by the private non-banking sector (dominated by institutional investors with strict restrictions on non-financial corporates) amounted to less than 1 percent of GDP. By 2000, holdings of foreign assets had peaked at 37 percent of GDP before falling back to 18 percent in 2004 and then rising again to 29 percent in 2009. Valuation effects (changes in asset prices and exchange rates) and the inclusion of shareholdings in re-domiciled South African multinationals have had an important impact on the trend in foreign asset holdings. Allowing for these effects, it is evident that the initial years of reform were associated with significant rebalancing of portfolios while, in more recent years, foreign asset holdings have stabilised relative to GDP (Figure 1).

Figure 1: Portfolio investment by the private non-banking sector

Stock of foreign assets as a percentage of GDP



Source: Calculated from data in *Quarterly Bulletin*, South African Reserve Bank, December 2010

The increase in foreign asset holdings in 1999 is partly explained by the classification of shareholdings in Anglo American, South African Breweries and Old Mutual as foreign assets following the relocation of the primary listings and headquarters of these companies to the UK. See Walters and Prinsloo (2002).

An important issue for the long-term sustainability of the external position is whether portfolio rebalancing by institutional investors is now largely complete or, conversely, whether there remains a significant pent-up demand for foreign assets that could imply large capital outflows under a new framework for prudential regulation of foreign investment. In this section, we examine evidence on the foreign asset holdings of institutional investors relative to existing foreign asset limits. The analysis explores the levels of foreign diversification facilitated by exchange control reform and the extent to which current limits appear to represent a constraint on foreign investment decisions.

We use data from the asset allocation reports submitted by institutional investors to the Financial Surveillance Department of the Reserve Bank for the end of December 2009. The data were provided for this study by National Treasury. We compare asset

allocations to the foreign asset limits in place at December 2009. We do not consider here the additional 5 percent African allowance as investment in African assets is very low relative to this limit (see Table 8).

Table 1 sets out the total assets under management by institutional investors, distinguishing between assets under management from retail clients and institutional clients. As noted above, foreign asset limits are currently applied to *retail* assets under management, with institutional clients maintaining responsibility for their overall compliance with the applicable foreign asset limit. It is also important to distinguish between these two sets of clients in order to remove double counting in the measurement of total assets managed by institutional investors. To avoid double counting, we use the sum of retail assets under management as our measure of the total assets of the sector. On this measure, retirement funds are by far the largest group of institutional investors, holding R2.0 trillion of assets at the end of December 2009 out of R3.6 trillion for institutional investors as a whole.

Table 1 also shows the percentage share of foreign assets in total assets for each sector at December 2009. The most striking feature is that, for the institutional investor industry as a whole, foreign asset holdings were not close to the corresponding limits: only 11.3 percent of the total assets managed by institutions were deemed to be foreign. This is also the case for each part of the industry: 12.1 percent for retirement funds and 9.2 percent for non-linked long-term insurance (compared to a limit of 20 percent at December 2009); and 8.5 percent for investment managers, 10.5 percent for CIS companies, and 16.8 percent for linked long-term insurance (compared to a limit of 30 percent at December 2009). One important feature of the industry is that a substantial fraction of the retirement fund sector is accounted for by the Government Employees Pension Fund. Excluding this very large fund increases the average foreign exposure of retirement funds to 14 percent and the aggregate industry average to 12 percent, still far below the constraint implied by the foreign asset limits. These data show that the limits have not represented a severe constraint on foreign investment by institutional investors *in aggregate*. However, the restrictions have become binding on many individual institutions, as revealed by the distribution of foreign exposures in each sector shown below.

Table 1: Assets of institutional investors, December 2009 (millions of rand)

	Retail[1]	Foreign exposure of retail assets	Institutional[2]	Total
Retirement funds	2,043,095	12.1%		2,043,095
Long-term insurance: non linked	448,977	9.2%	461,947	910,924
Long-term insurance: linked	182,036	16.8%	344,433	526,469
Investment managers	524,697	8.5%	1,913,660	2,438,356
CIS companies	372,108	10.5%	439,590	811,698
Total	3,570,913	11.3%		

Source: Calculated from Financial Surveillance Asset Allocation Reports for December 2009
Notes: 1. Assets under management from retail clients
2. Assets under management from institutional clients

3.1 Retirement funds and non-linked long-term insurance

Table 2 shows the *weighted* distribution of foreign exposures. Institutions are weighted by the value of total retail assets under management in order to illustrate the foreign exposures of savings held within the sector, as opposed to that of individual institutions which vary substantially in size. The table thus sets out the distribution of the total assets of institutions according to foreign exposure: for example, retirement funds with foreign exposure in the range from 15.0 to 19.9

percent held 22.9 percent of the total assets of the retirement sector. The table gives greater weight to larger institutions that are more of a concern in terms of the potential to generate significant capital outflows and risks to financial sector stability, as well as accounting for most of the savings held in the sector.

As noted above, our analysis is based on asset allocation reports submitted to the Financial Surveillance Department of the Reserve Bank for December 2009. For retirement funds, the following analysis is based on data reported by 3,545 funds; the largest funds are included such that coverage of total assets of the industry is reasonably complete. For non-linked insurance, the analysis is based on data from 27 companies, again including the largest companies accounting for most of the total assets of the sector.

Table 2 shows that most of the assets in the retirement fund and non-linked insurance sectors are held by institutions that reported foreign exposures substantially below the 20 percent limit in place at December 2009. Anecdotal reports suggest that some asset managers maintain foreign exposure just below the limit in order to avoid compliance problems in the face of valuation changes. Allowing for considerable flexibility to ensure compliance, 73 percent of the total assets of retirement funds and 98 percent of the total assets in non-linked insurance portfolios are held by institutions reporting foreign exposures of less than 15 percent.

Table 2: Distribution of foreign exposures, weighted by total retail assets, December 2009

Foreign exposure limit = 20% (Dec 09)	Retirement funds	*Retirement funds, excluding GEPF*	Non-linked long-term insurance
20% or more	4.0%	6.6%	0.0%
15.0% to 19.9%	22.9%	37.3%	2.3%
10.0% to 14.9%	27.4%	44.7%	41.1%
5.0% to 9.9%	43.0%	7.2%	54.3%
0.0% to 4.9%	2.6%	4.2%	2.2%

Source: Calculated from Financial Surveillance Asset Allocation Reports for December 2009

The asset-weighted distribution for the retirement fund sector is heavily influenced by the size of the Government Employees Pension Fund (GEPF). Removing this fund from the analysis reveals that foreign exposures tend to be higher in the private industry, with 44 percent of total assets held by funds reporting foreign exposures above 15 percent at December 2009 (compared to 27 percent for the industry including GEPF). However, only 7 percent of total assets are held in funds with foreign exposures of 20 percent or more (as shown in Table 2); moreover less than one-fifth of total assets are held by funds with exposures above 18 percent. This suggests that while the limit has been a binding constraint for a number of retirement funds, it does not appear to represent a widespread constraint on the foreign investment decisions of the industry as a whole.

Valuation changes have an important impact on the composition of the portfolio and, in the case of foreign asset holdings, exchange rate changes are a key influence on the rand value of holdings (reflecting currency risk). To demonstrate the impact of exchange rate effects, we examine the foreign asset holdings of private retirement funds (excluding GEPF) that submitted asset allocation reports to the Reserve Bank for four different points in time: March 2006, March 2007, March 2008 and December 2009. Matching the exact names of retirement funds across the four datasets, we are able to match reports for 882 retirement funds over time, representing just over two-thirds of the assets of the (non-GEPF) retirement sector.

The first column in Table 3 shows the aggregate foreign exposure across the 882 funds, i.e. aggregate foreign assets as a percentage of aggregate total assets. For December 2009, two measures are shown: the first is the actual foreign exposures

reflected in asset allocation reports; the second is an adjusted average that excludes estimated holdings of British American Tobacco (BAT) in order to provide a more consistent comparison with earlier years. The unbundling of the combined shareholding in BAT from Remgro and Richemont implies a structural change in the foreign asset data between March 2008 and December 2009. Direct shareholdings in the multinational BAT are now included in foreign asset limits, whereas the previous indirect exposure to BAT through Remgro and Richemont was excluded from the calculation of foreign assets because both Remgro and Richemont are classified as domestic companies.

The second column shows estimated foreign exposure after adjusting for the effects of exchange rate changes, using December 2009 as a benchmark. We assume that the aggregate foreign portfolio held by the retirement funds is comprised of assets denominated in US dollars, UK pounds and Euros. The percentage shares in each currency are based on year-end international investment position data reported in the Reserve Bank *Quarterly Bulletin* (the IIP data must first be adjusted to exclude foreign assets classified as domestic for the purposes of the foreign asset limit). The percentage shares in each currency vary slightly over time, reflecting changes in the composition of the portfolio and valuation effects. Foreign asset holdings for March 2006, 2007 and 2008 are re-valued using the relevant exchange rates as at the end of December 2009 and the re-valued foreign exposure is then calculated. The column thus shows estimated foreign asset positions holding exchange rates constant at their December 2009 levels.

At the end of March 2006, exchange rates against the major currencies reflected a long period of rand strength: against the US dollar, for instance, the rate stood at R6.19/US$, with an average rate in 2004-2005 of R6.41/US$. The strength of the rand in this period created considerable capacity for foreign investment by institutional investors, reinforced by the strong performance of domestic markets. From column 1 in Table 3, average foreign exposure for these funds was considerably below the 15 percent foreign asset limit in place at this time. Indeed, allowing for a small margin of flexibility for compliance with the limit, almost 70 percent of total assets were held by funds with foreign exposure below 13 percent. This suggests that there was limited pent-up demand for foreign assets in March 2006 - the majority of these retirement funds chose not to take full advantage of existing capacity for foreign investment in the context of the strengthening of the rand after 2003.

Foreign exposures of retirement funds increased after 2006. By March 2008, aggregate foreign exposure had reached 14.9 percent, effectively at the limit for the industry as a whole (the limit was increased to 20 percent only in February 2008). However, column 2 suggests that this increase was in large part due to the effects of the weakening of the rand against major currencies, as opposed to a widespread strategy of externalising assets. Indeed, holding exchange rates constant at December 2009 levels, estimated foreign exposures actually decline over this period. Although the precise estimates are sensitive to the assumptions regarding the currency composition of the portfolio, it is clear that the apparent increase in foreign exposures between 2006 and 2008 was strongly influenced by exchange rate valuation effects.

By December 2009, actual foreign exposure had fallen back relative to the levels reported in March 2008, although the exchange rate adjustment suggests that this fall is again mainly a valuation effect, reflecting a strengthening of the rand, as opposed to a scaling back of foreign asset holdings. However, while the constant exchange rate measure reveals an increase in foreign asset exposures in 2009, these retirement funds generally have not taken full advantage of the increase in the foreign asset limit to 20 percent in 2008: almost 90 percent of total assets are held by funds that have foreign exposure below 18 percent, and just over half of assets are with funds that have chosen to remain below 15 percent.

Thus, neither during the periods of rand strength between 2004 and 2006, nor following the 2008 increase in the foreign asset limit is there much evidence of funds

taking aggressive action to exploit the increased scope for foreign investment. These findings support the view that *pent-up* demand for foreign assets is not widespread. The retirement fund industry has not moved to increase foreign asset holdings to the maximum extent possible over time; instead many institutions appear to have taken a balanced view of domestic versus foreign fundamentals. This is likely to be reinforced by caution with regard to international investment in the climate of uncertainty caused by the global financial crisis.

Table 3: Impact of exchange rate movements on foreign exposure of retirement funds[1]

	Aggregate foreign exposure[2]				
	Actual	At December 2009 exchange rates[3]	Rand/US$	Rand/UK£	Rand/Euro
March 2006	11.6	13.8	6.1942	10.7707	7.5095
March 2007	13.5	13.3	7.2649	14.2157	9.6722
March 2008	14.9	12.7	8.1216	16.1267	12.8354
December 2009	14.6	14.6	7.3721	11.8934	10.6151
Dec. 2009, excluding BAT[4]	14.0	14.0			

Source: Calculated from Financial Surveillance Asset Allocation Reports for March 2006, 2007 and 2008 and December 2009, with end of period exchange rates from the South African Reserve Bank.

Notes:
1. Data on 882 private retirement funds reporting asset allocations for each period
2. Aggregate foreign assets as a percentage of aggregate total assets held by the retirement funds
3. Foreign exposure holding exchange rates constant at December 2009 levels. Based on a basket of three major currencies - US dollars, UK pounds, and Euros - derived from the reported foreign portfolio asset holdings of the private non-banking sector in the Reserve Bank *Quarterly Bulletin*.
4. Adjusted to exclude estimated unbundled holdings of British American Tobacco for consistent comparison with earlier periods. Holdings of BAT are estimated from the Asset Allocation Reports.

3.2 Investment managers, CIS companies and investment-linked insurance

Table 4 shows the asset-weighted distribution of foreign exposures of investment managers, CIS companies and the investment-linked business of long-term insurance companies as at December 2009. Data are available for 38 investment managers, 28 CIS companies, and 25 insurance companies.

The most striking aspect is the low levels of foreign exposure maintained by almost all investment managers and CIS companies relative to the foreign asset limit of 30 percent at December 2009 and to the previous limit of 25 percent. For investment managers, over 90 percent of total retail assets under management are held by institutions that reported foreign exposure below 15 percent; similarly, around three-quarters of retail assets for CIS companies. There is no indication that the foreign asset limit constrains international diversification of retail clients' investments for most of these institutions, in contrast to the constraint for part of the retirement fund industry shown above. Given the potential benefits of international diversification in investment portfolios, this raises the question of why these institutions (and their clients) have not increased foreign exposure by more. One possible reason for low levels of foreign exposure for these institutions is that, at an aggregate level, South African investors generally exhibit a preference for domestic assets. This would be consistent with the international literature on 'home bias', i.e., the observed tendency for investors to hold high proportions of domestic assets despite the potential benefits of risk diversification offered by foreign assets (see Leape and Thomas, 2009, for a discussion of home bias in South African and international equity portfolios).

Evidence on investment-linked insurance shows a slightly different pattern, however. Foreign exposures in this part of the industry tend to be higher than those reported by

investment managers and CIS companies, with four-fifths of retail investment-linked assets held by insurance companies reporting exposures above 15 percent.

It is also evident that the foreign exposures of *linked* insurance products are higher than the foreign exposures of the *non-linked* portfolios of long-term insurance companies (compare Tables 2 and 4). Prior to 2008, a 15 percent foreign asset limit applied to the total of linked and non-linked insurance assets. This approach meant that the pool of assets backing non-linked policies in the largest insurance companies allowed these companies to offer investors much higher levels of foreign exposure in linked policies than the overall limit of 15 percent would suggest.

It is possible that the split of investment-linked and non-linked portfolios in regulations introduced in 2008 will create additional capital outflows under the new prudential regulation regime. In particular, the apparent higher level of demand for foreign assets in investment-linked policies suggests that the substantially increased foreign asset limit for this type of business will create a new channel for capital outflows over time. However, this is unlikely to be a source of substantial outflows in the short term as the total retail assets under management in linked policies are much lower than other institutional investment. As at December 2009, total retail assets reported for linked policies amounted to R182 billion compared to R2,043 billion for retirement funds, R525 billion for investment managers and R372 billion for CIS companies.

Table 4: Distribution of foreign exposures, weighted by total retail assets, December 2009

Foreign exposure limit=30% (Dec 09)	Investment managers	CIS companies	Linked insurance
30% or more	0.0%	0.0%	2.2%
25.0% - 29.9%	2.1%	15.6%	0.0%
20.0% - 24.9%	4.4%	1.9%	16.4%
15.0% - 19.9%	2.4%	8.5%	61.1%
10.0% - 14.9%	41.5%	6.8%	11.4%
5.0% - 9.9%	20.1%	36.0%	7.5%
0.0% - 4.9%	29.6%	31.2%	1.3%

Source: Calculated from Financial Surveillance Asset Allocation Reports for December 2009

4. Objectives of prudential regulation of foreign exposure

The reforms announced in Budget 2008 marked the implementation of the longer-term prudential regulation of foreign exposure for institutional investors. Formal applications to the Reserve Bank are no longer required for foreign investment, although evidence of compliance with reporting requirements under exchange controls is required for Authorised Dealers to facilitate foreign currency investment. Asset managers now have greater freedom to manage their desired levels of foreign exposure in a symmetric fashion, i.e., buying and selling foreign assets in response to changing market conditions, subject only to applicable regulatory limits. This contrasts with the historical approach of exchange controls on transactions where the application process has created disincentives for institutions to sell foreign assets and repatriate capital because of the transaction costs associated with future applications and possibly also because of a fear of policy reversal.

The move from transactions-based exchange controls to a prudential risk-based approach implies an important change in objectives. The principal objective of exchange controls has been to limit outflows of capital from South Africa. In contrast, prudential regulation is concerned with ensuring the financial soundness of institutions - in part through requiring adequate portfolio diversification and liquidity - and, more

generally, with supporting systemic stability and, in turn, macroeconomic stability. The debate on finalising prudential foreign asset limits in South Africa must also be seen in the broader context of the global crisis in financial markets that has underscored the importance of strengthening the regulation of financial institutions. These events have demonstrated that the most developed financial systems are not immune to systemic crises and that cross-border linkages mean that such crises can be rapidly transmitted across countries, with macroeconomic implications.

Foreign asset limits in South Africa can be viewed as having both micro and macro-prudential objectives:

Micro-prudential regulation: used here to refer to supporting financial stability through the financial soundness of individual institutions

- To promote the benefits of foreign diversification in institutional portfolios, while recognising that foreign investment exposes institutions to new forms of risk
- To provide a limit on the overall foreign risk exposure of retirement funds and non-linked insurance, complementing the existing rules-based framework for (micro) prudential regulation of risk

Macro-prudential regulation: used here to refer to the management of macroeconomic risks associated with cross-border capital flows and exposures of institutional investors

- To limit the volatility of capital flows in periods of macroeconomic instability
- To limit the contagion of international crises
- To avoid excess reliance on costly and volatile foreign capital to fund domestic investment. The low domestic savings rate in South Africa means that outflows of domestic capital must be matched by inflows of foreign capital. This constraint implies a need to balance the private returns to foreign investment with the broader social returns.

4.1 The use of prudential portfolio regulation

In many countries - including South Africa - the (micro) prudential regulation of retirement funds and long-term insurance companies includes quantitative portfolio limits that set ceilings on holdings of certain classes of assets, including foreign assets (see below for an international comparison). The rationale for portfolio limits is that assets should be sufficiently diversified to limit the risk that an institution is unable to meet its liabilities to policy holders, fund members or investors. The alternative approach of relying on internal risk management subject to supervisory surveillance - known as the 'prudent person' rule - has grown in importance, especially in developed countries, but even under a prudent person approach, some types of portfolio restrictions can apply.

The broader question of the longer-term approach to prudential regulation in South Africa - and to what extent a move towards the prudent person model is appropriate in the emerging market context - is beyond the scope of this paper. It is worth noting, however, that the international financial crisis has revealed fundamental weaknesses in internal risk management and the associated structures of governance and incentives, even in the largest financial institutions in the US and Europe. These shortcomings have been reinforced by failures on the part of regulators to effectively supervise complex instruments and increasingly opaque counterparty risk. The crisis has thus brought into question the existing frameworks for financial regulation in the most advanced economies. In this light, a rapid or wholesale move towards a prudent person approach to regulating foreign exposure would seem inappropriate for South Africa as the development of sufficient specialised capacity in the supervision of foreign risk - together with appropriate governance and incentive structures in

financial institutions - would be a crucial pre-requisite for major reform in the longer term.

For these reasons, the analysis that follows assumes that quantitative portfolio rules will continue to be used in South Africa as part of the framework for financial regulation of retirement funds and long-term insurance companies.

4.2 Institutions subject to prudential portfolio regulation

In the discussion below, we use the terms *quantitative portfolio rules* and *prudential portfolio regulation* to refer to regulations applied to broad asset classes held at the aggregate level of the institution, i.e., ceilings on investments in equities, property, foreign assets, derivative products, etc. The regulation of products offered by institutional investors also includes other types of investment requirements, for instance on limiting exposures to single issuers, on the credit quality (investment rating) of issuers, and on recognised market listings. While these types of regulations are important for all institutional investors, they are not considered explicitly in the following discussion which focuses on foreign assets as a broad asset class commonly subject to quantitative portfolio rules.

Retirement funds are subject to prudential portfolio regulation in South Africa in order to protect member benefits, in other words to protect the future income of pensioners and dependents. For defined benefit funds, the long-term, stable nature of liabilities creates scope for mismatch between liabilities and assets, which are typically more volatile. Even in the case of defined contribution funds (where benefits are determined by the combination of contributions and investment growth), there are strong grounds for investment regulation to prevent excessive concentrations of risk. The rationale for regulation is to limit the vulnerability of retirement savings to poor investment decisions, especially in the context where fund members have limited financial expertise. The implementation of prudential regulation of foreign exposure is one aspect of a much larger reform agenda now facing the retirement fund industry and consultations are currently taking place on reforms to broader investment regulations set out in Regulation 28 under the Pension Fund Act.

Long-term insurance companies are also subject to prudential portfolio regulation. In South Africa, quantitative portfolio rules and spreading requirements are set out in the Long-Term Insurance Act. These rules are applied to the pool of assets backing the *non-linked policies* of the insurer (including the capital adequacy requirement). This includes limits on aggregate asset classes, as well as limits on exposure to single issuers or entities. There is scope for mismatch between the current market value of assets and the liabilities that arise from non-linked policies, exposing the insurer to risk. The financial soundness of these institutions therefore requires adequate diversification and liquidity in the portfolio.

South African insurers also offer *investment-linked policies*, defined in the Long-Term Insurance Act as policies with benefits that are determined by the value of specific assets that are held by the insurer for the purpose of the policy. For these policies, liabilities to policy holders are thus determined by the value of specified assets held by the insurer. The absence of mismatch means that quantitative portfolio rules for broad asset classes are not necessarily required for this aspect of the business of long-term insurers, although other elements of regulation of the products sold to investors are, of course, still important.

Collective investment scheme companies and other *investment managers* are not typically subject to the prudential portfolio regulation of the broad asset classes held in aggregate at the level of the financial institution. For these institutions, liabilities to investors are defined by the assets held on behalf of investors, as in the case of investment-linked insurance policies. These institutions may be characterised as discretionary savings vehicles where investment risk is (or should be) an accepted part of the investment decision for the client. However, investment regulations can apply to individual products - for example, collective investment schemes have

limitations on the composition of the portfolio and on exposures to single issuers. These regulations aim to support risk diversification and sound market conduct. The distinction between regulations affecting products versus financial companies is further noted in section 7.

The distinctions between types of institutional investors have been recognised in exchange control reforms. Since 2005, retirement funds and long-term insurance companies have had a lower foreign asset limit than CIS companies and investment managers, in part reflecting additional micro-prudential considerations. The reforms announced in February 2008 introduced a differential treatment of assets backing investment-linked and non-linked policies of long-term insurance companies, in line with the broader framework for prudential portfolio regulation of insurance companies. Investment-linked policies now have the same foreign asset limit as CIS companies and investment managers.

4.3 Foreign asset limits in prudential regulation

International evidence - discussed in section 5 - indicates that foreign asset restrictions are a common feature of prudential portfolio regulation for retirement funds, although there has been a shift to the prudent person approach in a number of developed economies. The implementation of an overall foreign asset limit in the framework for prudential regulation recognises that foreign assets form a distinct asset class creating particular risks for financial institutions. These risks include the impact of exchange rate volatility on the value of assets (currency risk), the broader forms of country risk, and the transmission of international crises. Indeed, the contagion experienced by developed and developing economies in the international financial crisis has highlighted the important role of supervision of foreign exposures in supporting financial stability. For developing countries, the macroeconomic risks associated with the volatility of cross-border investment and the loss of domestic capital in the context of balance of payments constraints have provided a further important rationale for such limits.

An overall foreign asset limit does not, however, differentiate between the varied country and currency risks associated with specific types of assets within this class. In this light, prudential regulations often impose different limits across categories of foreign assets (see below on international experience). In the case of South Africa, the broader set of prudential portfolio rules administered by the FSB provides the appropriate framework for differentiating these risks. There is therefore a strong case for harmonisation of the 'macro-prudential' surveillance of foreign exposure with micro-prudential portfolio regulations in order to support an effective overall framework for risk-based regulation.

The implementation of prudential regulation of foreign exposure for retirement funds and non-linked long-term insurance should thus consider whether there is scope for greater harmonisation of the supervision of foreign exposure – currently administered by the Reserve Bank – with the prudential rules governing asset allocation in institutional portfolios administered by FSB through the Pension Fund Act and Long-Term Insurance Act. Reforms aimed at supporting harmonisation of these regulatory frameworks should not only contribute to strengthening the consistency of portfolio regulations but should also help to minimise the administrative burden of compliance for institutional investors and the relevant regulatory authorities. This issue is discussed further in section 6.

As noted above, prudential portfolio restrictions at the level of the financial institution do not apply in the case of CIS companies, investment managers and linked insurance. The longer-term role of a foreign asset limit for these institutions is explored in section 7 with an emphasis on the broader framework for managing macroeconomic risk.

5. International evidence on foreign asset limits

Foreign asset restrictions are a fairly common feature of quantitative portfolio regulations in OECD and emerging market economies. As noted above, the use of foreign exposure limits within quantitative portfolio regulation reflects the particular risks associated with holding foreign assets, including the impact of exchange rates and the contagion of financial instability across borders.

Restrictions on foreign investment have been criticised on the basis that they impose a constraint on the ability of institutions to achieve the benefits of risk diversification through international investment (e.g., Davis, 2001; Dickinson, 2001). However, the impact of foreign asset limits in constraining foreign diversification is not necessarily straightforward in the context where domestic institutions exhibit at least some preference for more familiar domestic assets and markets. It is therefore useful to differentiate between low limits which severely constrain sound asset management decisions and higher limits which provide flexibility for foreign investment but aim to prevent excessive concentrations of foreign risk if weaknesses in internal risk management and supervisory capacity occur.

Moreover, it is suggested that the rationale for foreign asset restrictions in developing countries has been more motivated by macroeconomic concerns, such as the implications of volatility of capital flows, constraints on access to international capital and the development of domestic capital markets (e.g., de Menil 2005; Davis, 2002; Yermo, 2000). In these circumstances, the reform of restrictions on foreign investment must therefore balance macroeconomic considerations - including the effectiveness of specific restrictions - against the gains of increased diversification of risk in institutional portfolios. For South Africa, the importance of international diversification of investment portfolios for risk management purposes and for stabilising real consumption levels in retirement has been recognised in recent reforms, including the interim increase in the foreign asset limits announced in 2008. Policy on final prudential foreign asset limits should seek to facilitate appropriate levels of risk diversification in institutional portfolios, while safeguarding financial stability in the context of the macroeconomic risks faced by emerging economies.

In the following, we review the available international evidence on the use of foreign asset limits for institutional investors. This is intended to provide some context for the debate on final foreign asset limits in South Africa. However, foreign asset restrictions vary across countries both in terms of the level and the definition. As such, the international evidence does not necessarily provide any clear recommendations on appropriate limits for South Africa.

The regulation of foreign investment by institutional investors is widespread internationally, as shown by the IMF *Annual Report on Exchange Arrangements and Exchange Restrictions* - 119 out of 185 countries had some form of regulation of foreign investment by institutional investors according to the 2008 *Report.* Restrictions are common even amongst higher income countries, although the nature of these restrictions varies across countries. The OECD *Code of Liberalisation of Capital Movements* considers restrictions on portfolio investment abroad by insurance companies and pension funds as a barrier to the free movement of capital and provides a framework to promote the liberalisation of cross-border transactions. In the 2009 update of the Code, restrictions on foreign investment by institutional investors were common amongst member countries, with 17 of the 30 reporting some form of restriction on cross-border investment for insurance companies and 9 reporting some restrictions on pension funds.

Table 5 presents more detailed information on the limits applied to foreign investment by pension funds as reported by the OECD in its regular survey of investment regulations. This covers both OECD members and a small number of non-OECD countries, including South Africa. The reporting date is end of December 2009. We focus on the regulation of pension funds as this is the most recent available survey of portfolio regulations for institutional investors; as noted above, pension (retirement)

funds are also by far the largest group of institutional investors in South Africa. Earlier studies indicate that foreign asset restrictions have also been a common feature of regulation for long-term insurance companies in both developed and developing countries (e.g., Kong and Singh, 2005; OECD, 2003; 2001; Davis, 2001).

Countries are grouped into four main categories according to: (i) whether an overall limit on foreign assets is reported and/or (ii) whether restrictions on investment in specific types of foreign assets are reported. Restrictions on specific types of foreign assets include different limits for particular classes of assets (for instance equity versus bonds versus real estate) and distinctions between OECD versus non-OECD assets (in some OECD members) or European versus non-European assets (in some EU members). It also covers differences in regulatory treatment based on characteristics such as listings in regulated markets and credit ratings. These features are important because they demonstrate that the prudential approach can distinguish between the risks associated with different types of foreign assets. In total, there are 37 countries in the comparison. Some countries apply different rules to different types of funds (Germany, Korea and Luxembourg).

The regulations reported for South Africa at the end of 2009 include an overall foreign asset limit of 20 percent, with additional restrictions on investment in real estate and investment funds. Five other countries report similar types of regulations (i.e., an overall limit with additional asset-specific restrictions), mainly upper middle-income economies, such as Chile and Mexico, but also in parts of the pension system in Korea. A further five countries have an overall foreign asset limit but no additional restrictions on specific types of foreign assets are reported, including high-income Austria and Switzerland.

Amongst the countries that report an overall foreign asset limit, the most common limits are 20 percent and 30 percent but there is significant diversity. Brazil has recently increased the foreign investment limit to 10 percent (from 2-3 percent previously) while for Chile, the aggregate limit for a pension fund manager is 60 percent, with limits by type of fund provided. Many countries do not have overall foreign asset limits, however. In 13 cases, no overall limit is reported but there are restrictions on specific types of foreign assets. Furthermore, in 17 cases, no specific restrictions on foreign assets are reported. Within this latter group, more than half appear to be implementing the prudent person approach to regulation in that no quantitative limits on other broad asset classes are reported (other diversification rules may apply under a PPR approach, however).

While many countries in the OECD have now moved away from overall foreign asset limits for retirement funds, not all OECD countries have removed these types of restrictions and, moreover, foreign asset limits are in place in most of the non-OECD economies covered here. The continued use of a prudential foreign asset limit in South Africa is thus broadly supported by current international practice.

Table 5: Regulation of pension fund investment in foreign assets (end-2009)

Description	Countries	Overall foreign asset limit
Overall foreign asset limit, with restrictions applied to specific types of foreign assets	Brazil	2-3% (now increased to 10%)
	Colombia	40%
	Chile (varies by fund; joint limit for all funds)	60%
	Korea (Corporate pension: DC) [1]	30%
	Mexico	20%
	South Africa	**20%**
Overall foreign asset limit, with no restrictions on specific types of foreign assets reported	Austria	30%
	Korea (Personal pension: insurance) [1]	20%
	Poland (mandatory personal pensions)	5%
	Russian Federation	10% (20% from 2010)
	Switzerland	30% (foreign currency, hedging allowed)
No overall foreign asset limit but restrictions applied to specific types of foreign assets	Czech Republic	
	Denmark	
	Finland	
	Germany (Pensionskassens) [1]	
	Greece	
	Hungary	
	Iceland	
	Israel	
	Italy	
	Korea (Corporate pension: DB) [1]	
	Luxembourg (CAA supervised funds) [1]	
	Portugal	
	Slovak Republic	
Description	**Countries**	**PPR or quantitative limits[2]**
No limits on foreign assets	Australia	No quantitative limits reported
	Belgium	No quantitative limits reported
	Canada	Limit on real estate
	Estonia	Quantitative limits apply
	Germany (Pensionsfonds) [1]	No quantitative limits reported
	Ireland	No quantitative limits reported
	Japan	Restrictions on real estate & loans
	Korea (Personal pension: trust & inv. funds) [1]	No quantitative limits reported
	Luxembourg (SEPCAV & ASSEP)[1]	No quantitative limits reported
	Netherlands	No quantitative limits reported
	New Zealand	No quantitative limits reported
	Norway	Quantitative limits apply
	Spain	Quantitative limits apply
	Sweden	Quantitative limits in parts of system
	Turkey	Quantitative limits apply
	UK	No quantitative limits reported
	US	No quantitative limits reported

Source: Drawn from the *Survey of Investment Regulation of Pension Funds*, OECD, February 2010.
Note: 1. Different limits are reported for different types of funds in Germany, Korea and Luxembourg.
2. Quantitative limits across broad asset classes: equity, real estate, bonds, retail and private investment funds, loans, bank deposits. This does not include other investment rules such as restrictions on assets associated with the employer, single issuer and ownership concentration limits, and limits on unlisted securities.

6. Prudential foreign asset limits for retirement funds and long-term insurance companies

As emphasised above, the shift from transaction-based exchange controls to prudential regulation of foreign risk exposure implies a change in the principal objective of regulation from limiting the outflow of capital to ensuring the financial soundness of institutions and supporting systemic and macroeconomic stability. The adoption of a prudential foreign asset limit for retirement funds and non-linked long-term insurance aligns the regulatory treatment of foreign exposure with the broader approach of prudential portfolio regulation in South Africa.

The change in objective of regulation raises new issues about the appropriate measurement of foreign risk exposure for retirement funds and long-term insurance companies. There are differences between the application of the foreign asset limit in the macro-prudential surveillance system supervised by the Financial Surveillance Department at the Reserve Bank and the broader micro-prudential portfolio rules administered by the Financial Services Board. Greater harmonisation between these two systems would improve the consistency of regulation and should also help to reduce the administrative burden of regulation for institutions and supervisors.

A key issue for consideration is the treatment of foreign risk exposures that arise from the interaction between long-term insurance companies and retirement funds. The move to prudential regulation has already involved a separation of the assets backing investment-linked versus non-linked policy liabilities from the perspective of long-term insurers. The regulation of exposures arising from these two categories of policies should now be considered from the perspective of retirement funds that hold insurance policies as assets. This is an important issue as the scale of assets involved is substantial: from Table 1, long-term insurance companies managed assets of R1,437 billion at the end of December 2009 (linked and non-linked), with R806 billion in the form of assets backing liabilities to institutional clients, mainly retirement funds.

6.1 Prudential regulation of the non-linked liabilities of insurance companies

From 2003, the exchange control regime required a separation of institutional and retail clients, with the foreign asset limit applied only to retail assets under management. The purpose of this separation under exchange control was to ensure that responsibility for compliance remained with the relevant institutional client. It has also prevented the double-counting of assets in the application of foreign asset limits. This approach has followed from the historical exchange control objective of limiting outflows of capital. The result is that the current foreign asset limit for non-linked insurance applies *only* to assets backing the policies of retail clients. In parallel, the application of the foreign asset limit for retirement funds takes into account the underlying composition of assets backing insurance policies held by the fund, regardless of whether they are linked or non-linked policies.

The shift to prudential regulation of foreign risk exposure implies that the treatment of the non-linked liabilities of long-term insurers should be driven by considerations of financial soundness. This suggests that the foreign asset limit should apply to the assets backing *all* non-linked liabilities, regardless of the nature of policy holders. The rationale is that the type of policy holder is not the most relevant factor for prudential (risk-based) regulation. Instead, the critical feature is the nature of non-linked liabilities that create a potential mismatch in adverse economic conditions between the current market value of policy-holder fund assets and the value of liabilities to policy holders, thereby exposing the insurer (and shareholder capital) to risk.

A foreign asset limit based on the total assets backing all non-linked liabilities would be more consistent with the current spreading requirements (prudential portfolio regulations) under the Long-Term Insurance Act. This change would therefore support greater harmonisation with the broader framework for prudential portfolio regulation for non-linked insurance. Data from Financial Surveillance asset allocation reports

show that the foreign exposure of assets backing non-linked liabilities to institutional clients is, on average, higher than for retail liabilities. However, as most of the long-term insurance industry has foreign exposure significantly below the current limit for retail non-linked business, a shift in the application of the limit to total assets (retail and institutional) would not require significant short-term adjustments. Only one company would now exceed the existing 20 percent limit following this change (with foreign exposure of just 20.1 percent compared to 18.8 percent on the retail side), accounting for just over 5 percent of the non-linked insurance sector. Table 6 illustrates the implications of this change for the distribution of foreign exposures in the non-linked insurance sector, using the same methodology as described for Table 1 in section 3. The vast majority of the sector would still have foreign exposures below 15 percent.

Table 6: Distribution of foreign exposures for non-linked insurance – retail versus total asset base

	Foreign exposures of retail assets	Foreign exposures of total assets, retail and institutional
20.0% or more	0.0%	5.5%
15.0% to 19.9%	2.3%	0.0%
10.0% to 14.9%	41.1%	54.5%
5.0% to 9.9%	54.3%	39.3%
0.0% to 4.9%	2.2%	0.7%

Source: Calculated from Financial Surveillance Asset Allocation Reports, December 2009
Notes: Distribution of foreign exposures weighted by assets under management - retail assets in the first column; total assets in the second column.

There remains a strong case, however, for maintaining the disaggregated reporting of institutional and retail assets of long-term insurers, as in the current reporting system administered by the Reserve Bank. This disaggregation of assets contributes to consistent data on the asset allocation of the institutional investor sector as a whole, supporting the role of the reporting system in financial and macroeconomic surveillance.

Consistency with the application of the broader prudential spreading requirements raises a further issue for long-term reform. Spreading requirements under the Long-Term Insurance Act are based on the value of non-linked policy liabilities and the capital adequacy requirement (CAR), as opposed to the value of total assets of the insurer, with the result that the composition of the excess of total assets over liabilities and CAR is not strictly restricted by prudential limits. The motivation here is that the Act requires the insurer to have a portfolio of assets of a particular kind and spread that is at least sufficient to match non-linked policy liabilities plus CAR. The implementation of the prudential foreign asset limit for long-term insurance should thus also consider the most appropriate basis for application, i.e., assets or liabilities, and the implications for investment of policyholder funds and shareholder capital. An assessment of the implications of using an asset versus liability basis would require new data from the institutions on the value of policy liabilities and CAR. Any further reform along these lines would require close coordination with the Financial Services Board to ensure consistent measurement and application of limits, together with a harmonised approach to any future changes to prudential portfolio regulation.

6.2 Prudential regulation of linked versus non-linked insurance policies held by retirement funds

Under exchange control, the foreign asset limit has applied to the total assets of retirement funds (by definition, these assets are wholly retail). A 'look-through' principle has been used in the reporting of foreign exposure, based on current market values: all funds invested with other domestic institutional investors - including long-term insurers - are disaggregated into the underlying assets. Hence, if a long-term

insurer holds foreign assets to back its liabilities to a retirement fund client, then these should be counted towards the foreign asset limit of the retirement fund, not the long-term insurer. As noted above, this approach has followed from the objective of limiting capital outflows under exchange controls.

Under a risk-based foreign asset limit, further consideration should be given to the different risk exposures for retirement funds associated with holdings of investment-linked insurance policies and non-linked insurance policies.

In *investment-linked policies*, investment risk is wholly faced by the retirement fund as assets are matched to liabilities at the level of the insurer. The prudential regulation of foreign exposure of these policies should thus be applied at the level of the retirement fund in line with the recent practice under exchange control. In other words, the underlying assets specified in these policies should continue to be reported by retirement funds as actual exposures, following the look-through principle, and therefore be subject to the foreign asset limit.

In contrast, a consistent approach to prudential regulation of *non-linked insurance policies* held by retirement funds suggests that these policies should be classified in line with the benefits that are specified in the policy, rather than strictly according to the current market value of the underlying assets held by the insurer. Since the retirement fund does not necessarily bear the full investment risk associated with the short-term volatility of these assets, 'look-through' to the composition of the underlying assets (reported at current market values) may not always provide an accurate indication of the risk profile of non-linked policies, which may include cumulative vested benefits as well as any implicit or explicit guarantees regarding future returns. This raises the crucial question of how these assets should be valued and classified in the accounts of retirement funds which, in principle, should depend on how the returns are structured, including the nature of any guarantees. One solution could be for these policies to be reported as a separate class of assets that would not be included in the retirement fund's calculation of the foreign asset limit *provided that* the investment mandates of individual policies comply with the foreign exposure limit – here, regulatory compliance would be delegated to the insurer for these policies.

Reform in this area should allow for greater harmonisation with the prudential portfolio limits set out in Regulation 28 under the Pension Fund Act. These broader limits have applied to a subset of retirement fund assets: all non-linked policies are excluded, as are linked policies that are certified as complying with Regulation 28 (in effect delegating regulatory compliance to the insurer). As noted elsewhere, Regulation 28 is currently under review and consideration should thus also be given to the consistency of reforms proposed for the foreign asset limit with changes to the broader framework of investment regulation for retirement funds.

The above approach would require a consistent definition and treatment of investment-linked and non-linked policies in the framework for prudential regulation of foreign exposure for both long-term insurers and retirement funds. It will be important to avoid gaps or inconsistencies in the application of prudential rules governing the interaction between long-term insurers and retirement funds which might otherwise create scope for unregulated foreign positions. One of the major challenges in developing consistent definitions in this area will be to assess the implications of the investment and guarantee elements of non-linked policies in order to identify the true risk profile from the perspective of retirement funds.

7. Macro-prudential regulation for investment managers, CIS companies and investment-linked insurance

The current foreign asset limit for investment managers, CIS companies and investment-linked insurance is applied at an *aggregate level* to the total retail assets managed by the institution. One important implication is that these institutions are able in principle to offer investment products that provide up to 100 percent foreign exposure for their retail clients as long as they also manage domestic assets of sufficient size to generate the foreign asset allowance required for these international investments. The foreign asset limit thus operates purely at a 'macro-prudential' level for this group of institutions by supporting an overall limit on the investment of South African institutional savings in foreign assets. As noted earlier, there are no corresponding quantitative prudential limits on the aggregate composition of assets or investment funds managed by these institutions, for instance, in terms of the overall mix of equity funds versus property funds versus fixed-income funds etc. Instead, investment rules apply to *individual products* such as collective investment schemes to provide for a consistent definition of the categories of assets that may be held under different types of schemes and to limit concentration and credit risks.

The analysis in section 3 shows that most CIS companies and investment managers have foreign exposure levels considerably below the existing foreign asset limit. There is therefore no evidence of a binding constraint on retail demand for foreign assets via these channels. These institutions and their retail clients appear to have an underlying preference for domestic assets - or an emphasis on domestic investment expertise - that is not unusual in the international context. Linked insurance policies tend to have somewhat higher levels of foreign exposure. However, the total retail assets under management in linked policies are currently lower than for other institutional investment; in the short to medium term, linked insurance is therefore less of a concern from a macro-prudential perspective, although it is of course possible that linked business will grow rapidly in the future, especially with a liberalised foreign investment regime.

It might be argued that the apparent low level of demand for foreign assets by the retail clients of investment managers and CIS companies suggests that the benefits of a long-term limit on foreign assets for these institutions may be rather limited and thus potentially outweighed by the positive signalling benefits of full liberalisation. Even if there is an internal or external shock that increases demand for foreign assets, a very substantial reallocation of portfolios would be required for the existing foreign asset limit to become binding on these institutions.

It must be recognised, however, that small and open emerging economies like South Africa will continue to be more susceptible to external shocks than the most highly developed economies and also to investor perceptions of higher levels of country and currency risk than developed economies. This environment creates risks to financial and macroeconomic stability while also inhibiting flows of long-term investment capital, with adverse implications for growth. Indeed, the global financial crisis has illustrated the speed and force with which financial stress can cross borders – even between highly developed economies – with macroeconomic effects. The greater vulnerability of emerging economies suggests that the regulatory framework best suited to South Africa is likely to differ from that in the most developed economies and, in particular, it is desirable to develop instruments that enhance the authorities' capacity for managing macroeconomic risk. In this context, a longer-term 'macro-prudential' limit for these institutions would complement the prudential foreign asset limit for retirement funds and non-linked insurance in managing the macroeconomic risks associated with volatile capital outflows and the potential loss of long-term capital for domestic investment. A key consideration for discussion amongst stakeholders is the potential role for such a limit as part of the policy framework to promote financial and macroeconomic stability.

A macro-prudential foreign asset limit could continue to apply to the retail asset base of these institutions, with retirement funds and other institutional investors reporting

exposures associated with these investments on a look-through basis, as discussed above. Such a limit could also continue to be set higher than the prudential limit on retirement funds and non-linked insurance as its objectives would be limited to underpinning macroeconomic stability, especially in periods of financial crisis, while minimising the adverse effects on portfolio management under normal economic conditions.

The use of a macro-prudential limit in the long term should also take into account the broader strategy of exchange control reform and, in particular, the alternative channels for outward investment by private individuals. It is important to consider the consistency of reform across different parts of the financial sector and across institutional investors and individual investors. The gradual lifting of constraints on direct offshore investment by individuals implies that a macro-prudential limit for these institutions should be set high enough to ensure that these institutions can continue to compete effectively as locally-based vehicles for foreign diversification.

Regardless of whether or not a macro-prudential foreign asset limit for these institutions is implemented, the reporting system currently administered by the Financial Surveillance Department should be maintained in order to support financial and macroeconomic surveillance.

8. Classification of foreign assets under prudential regulation

The preceding sections of this paper have explored the role of prudential regulation of foreign exposure and the application of foreign asset limits, drawing on the framework for financial regulation in South Africa and on international experience. The regulation of foreign exposure is common international practice, reflecting the particular risks associated with foreign investment by institutional investors.

The shift to risk-based prudential regulation raises important questions about the appropriate definition of foreign exposure. Inconsistencies in the classification of existing foreign assets have resulted in uncertainty over the longer-term application of foreign asset limits and the effectiveness of regulation. Moreover, the classification of foreign assets implemented under prudential regulation needs to be robust in the context of the increasing pool of foreign assets that become available to institutional investors in domestic capital markets, in part as a result of the broader strategy for exchange control reform.

8.1 Principles of classification

The historical focus of exchange controls on cross-border currency transactions was reflected in a currency-based definition of foreign assets. The reforms implemented in 2003 (discussed above) marked a clear shift away from this approach towards a focus on exposures to foreign risk, supporting the transition to a prudential approach. In particular, the 2003 reforms introduced a 'look-through' principle in the reporting of asset allocations. Institutions are thus required to report foreign asset exposure acquired both directly – as a result of foreign currency transfers – and indirectly through another domestic intermediary, such as a (rand-denominated) collective investment scheme backed mainly or in part by foreign assets. This broader emphasis on foreign exposures was an important step towards establishing risk-based regulation at the level of the individual institution, as it recognised the increasing role of domestic intermediaries as a channel for foreign diversification.

A consistent classification principle has not, however, been fully applied in the case of foreign securities that are traded in rand on the JSE:

- In 2004, the Minister announced that foreign (non-resident) entities would be permitted to list on the JSE and that institutional investors would be able to invest in these companies subject to their foreign asset limits, including an additional allowance for African securities, reflecting a hybrid classification. This approach is

consistent with the broader principle that assets representing exposure to international risks and returns are classified as foreign, even if acquired in rand through domestic markets or intermediaries. This group of non-resident entities is referred to as the '*inward listings*'.

- However, there are several non-resident firms that established secondary listings on the JSE prior to the introduction of the inward listing policy in 2004. These equities continue to be categorised as domestic assets for the purposes of current foreign asset limits, reflecting the historical currency-based approach of exchange control. In the discussion below, this group of non-resident companies is referred to for convenience as the '*secondary listings*'.
- A third category of non-resident listings can also be distinguished: the offshore holdings of South African dual listed companies. This includes Investec plc and Mondi plc. The Investec dual listing has been classified as a domestic asset since 2002; this is now also the approach used for the Mondi dual listing following the reclassification of Mondi plc as a domestic asset in July 2009. One rationale for domestic classification in these cases is that shareholdings in dual-listed structures represent an economic interest in the combined group that incorporates a domicile in South Africa.

Table 7: Classification of non-resident companies listed on the JSE (Ranked by total market capitalisation at December 2010)

Company	Current classification
BHP Billiton plc***	Domestic; secondary listing
BAT plc***	Foreign; inward listing
Anglo American plc***	Domestic; secondary listing
SABMiller plc***	Domestic; secondary listing
Compagnie Financière Richemont**	Domestic; secondary listing
Old Mutual plc**	Domestic; secondary listing
Lonmin plc*	Domestic; secondary listing
Investec plc*	Domestic; South African DLC
Capital Shopping Centres plc*	Domestic; secondary listing
Reinet Investments SCA*	Domestic; secondary listing
Mondi plc*	Domestic; South African DLC
Other non-resident firms	
Number of firms: 21	African
Number of firms: 6	Foreign
Number of firms: 8	Domestic

Source: Own classification based on the location of registered headquarters and/or country of incorporation, identified from information on JSE and company websites.

Notes: *** indicates the company is in the top five largest companies with listings on the JSE
** indicates the company is in the top 20 largest companies with listings on the JSE
* indicates the company is in the top 50 largest companies with listings on the JSE

The classification of foreign securities traded on the local stock exchange is an important issue for South Africa because several of the largest companies listed on the JSE are non-resident, accounting for a significant fraction of total equity market capitalisation. In part, this feature of the JSE follows from changes in domicile and primary listings by large South African multinationals between 1997 and 1999: Billiton in 1997 (now BHP Billiton plc), Anglo American, South African Breweries (now SABMiller), and Old Mutual in 1999 (the 'London Four'). Dimension Data also established a primary listing in London in 2000, although this company has now been acquired by NTT of Japan. But it also includes older listings reflecting earlier periods of unbundling and re-domiciling of South African international assets, in particular, Swiss-based Richemont, more recently restructured into the luxury goods group Compagnie Financière Richemont and Reinet Investments with the unbundling of the shareholding of British American Tobacco (BAT).

Out of the top 20 largest listed companies on the JSE (as at December 2010), six can be classified as non-resident on the basis of the location of registered headquarters and/or country of incorporation. This includes BHP Billiton plc, BAT, Anglo American, SABMiller, Compagnie Financière Richemont and Old Mutual plc. Of these six, only BAT is currently classified as a 'foreign' inward listing; the other five are secondary listings treated as domestic assets in line with the historical approach of exchange control. A further five non-resident companies rank within the top 50 largest companies on the JSE: three are 'domestic' secondary listings and two have a domestic classification under a DLC structure. A further 35 non-resident companies have listings on the JSE, although these are all small companies relative to the benchmark Top 40. Most of these companies - 21 in number - have an 'African' classification, reflecting mainly (but not exclusively) mining interests, including operations in South Africa.

The presence of large non-resident companies in the local equity market means that the classification of these assets has significant implications for the robustness of prudential regulation of foreign exposure in the longer term. At the same time, the importance of the secondary listings for the JSE and for institutional equity portfolios implies that any changes to existing classifications would create substantial transitional challenges.

To put this issue into context, Table 8 shows the aggregate exposure of institutional investors to three main categories of foreign assets: (i) assets deemed foreign under the current foreign asset limit; (ii) assets that qualify for the additional 5 percent allowance for African securities; and (iii) holdings of secondary-listed equities that are recorded as domestic assets under for the current foreign asset limit. Holdings of secondary-listed equities with a domestic classification amount to 6.1 percent of the total (retail) assets under management by institutional investors and represent just over one-third of this broad measure of foreign asset holdings.

Table 8: Broad measure of foreign assets, end December 2009, percent of retail assets

	Exchange control foreign assets[1]	African assets[2]	Secondary-listed equities on JSE[3]	Total foreign
Retirement Funds	12.1%	0.2%	6.0%	18.3%
Excluding GEPF[4]	*14.3%*	*0.4%*	*9.1%*	*23.7%*
Non-linked Insurance	9.2%	0.1%	4.8%	14.1%
Investment Managers	8.5%	1.0%	7.6%	17.1%
CIS Companies	10.5%	0.3%	6.1%	16.8%
Linked Insurance	16.8%	0.0%	6.4%	23.2%
Total	**11.3%**	**0.3%**	**6.1%**	**17.7%**

Source: Calculated from Financial Surveillance Asset Allocation Reports for December 2009
Notes: 1. Assets deemed foreign under current foreign asset limit
2. Assets eligible for the additional 5 percent African limit
3. Secondary-listed equities on the JSE deemed domestic under the current foreign asset limit
4. Retirement fund assets excluding the Government Employees Pension Fund

8.2 Challenges for micro-prudential regulation

The current inconsistency in the classification of inward listings and secondary listings on the JSE undermines the micro-prudential regulation of foreign exposure in several ways:

First, institutional investors are able, in principle, to maintain levels of exposure to foreign companies substantially higher than the existing foreign asset limit because holdings of the secondary listings on the JSE are not subject to the limit. This undermines the effectiveness of the prudential regulation of foreign exposures of

individual institutions. The fact that shares are traded locally in rand does not shield the investor from the underlying country and currency risks associated with international firms.

Second, non-resident firms listed on the JSE can be classified as either foreign assets if they are inward listings or domestic assets if they are secondary listings acquired via the JSE, as noted above. The distinction is linked to the date of listing - before or after 2004 – but this is an irrelevant factor in determining the extent of foreign versus domestic risk exposures of these assets.

Third, exposure to the secondary-listed companies can be classified as either domestic or foreign depending on where the assets are acquired. The secondary listings are domestic assets if acquired in rand via the JSE but the same companies are foreign assets if acquired via foreign currency investment in the offshore primary market. For example, if a pension fund buys shares in BHP Billiton plc on the JSE then this would count as domestic exposure. If instead, the pension fund buys BHP Billiton plc shares on the London Stock Exchange then this would count towards the foreign asset allowance. This means that holdings of essentially identical assets can be either foreign or domestic under current regulations, which is inconsistent with a prudential approach based on risk exposure.

Finally, the arbitrary distinctions between non-resident companies based on place and time of listing may also foster inefficiencies in South African institutional portfolios. Historically, secondary-listed firms benefitted South African institutional investors as 'rand hedge' stocks that enabled institutions to achieve a degree of international diversification when foreign asset holdings were more restricted. However, the introduction of a prudential foreign asset limit has meant that this 'rand hedge' role is increasingly obsolete as institutions have gained access to a wider universe of international investment opportunities. The inconsistent application of limits on holdings of non-resident companies in the current system creates incentives for institutions to continue to fragment their foreign portfolios into 'rand hedge' assets and offshore assets, which risks undermining the efficient management of overall foreign exposure.

The international profile of the largest of these non-resident firms implies that a simple domestic classification of foreign listings on the JSE would conflict with a micro-prudential approach to regulating the foreign risk exposures of individual institutions. Even in the case of the London Four companies, the geographic location of operations - as well as the shareholder base - has generally become more international over time, via new international investment, mergers and acquisition. South African institutional investors have therefore had increased exposure to international risks and returns through their holdings of these companies. Nevertheless, it is also important to acknowledge that a number of these non-resident firms maintain substantial investments in South Africa, representing significant domestic exposures for their shareholders: Anglo American and Old Mutual are key examples here. For this reason, a simple foreign classification of non-resident companies based purely on the location of headquarters (or country of registration) and primary stock exchange listing would also have important disadvantages from a micro-prudential perspective.

8.3 Challenges for macro-prudential regulation

There are also important macroeconomic considerations to take into account when considering the classification of foreign listings on the JSE.

Capital flows can arise from foreign listings on the JSE as a result of the linkages between the primary and secondary stock exchanges and the interaction between non-resident and resident investors in these shares. In the case of the London Four, exchange rate adjusted share prices on the London Stock Exchange and the JSE broadly correspond over time indicating the presence of efficient linkages between the two markets: rand-denominated shares on the JSE are essentially equivalent to their

foreign currency counterparts on the primary stock exchange. Non-residents can freely move their holdings between the London and South African share registers as they are not subject to exchange control. This means that, in principle, they are able to buy shares in London, sell locally in rand to South African institutions, and then remit the proceeds offshore in foreign currency. The outcome from a macroeconomic perspective would be an outflow of capital from South Africa in the same way as if South African institutions directly acquired the same shares in the London share market.

The presence of large multinational companies on the JSE may also offer potential macroeconomic benefits for South Africa but, here, there are also questions about the extent to which net benefits materialise in practice:

Local listings can encourage inward FDI through providing a domestic source of financing for foreign firms; indeed, this was one of the main objectives of the inward listing policy introduced in 2004. But this link is not automatic and there are considerable differences between the extent of operations in South Africa across the foreign firms currently listed on the JSE. There is an obvious contrast in terms of FDI between local listings of purely international investments and foreign firms with large established operations in South Africa.

The strategy of attracting foreign listings to the JSE is further based on the notion that this will contribute to capital market development. Indeed, the existing secondary listings are seen as an important component of the overall liquidity of the JSE, which contributes to the attractiveness of the Exchange for both investors and issuers. Here, however, the impact of foreign listings on the supply of finance to domestic firms must also be considered. To the extent that large multinational firms attract a substantial fraction of institutional investment on the JSE, medium-sized and smaller domestic firms face greater competition in attracting equity financing. More generally, evidence from emerging economies suggests that the internationalisation of stock exchange listings by large firms can have a negative effect on the trading of firms that remain listed only in the local market (Levine and Schmukler, 2007 and 2006; Karolyi, 2004). While at an aggregate level there may be gains for local stock market development - characterised by size and liquidity (e.g., Hargis, 2000), there may be differential effects in that firms with an international presence gain at the expense of firms that do not pursue international listings. Any assessment of the net benefits of international listings therefore must take into account the impact on both multinationals and (smaller) domestic-listed firms.

Finally, it is possible that the presence of large non-resident firms in the benchmark FTSE/JSE indices could have positive spillovers for smaller domestic firms through the role of the indices in attracting foreign portfolio investment. However, evidence of this effect is weak at best, as foreign investors appear to come to the JSE mainly to invest in South African resident firms. As at September 2009, non-residents in aggregate held only 4 percent of their (STRATE-based) portfolio in the major secondary-listed shares compared to a notional index weight of around 20 percent in the SWIX Top 40. In other words, non-resident investors in the South African market substantially underweight these firms relative to the FTSE/JSE benchmark. International investors clearly prefer to hold the major secondary-listed companies on the international share register; indeed, in the case of the London Four, a large fraction of the international shareholding is likely to be driven by the inclusion of these companies in the FTSE 100 (UK) index.

8.4 Options for reform

From both micro and macro-prudential perspectives, the classification of non-resident firms on the JSE deserves careful attention in order to resolve the uncertainty over the long-term classification of these assets and the application of prudential limits. The urgent need for a more consistent and transparent framework for classification has been demonstrated by the unbundling of Mondi from Anglo American (2007) and BAT from Remgro and Richemont (2008): these two cases have highlighted the

importance of a framework that provides an unambiguous treatment of new foreign listings that emerge from corporate restructurings. Prospects for future cross-border acquisitions of listed South African companies provide a further motivation for a more robust classification system.

The challenges associated with classification have been explored in various internal papers for the National Treasury. Two options for reform to emerge from this process are outlined below.

8.4.1 Basis of classification: domicile versus listing

The starting point in developing a classification system is to recognise that it is not remotely feasible from an administrative perspective to quantify the precise risk exposures of foreign and South African listed companies based on the geographic location of assets or revenue and associated hedging of exposures. For this reason, a more workable definition of 'foreign' is required.

Under the inward listing policy, classification has been based on domicile but with consideration given to the main location of operations. This provides the most practical basis for foreign classification in the longer term. Domicile is, from a risk-based perspective, the most attractive starting point for classification. Although many South African companies have international exposures, foreign multinationals tend to be more geographically diverse and to have a far smaller component of South African activity; there are some important exceptions, however, as noted below. Moreover, international revenue and cost streams may well be hedged into the reporting currency required in the home country in order to stabilise earnings over time.

An alternative approach to classification based solely on the place of listing – with domestic classification of all non-resident listings on the JSE – would not be consistent with the shift to risk-based prudential regulation of foreign exposure, as it is essentially equivalent to returning to the exchange control approach based on foreign currency transactions. While classification based on listing would benefit the JSE and the foreign companies that choose to list in South Africa, these benefits must be placed against the potential social costs of this approach in terms of undermining the objectives of micro and macro-prudential regulation.

The use of domicile would mean that all South African resident companies would continue to be classified as domestic assets for institutional investors, regardless of the geographical spread of their investments. Under both options discussed below, non-resident companies would be classified as foreign on the basis of domicile but with an exemption for non-resident companies that have substantial operations in South Africa or the rest of Africa. This would require the long-term monitoring of the foreign and domestic exposures of non-resident companies with listings on the JSE, although the administrative burden for supervisors and institutions could be minimised through requiring only an annual assessment of financial reports, with exposures measured over a multi-year period to allow for smoothing.

Under both options, it is further proposed that the existing additional allowance for African securities be removed as this limit is not a meaningful constraint on the decisions of institutional investors. Assets that qualify for the African allowance amounted to just 0.3 percent of total assets of institutional investors at December 2009, compared to the allowance of 5 percent of total assets (see Table 8). This reflects limited investment opportunities as the market capitalisation of African listings on the JSE to date is rather small and reportedly lacks liquidity; there are also prudential barriers to offshore investment on African exchanges. Removing the limit for companies that meet the African criteria would thus remove an ineffective constraint and in the longer term should contribute to the strategy for promoting South Africa as a financial centre for African investment.

8.4.2 Option 1: Foreign classification with 'partial' grandfathering

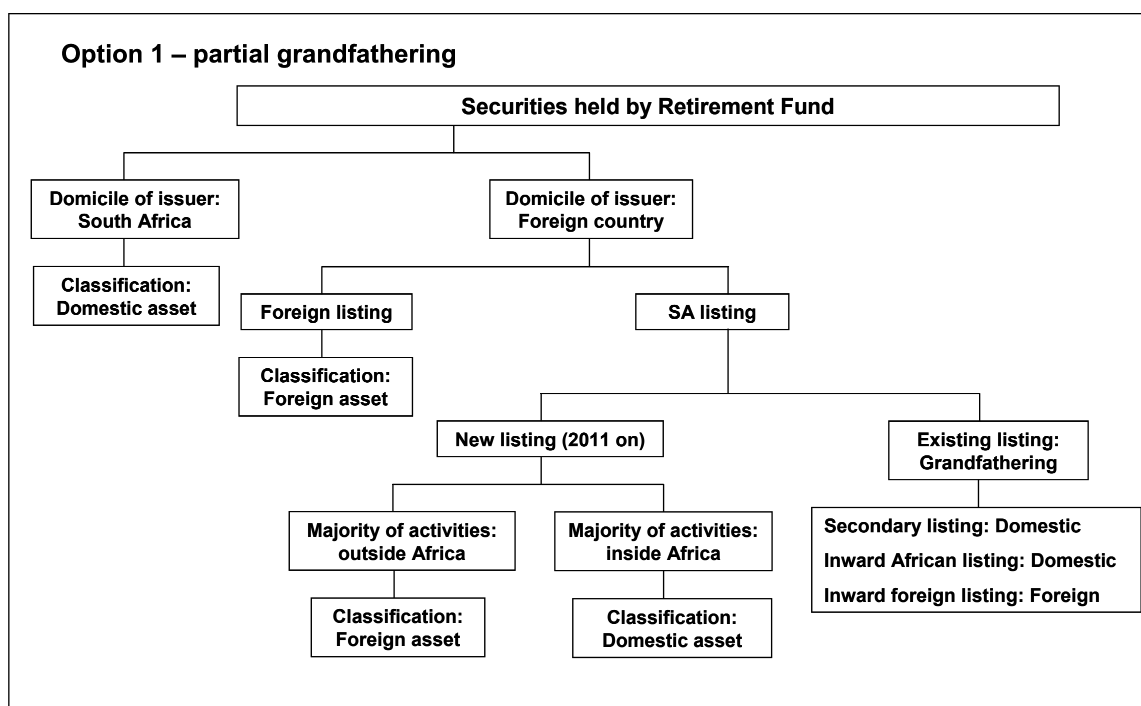
The first option is to apply a new framework for classification to all future non-resident listings on the JSE but to maintain the current classification for existing inward and secondary listings (i.e., either foreign, African or domestic). The main features of the classification system under this option are:

- New non-resident listings would be classified as either 'foreign' or 'African', in line with current practice. African entities would continue to be defined as domiciled in Africa or the majority of activities located in Africa.
- All non-resident listings classified as 'foreign' would be subject to prudential foreign asset limits for institutional investors.
- All non-resident listings classified as 'domestic' (i.e., the existing secondary listings) or 'African' would be exempt from prudential foreign asset limits.
- The classification of any future South African DLC structures would follow current practice: a domestic classification would be appropriate for Groups that maintain a South African domicile and identity.

The 'partial' grandfathering of domestic classification of the secondary-listed companies would apply only to these companies in their current form. Any new non-resident listing that emerges from a future restructuring of the company – for example, through unbundling of international assets or through merger/acquisition with another foreign firm – would be subject to the new framework for classification. Thus, under this approach, BAT shares would continue to be classified as foreign assets even though the shareholding was unbundled from a non-resident company with a domestic classification (Richemont) and a domestic company (Remgro).

The principal benefit of the partial grandfathering approach is that it establishes a transparent framework for foreign classification in the longer term, building on the 2003 reforms, while avoiding the significant transitional costs for the private sector that would arise from any reclassification of existing secondary listings (discussed under option 2).

These benefits must be weighed against the costs of maintaining an anomalous treatment of a small group of large non-resident firms with varying degrees of



exposure to South Africa. Grandfathering implies that the inconsistent treatment based on place and date of listing of these firms would remain, with the implication that the prudential foreign asset limit is incomplete in its coverage of exposure to international investments. As discussed above, this works to undermine the overall integrity of micro and macro-prudential regulation.

8.4.3 Option 2: Foreign classification with exempt status

The second option is to apply the new framework for classification to all non-resident listings on the JSE (new and existing) but to apply a more generous threshold for exempt status. A more generous threshold would incorporate large multinational companies that have maintained a substantial centre of operations in South Africa or the rest of Africa but who would not necessarily satisfy the condition under the existing inward listing policy of the majority of economic activities in Africa.

The main features of the classification system under this option are:

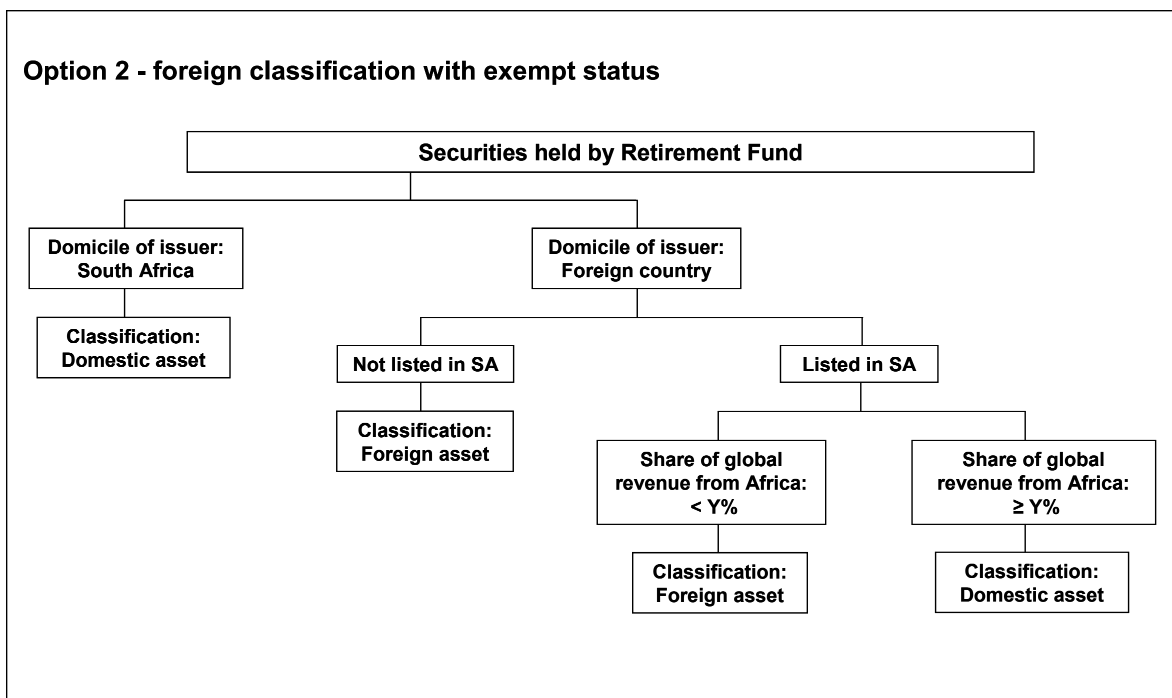
- All non-resident listings (new and existing) would be classified as either 'foreign' or 'exempt'. Exempt status would be defined by a threshold for the share of revenue or assets located in South Africa or the rest of Africa. This threshold would be set at a percentage to reflect a substantial centre of operations in Africa but would be less than 50 percent.
- All non-resident listings classified as 'foreign' would be subject to prudential foreign asset limits for institutional investors.
- All non-resident listings classified as 'exempt' would be treated as domestic assets, i.e., exempt from the prudential foreign asset limits.
- The classification of any future South African DLC structures would follow current practice: domestic classification would be appropriate for Groups that maintain a South African domicile and identity.

This system provides a clear conceptual basis for classification and supports the objectives of micro and macro-prudential regulation by aligning the classification of non-resident listings more closely with the underlying foreign and domestic risk exposures. In particular, exempt status would recognise the hybrid nature of some non-resident listings and would support local listings by foreign firms that remain committed over time to substantial investment in South Africa.

This approach would create significant transitional challenges as it is envisaged that some of the existing secondary listings would be re-classified from domestic to foreign assets, linked to level of the exemption threshold. Some non-resident companies would be unlikely to satisfy any exemption criteria based on the geographic location of revenue and assets.

The reclassification of some of the existing secondary listings would require several related reforms in order to smooth the transition to a consistent classification system under risk-based prudential regulation. These reforms would not be necessary under the partial grandfathering approach outlined in option 1.

First, reclassification would need to be accompanied by a recalibration of the foreign asset limit in order to accommodate existing holdings of the affected equities, i.e., the foreign asset limit would be increased to reflect the true foreign exposures of institutional investors. Recalibration would be crucial to avoid large-scale portfolio adjustments for institutional investors and South African capital markets more generally. From Table 8, the secondary listings in aggregate account for 6 percent of the total assets of institutional investors, although this does not reflect any exemptions. Recalibration of the limit would also need to take into account the distribution of exposures across individual institutions to ensure that sufficient flexibility is provided under the new foreign asset limit.



Second, the implications of reclassification for the composition of the FTSE/JSE indices would need to be considered. The current index rules indicate that inward foreign listings are not eligible for inclusion in the indices. In contrast, the secondary listings are currently eligible for inclusion and together represent a substantial component of the main FTSE/JSE benchmark. While the appropriate response to any re-classification would ultimately depend on the objectives of the private index providers and their principal clients, Government could support the process of reform of the indices by removing the Exchange Control rule that prevents the inclusion of foreign inward listings in the JSE indices. One possible approach could then be the development of revised benchmark indices for the JSE, reflecting the total market, including foreign securities, and the purely domestic market. A similar approach to the reform of indices to reflect the listing of foreign firms has recently taken place in Australia (S&P/ASX, 2007 and 2006).

Finally, changes in the classification of assets may also require revisions to the structure of mandates governing institutional investment to align the distinction between foreign and domestic portfolios with the revised classification of foreign assets under prudential regulation. Consultation with the asset management industry will be important to understand the nature of the constraints implied by the structure of mandates and the prospects for harmonising the development of new market benchmarks with reforms to mandates to support the role of the JSE as a channel for foreign investment.

9. Conclusion

This paper seeks to contribute to the debate on finalising prudential foreign asset limits in South Africa. This debate is taking place in the aftermath of a global financial crisis that has underscored the importance of strengthening the prudential regulation of financial institutions. The crisis has also demonstrated the vulnerability of emerging economies to the contagion of international shocks and the challenges for maintaining macroeconomic and systemic stability.

The paper highlights a key change in the underlying objective of the regulation of foreign investment by South African institutional investors. Exchange controls were

primarily intended to limit and sequence capital outflows, while the prudential regulation of foreign exposure focuses on the soundness of financial institutions (micro-prudential) and, more broadly, on financial and macroeconomic stability (macro-prudential).

We take as our starting point that a prudential foreign asset limit will apply to retirement funds and the non-linked business of long-term insurance companies in line with the broader approach of prudential portfolio regulation for these institutions. Regulation of foreign investment by retirement funds and insurance companies is common international practice, although there has been some decline over time in the use of quantitative limits in prudential regulation. The paper identifies areas for further reform in order to support greater harmonisation of the macro-prudential surveillance of foreign exposure administered by the Reserve Bank and the broader framework for micro-prudential regulation of institutional investors administered by the Financial Services Board.

For investment managers, CIS companies and the investment-linked business of long-term insurance companies, a macro-prudential foreign asset limit would form part of the policy framework for managing the macroeconomic risks associated with the volatility of capital flows, complementing the role of a prudential foreign asset limit for retirement funds and non-linked insurance.

Finally, the paper highlights the need for a robust classification of foreign assets. In particular, the classification of foreign companies listed on the JSE needs to be considered carefully, from both macro and micro-prudential perspectives. This is an important issue for South Africa because it has long-term implications for the effectiveness of prudential regulation of foreign risk and for the supply of equity finance and the development of the JSE as a financial centre for African investment.

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