Risk, reward, and the realities of doing business right

Insights from the Deloitte Risk Conference

Dr. Martyn Davies
Managing Director
Emerging Markets & Africa
Deloitte South Africa

Hannah Edinger
Associate Director
Africa Services Group
Deloitte South Africa

Akiva Ehrlich
Director
Risk Advisory
Deloitte South Africa

The Deloitte Risk Conference 2017, held in October last year in South Africa, brought together global thought leaders in the field of risk management under the theme of "Creating and sustaining value." With speakers including Nhlanhla Nene, Trevor Manuel, and Justice Malala, the conference was a must-attend event for South Africa's corporate elite. Making an unwelcome appearance at the conference was the ever-present shadow of the accounting profession's so-called "black swan," highlighting that irrespective of how thorough risk management is, black swan events can still be overlooked.

Help us choose our Top 10 Topics for 2018
www.deloitte.com/lu/InsideRisk2018j

To ensure good corporate governance, the focus needs to be on the financial management decisions of a company.

On that note, the conference kicked off by discussing how business in South Africa is now perceived as being exploitative, self-interested, and a vehicle for corruption. This follows a series of scandals that have hit the country in recent years. The majority of businesses know that this is not a true representation; however, these perceptions tarnish the image of the majority of good corporate citizens. To have a credible voice on important issues, businesses must be willing to “clean house.”

The auditing profession specifically has been affected. This is shown in the recently released World Economic Forum’s Global Competitiveness Report. South Africa’s rating for “Strength of auditing and reporting standards” slipped from the first to the thirtieth position out of the 137 economies included in the index worldwide.

South Africa’s institutional strength has also been eroded. As reported in the Global Competitiveness Report, the strength of South Africa’s institutions dropped from position 40 to position 76 in the last year. Although this is likely to be an overreaction based on recent events, it requires a concerted response from both government and business to restore trust in the country’s institutions.

Keynote speaker and Old Mutual Chairman Trevor Manuel explained that good corporate governance should be a firm’s first safeguard against both internal and external risks.

To ensure good corporate governance, the focus needs to be on the financial management decisions of a company. The failure of a system to address risk is

As reported in the Global Competitiveness Report, the strength of South Africa's institutions dropped from position

40

to position

76

in the last year.

the result of internal processes. In order to survive and mitigate risk, both companies and countries need to focus on the long-term view and internalize risk management to be effective.

According to Manuel, South Africa's current environment and unpredictability have resulted in uncertain long-term consequences and made it very difficult for companies to make decisions.

Ian Stewart, Chief Economist at Deloitte UK, gave a wider, global view on risk and volatility, explaining how the global economy had entered the "new normal," with slower growth and greater volatility after the global financial crisis.

Global growth is approximately only

75%

of its pre-crisis level.

Global growth is approximately only 75 percent of its pre-crisis level. Slower growth leads to heightened volatility, and risks become more difficult to manage and mitigate. Corporates are exhibiting behavior that is more cautious and risk averse as perceptions of risk increase; risk appetite declines; investments, mergers, and acquisitions fall; and corporate cash balances increase.

Stewart shared the global economy's current top five risks, which are Brexit, imbalances in the Chinese economy, rising US protectionism, North Korea, and—possibly the most important—monetary tightening.

The effect of global politics was also discussed at the conference. Whether it is the inauguration of Donald Trump as President of the United States, Brexit in Europe, preparations underway for China's new leadership, or allegations of state capture and corruption in South Africa, uncertainty about trade and investment policy is rising for both international and South African businesses.

According to the speakers, for South African businesses, the biggest risk from the ongoing local political turmoil is a prolonged low growth environment, with growth expected to reach a mere 0.6 percent in 2017 and recover to just over 1 percent in the medium term. This lackluster growth will continue to place pressure on industries such as retail and financial services.

However, the situation is unlikely to worsen to the extent seen in, for example, its emerging market peer Brazil, where analysts expect the economy to continue shrinking, after contracting by 4 percent annually for the past two years. Political uncertainty is predicted to start waning past the ANC's December elective conference and this could mark the end of a downward cycle for South Africa, though the economic recovery thereafter will likely be slow.

Another risk to South Africa's political economy is the country's changing demographics. About 40 percent of South Africa's population is under the age of 20, and 75 percent of its people are under the age of 40. As young people seek employment opportunities, net migration within South Africa is toward the major business hubs in Gauteng. With more young people migrating into urban hubs, a greater proportion of the population is becoming interracial, intercultural, and more socially integrated. This is setting the stage for what could be an incredible political shift.

From an investment perspective, many companies have grown tired of South Africa's political risk, and are looking for other opportunities inside and outside of Africa. Accordingly, foreign direct investments to South Africa have fallen and portfolio investments, rather than bricks and mortar, make up the bulk investment flows into the country.

Despite the high level of political uncertainty in South Africa, when compared to the sentiments of investors about Brexit, for instance, and political turmoil in other emerging countries such as Brazil, South African bond issues are still oversubscribed by foreign funds to a surprising extent. This continued confidence from international investors highlights the independence and strength of domestic institutions such as the South African Reserve Bank, and points toward brighter prospects for the economy.

One conference topic with very little positive sentiment to boast of was that of cyber risk. According to the 2017 World Economic Forum's Global Risk Report, cybercrime ranked sixth among the top 10 risk concerns for executives across the world. With the recent surge in major cyber-attacks, organizations that fail to pay significantly more attention to cyber security do so at their own peril. The nature of cybercrime has changed drastically over the past decade with even nation states and multinationals actively perpetrating attacks through various organized cybercrime networks.

Besides the rise in orchestration of cybercrimes by well-resourced organizations, the form of attacks is rapidly expanding with new major business threats presented through Internet-of-Things innovations. As perpetrators such as nation states are better resourced and have better technological capabilities, businesses can barely keep up with cybersecurity innovations and defend themselves against constantly evolving forms of attack.

Looking in more detail at the South African context, the Ponemon Institute's 2017 Cost of Data Breach Study found that South African organizations are the most vulnerable to cyber-attacks compared to organizations in other countries. A major reason for this is poor capacity. Though cyber security skills programs in the country are oversubscribed, there is still a shortage of skills in the sector. As a result, businesses lack the necessary human capital to manage cyber-related risks.

The topic of regulatory compliance also received its time in the limelight at this year's event and, as demonstrated, for good reason. Thomson Reuters tracks about 750 different regulators globally. Between them, these regulators produce a regulatory update every seven minutes. This statistic marks how challenging complying with regulation and legislation has become in the last few years.

In South Africa, regulation is currently incredibly costly and can stifle business growth. According to the World Bank, it takes up to 56 days to register a business in South Africa compared to less than 10 days in Rwanda.

South African bond issues are still oversubscribed by foreign funds to a surprising extent.

As many analysts point to insufficient regulation as the major cause for the 2008 global financial crisis, regulation in the financial sector has become an increasingly serious issue. In South Africa's context, increasing regulation has largely had a negative impact on the financial sector from a financial inclusion perspective. On a global scale, analysts forecast that banks will have paid over US$400 billion in fines between now and 2020 due to failure to comply with a rapidly changing regulatory environment.

Although regulation is burdensome for corporate South Africa, companies must not view compliance as the avoidance of penalties, but rather as an opportunity for proactive risk management. Regulation always has unintended consequences, but from a risk management point of view it is critical to mitigating various economic and business risks.

Though cyber security skills programs in the country are oversubscribed, there is still a shortage of skills in the sector. As a result, businesses lack the necessary human capital to manage related risks.

Possibly the most important economic risk facing decision-makers in South Africa are the implications of the outcome of the ANC national elective conference in December 2017.

Possibly the most important economic risk facing decision-makers in South Africa are the implications of the outcome of the ANC national elective conference in December 2017. According to political analyst Justice Malala, however, the question was whether the elective conference would even take place.

As Malala explained, if the faction supporting President Jacob Zuma thought that there was a possibility that they may lose, they would disrupt the proceedings, delay the appointment of a leadership team, and finally install a compliant team of their own choosing.

There were concerns that KwaZulu-Natal (and possibly the Eastern Cape) would not be able to resolve their leadership disputes in time, and hence be excluded. If they had been excluded, Zuma's faction could have argued that the conference lacked credibility as two of the largest provinces were not represented and therefore the conference could not have gone ahead. Although Cyril Ramaphosa and Dr. Zweli Mkhize's supporters would have pushed for the conference to go ahead, there was approximately only a 60 percent probability of the conference happening.

There were three contenders in the ANC leadership race: Dr. Nkosazana Dlamini-Zuma, Cyril Ramaphosa and Dr. Zweli Mkhize. Ramaphosa, who emerged victorious from the conference, chose to keep quiet through numerous scandals involving President Zuma, allowing the status quo to continue and alienating many that had goodwill and faith in his leadership abilities. In 2017, Ramaphosa finally found his voice and began to speak out against the corruption he previously tacitly supported. In terms of policy, he supports the implementation of the National Development Plan. In the run-up to the conference, Ramaphosa was seen as the most business- and reform-friendly candidate.

Dlamini-Zuma's policy stance was centered on radical economic transformation and the expropriation of land without compensation. This also related to the question of ownership of the South African Reserve Bank. Dlamini-Zuma's policy stance closely mirrored what President Zuma articulated in the State of the Nation Address in February last year. Her greatest drawback was the support shown to her by the ANC Youth League and the Umkhonto we Sizwe Military Veterans Association as this associated her campaign with the Zuma-Gupta faction.

Mkhize had been running a low-level campaign. However, he had delivered more speeches than any other candidate had. Although his campaign had been less forceful than Dlamini-Zuma and Ramaphosa's, it had been very thorough, astute, and professional. His policy stance was very closely aligned with that of Ramaphosa's.

Although Dlamini-Zuma's campaign seemed to be dead in the water in the weeks prior to the conference, there was the risk that her camp would use gatekeeping, corruption, cash bribery, and the forging of memberships to sway the election in her favor. If she had won, the status quo would have continued. Her victory would have increased the risk of the ANC as a party to split and actors such as Ramaphosa, Makhosi Khoza, and Pravin Gordhan to form a new party, resulting in the legal ANC and a new party claiming to be the "true" ANC.

Malala predicts the national election in 2019 will likely be a standoff between establishment and anti-establishment politics. Had Dlamini-Zuma become the leader of the ANC, a coalition government after 2019 would have been very likely and would have resulted in horse-trading between parties. Ramaphosa's victory, however, makes the outcomes of 2019 much more difficult to predict.

Despite the uncertainty currently facing the economy, one consistent message emerged from the Deloitte Risk Conference 2017—companies need to move away from short-termism and aspire to the long-term view. The importance of risk management should now be built into company strategies as lower growth and higher volatility further compound existing risks. Although mitigation of risks is costly, it provides companies with the opportunity to understand both their business and clients better and, hopefully, thrive for years to come.