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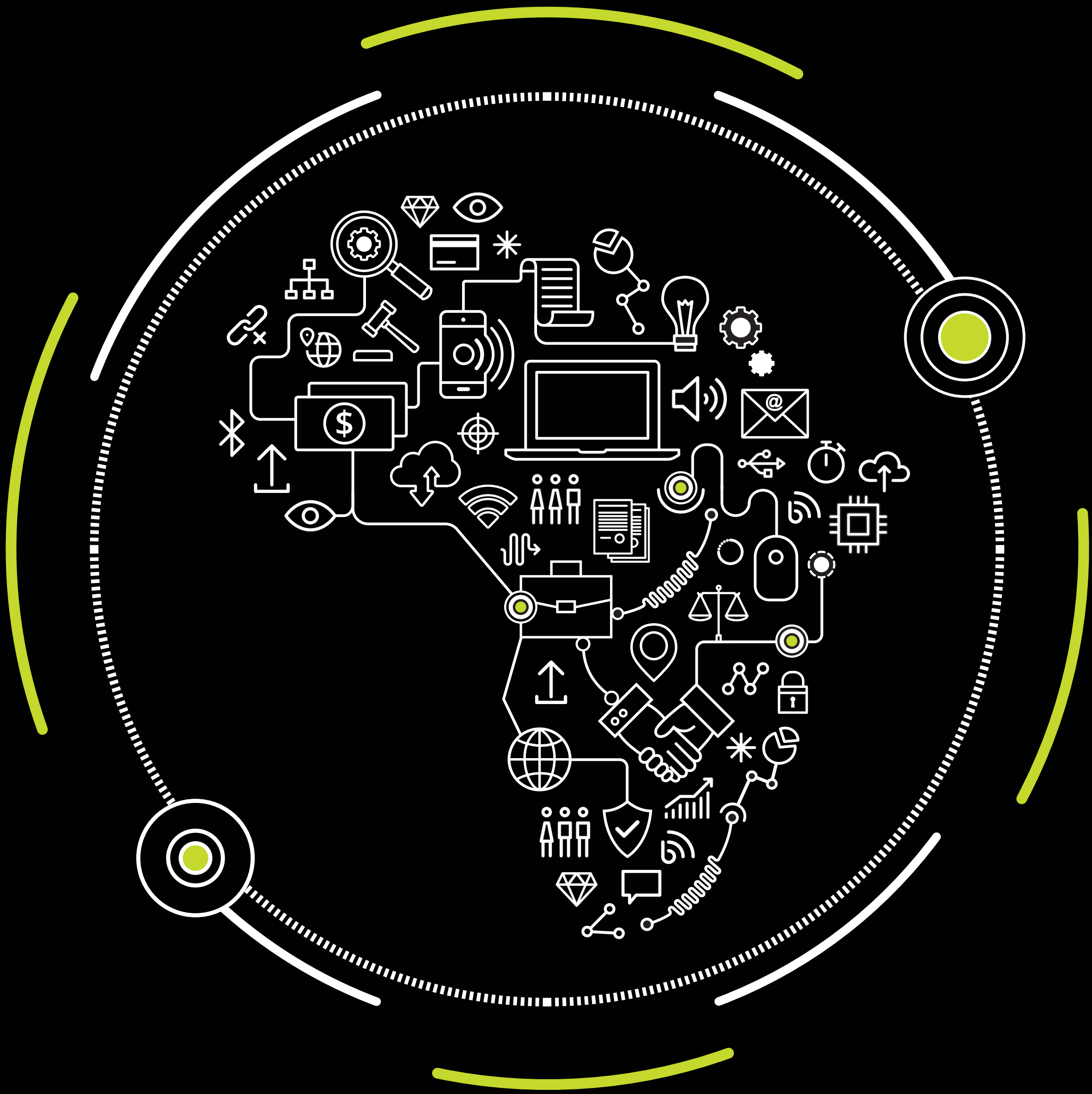

Deloitte Risk Conference 2017

Creating and sustaining value

Summary Report

October 2017

Welcome **and Introduction**

Managing risk is about creating and sustaining value. Value can be created but cannot be sustained if risk is not managed. Irrespective of how thorough risk management is, black swan events are missed. The accounting profession's black swan has arrived.

In South Africa's current context, business is perceived as being exploitative, self-interested and aiding in corruption. The majority of businesses know that this is not a true representation; business is a force for good and contributes positively to society.

These perceptions and alleged unethical behaviour tarnish the image of the majority of good corporate citizens, which should make ethical leaders and businesses uncomfortable. 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 "Strength of auditing and reporting standards" slipped from the first to the thirtieth position out of 137 economies globally. Auditors and their opinions ironically are not audited. The profession is built on integrity and trust. The public's expectations of the profession have changed. The accounting profession can no longer only comply with internal standards. Expectations are higher and therefore the profession's standards need to increase too. To survive, the profession will need to be introspective.

South Africa's institutional strength has also been eroded in the last year. 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 an overreaction based on recent events, it requires a concerted response from both government and business to restore trust in the country's institutions.

Lwazi **Bam**
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Keynote:
How do we manage risk?

Good corporate governance should be a firm's first safeguard against both internal and external risks. Corporate governance is able to mitigate risk successfully if it works the way in which it was intended.

To ensure good corporate governance, the focus needs to be on financial management decisions of a company. The failure of a system to address risks is the result of internal processes. In order to survive and mitigate risks, both countries and companies need to focus on the long-term view.

Companies should make use of a five-point framework to identify and mitigate different types of risks:

1. Risk is a judgement of benefits and consequences. "Short termism" which tries to determine which party will benefit from a decision now, rather than looking for the greater benefit in the long term, results in a reduction of value.

2. The ability of a board to mitigate against risk is dependent on a degree of certainty. Board members need to be encouraged to read externally in order to understand and anticipate exogenous macroeconomic and political risks.

3. Communication is critically important to identifying and mitigating risks. Communication between the Board and other company employees as well as communication between the company and its clients builds trust.

4. The implementation of any strategy is dependent on people and therefore, it can be disrupted by unequal power relations. To be effective, the implementation of risk mitigation strategies needs to be measured against predetermined parameters.

5. Successful implementation is the result of accountability. Stakeholders need to be responsible for the implementation of specific elements of a risk mitigation strategy.

Risk management needs to be internalised to be effective. Within the framework, a number of variables can change depending on time, geography and circumstance. Companies need to develop the norms and standards to react to sudden changes as part of their risk mitigation strategy.

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

A smart approach to risk will be to mesh the framework with current occurrences. Company Boards need to spend less time reading onerous reports and more time really understanding the company and the risks that it faces if they are to govern ethically and correctly.

Trevor **Manuel**
Chairman, Old Mutual

Risk and volatility: **The corporate perspective**

In the last 100 years, the frequency of references to 'risk' and 'volatility' in English-language books has risen sharply. The conclusion we draw is that as societies become richer, they become less tolerant of risk and more willing to pay insurance to hedge themselves against uncertainty.

In the 1990s, it seemed that the world was entering an era of stable growth, low inflation and reduced volatility. The financial crisis destroyed that illusion, highlighting and accentuating vulnerabilities in the global economy. Corporates have responded with an increased focus on mitigating external risk.

The Global Financial Crisis ushered in a "new normal" of slower growth and greater volatility. Economics has become more important for businesses as an unpredictable environment and external risks create new challenges for corporates. Macroeconomic, financial and political risk are now business risks. The crisis gave new impetus to corporate risk management. Google searches for the term "Chief Risk Officer" almost tripled between 2007 and 2017.

Global growth is running at around three-quarters of the rates seen before the crisis. Slower growth has been accompanied by bursts of volatility, making risk more difficult to manage and mitigate. Corporates have become more cautious and risk averse. Deloitte's own work with CFOs shows that as perceptions of risk increase, risk appetite declines, investments, mergers, and acquisitions fall and corporate cash balances increase.

A year ago, there was a high focus on risk and uncertainty in news flow. Yet over the last year the mood has changed. References in the press to economic and financial uncertainty have fallen sharply in the US, China and Europe. Almost all indices of financial risk have declined in recent months. The Chicago Board Options Exchange *Volatility Index* (VIX), sometimes referred to as the "fear gauge", is close to a 25-year low. Financial markets seem to be counting on exceptionally low uncertainty and good prospects. To some extent, this is consistent with the global recovery that is unfolding, but it also prompts concerns that financial markets are becoming excessively optimistic.

The economic effect of external shocks, such as natural disasters or terrorist attacks, on rich economies is often muted. This is as such events only rarely change macroeconomic fundamentals; to the extent these shocks have economic effects they tend to displace activity in time, not permanently destroy it. Policymakers can use fiscal and monetary policy to "lean against" the effects of external shocks. Paradoxically, capital destruction in the case of natural disasters often leads to stimulus as economies rebuild.

There are important exceptions, ones where external shocks have a significant effect on economies. Deep financial crises cause deep recessions. Systemic mismanagement by governments, as in Venezuela, has dire economic effects. And what is called 'traumatic resets', such as the Arab-Israeli War in 1973 which sent the oil price soaring, change vital economic relationships which damage the economy.

The decline of institutions and systems is a powerful sign of systemic failure. International rankings, such as such as the WEF *Global Competitiveness Report*, World Bank *Ease of Doing Business Report* and the Heritage Foundation *Index of Economic Freedom*, provide a way of thinking about the strength of institutions. Small countries tend to do well in such rankings, and tend to be more resilient to shocks.

The greatest uncertainties facing the global economy today are posed by imbalances in the Chinese economy, the prospect of a more protectionist US, events in North Korea, Brexit and the unpredictable effects of monetary tightening. The last point reflects a potentially risky set of events: increasingly stretched asset values, rampant risk appetite and the unwinding of US quantitative easing.

In conclusion, news flow and sentiment change rapidly and feed through to business optimism. Yet the corporate horizon, with its premium on strategic thinking, is far longer than the news flow horizon. Businesses need to mitigate, manage and identify emerging risks. But they need, too, not to overreact to every movement in markets and news. Sometimes the right response is to ride out negative sentiment. Many risks are transient and many fail to materialise. Businesses need to resist short-term pressures and aspire to the long view.

Ian **Stewart**
Chief Economist, Deloitte UK

The global political economy: **What are the implications for business?**

In its 2017 *Global Risk Report* the World Economic Forum notes that years of building pressure fuelled by the 2008 Global Financial Crisis crystallised into dramatic political results, especially witnessed during the course of 2016. This resulted in a more challenging business environment globally.

Whether it is the inauguration of Trump's administration in the US, 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.

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% in 2017 and recover to just over 1% in the medium term. This falls short of increasing economic activity for industries such as retail or financial services.

However, the situation is unlikely to worsen to the extent of, for example, an emerging market peer such as Brazil where analysts expect the economy to continue shrinking, after contracting by 4% annually for the past two years. Political uncertainty is anticipated 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% of South Africa's population is under the age of 20, and 75% is under the age of 40. As youths seek employment opportunities, net migration within South Africa is towards the major business hubs in Gauteng. With more youths 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.

The youth that are soon going to be of voting age and making future political decisions are likely to be less loyal in terms of race, tribalism, culture and religion, and are likely to make decisions in a completely different way from what South Africa's current generation is used to.

From an investment perspective, many companies have grown tired of South Africa's political risk, and are looking offshore and into other countries on the continent. Accordingly, FDI to South Africa has fallen and mainly portfolio rather than bricks and mortar investments make up investment flows to the country. This comes with various risks.

For example, as the Trump administration looks to decrease corporate taxes American multinational firms could consider repatriating their dividends due to South Africa's rising political risk profile and worsening credit rating. More so, due to South Africa's overreliance on portfolio flows, sudden capital outflows because of better opportunities outside the country's borders could result in serious negative implications on its national accounts, specifically the current account balance.

Despite the 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 issuances, surprisingly so, are still oversubscribed by foreign funds. This continued confidence from international investors highlights the independence and strength of domestic institutions such as the South African Reserve Bank and points towards brighter prospects for the economy.

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Securing your business against cyber risk: **How big is the threat?**

According to the 2017 World Economic Forum *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, organisations 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 among various organised cybercrime networks.

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

One of the most effective ways businesses can minimise cyber security risks is to cultivate a culture of vigilance about operating digitally. Supporting this approach, a cyber-attack simulation conducted by the Bank of England found that financial services firms that were most vigilant about their cyber security prevented cyber-attacks much better than firms that were confident their digital networks were secure.

In addition, firms can also more effectively mitigate cyber security risks by collaborating against cybercrime through community-based threat intelligence.

Looking in more detail at the South African context, the Ponemon Institute's *2017 Cost of Data Breach Study* found South African organisations as being the most vulnerable to cyber-attacks compared to organisations in other countries. A major reason for this is poor capacity. Though cyber security skills programmes 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.

Another element contributing to the higher vulnerability of organisations in South Africa is poor enforcement of digital governance and compliance policies. Organisations over-invest in cyber security technology rather than people and processes.

Beyond technological vulnerability, social engineering, which entails attacks such as phishing, is somewhat overlooked and organisations need to drive awareness about this at every level of personnel to ensure their people are not key points of cyber vulnerability campaigns in addition to technological security measures.

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Understanding the cost of **regulatory compliance**

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. For compliance officers, the main question is how to keep up with a rapidly changing and increasingly demanding global regulatory environment.

In South Africa, regulation is currently incredibly costly and can stifle business growth. For instance, 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.

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 since. In South Africa's context, increasing regulation has largely had a negative impact on the financial sector from a financial inclusion perspective. As policy makers seek to enhance financial inclusion, demanding financial regulations such as KYC, this has simply made it too costly for formal financial services firms to cater for the underserved population.

On a global scale, analysts forecast that banks would have paid over US$400bn in fines between now and 2020 due to failure to comply with a rapidly changing regulatory environment.

Arguably, in South Africa attention has shifted away from business growth in order to regulate. As much as regulation is important in ensuring a stable business environment, over regulation – as clearly evidenced in South Africa – is costing countries globally in terms of business and consequently employment growth.

South Africa's mining sector is another example of how regulation can stifle businesses. The country has lost out to the rest of the world in a sector in which it was a global leader for many decades. Due to over-burdensome regulation, many mining firms have downsized and some have even left the country to invest in countries providing a less costly operating environment.

Nonetheless, some of the regulation in the mining sector, especially health and safety regulations are a necessity. Sectoral regulation is imperative but as seen in the best practice approach of health and safety regulations in the mining sector, regulation across different economic sectors needs to be risk based such that the more risky operations in a given industry are, the more regulated that specific industry should be.

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 is critical to mitigating various economic and business risks.

A balance must be struck between regulation, and industrialisation and development policy objectives to avoid red tape from preventing business growth. A starting point for regulators is to focus on developing well thought out growth-based and market-related regulations.

A case in point is South Africa's labour law. Labour regulations in South Africa are based on a developed country model while the country is still a developing country and as a result, this has hindered employment growth significantly.

Comparing development and regulatory models across the world, the approach likely to benefit South Africa the most is the one adopted by some of Asia's most thriving economies. It is not that economies in the East do not have stringent regulations but rather they have well thought out regulatory systems in conjunction with strong human capital development. This has in turn enabled them to take advantage of emerging technological developments to an extent that their business environments now surpass many western economies.

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Nic **Swingler**
Head of Financial Crime, Barclays Africa

Anthony **Smith**
Director: Deloitte Risk Advisory Africa

An insight and an idea: **Who is SA's next president?**

The winner of the ANC's national elective conference in December will likely become the country's president in 2019. Currently, the greatest question in the South African political space is "Will there be an ANC elective conference in December?" If the faction supporting President Jacob Zuma thinks that there is a possibility that they may lose, they will disrupt the proceedings, delay the appointment of a leadership team and finally install a compliant team of their own choosing. This tactic has been used successfully in recent weeks in the Free State and Eastern Cape and it nearly succeeded in the Northern Cape too.

KwaZulu-Natal (and possibly the Eastern Cape) may not resolve their leadership disputes in time for the ANC conference in December and so may be excluded. Should KwaZulu-Natal and the Eastern Cape be excluded, Zuma's faction will argue that the conference lacks credibility as two of the largest provinces are not represented and therefore the conference cannot go ahead. Although Cyril Ramaphosa and Dr Zweli Mkhize's supporters will push for the conference to go ahead there is approximately only a 60% probability of the conference happening.

There are currently three contenders in the ANC leadership race: Dr Nkosazana Dlamini-Zuma, Cyril Ramaphosa and Dr Zweli Mkhize. Ramaphosa 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.

Dlamini-Zuma's policy stance is centred on Radical Economic Transformation and the expropriation of land without compensation. This also translates to ownership of the South African Reserve Bank. Dlamini-Zuma's policy stance closely mirrors what President Zuma articulated in the State of the Nation Address in February. Her greatest drawback is the support shown to her by the ANC Youth League and the Umkhonto we Sizwe Military Veterans Association as this associates her campaign with the Zuma-Gupta faction.

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

The next leader of the ANC will be determined by whom the branches send as delegates to the conference. The assumption is that KwaZulu-Natal, as the largest province according to the number of delegates, will elect the leader. The province's leadership is no longer partisan and support is split between candidates. Massive corruption regarding branch delegates has been uncovered in the province, with 4, 000 fake delegates registered.

Although Dlamini-Zuma's campaign currently seems to be dead in the water, she may still win due to gatekeeping, corruption, cash bribery and the forging of memberships. If she wins, the status quo will continue. The ANC as a party may split and actors such as Ramaphosa, Makhosi Khoza and Pravin Gordhan may form a new party, resulting in the legal ANC and a new party claiming to be the "true" ANC.

The national election in 2019 will likely be a standoff between establishment and anti-establishment politics. Should Dlamini-Zuma become the leader of the ANC, a coalition government after 2019 is very likely and will result in horse-trading between parties. If Ramaphosa or Mkhize win the ANC's leadership conference, the outcomes of 2019 are much more difficult to predict.

Justice **Malala**
SA political commentator, presenter and author

Summary **and close**

Companies need to aspire to the long-term view. The importance of risk management is now being built into company strategies as lower growth and higher volatility further compound existing risks.

Financial volatility is at a 25-year low and this creates numerous opportunities and greenshoots for businesses in South Africa. To take advantage of this, companies need to build independent oversight with assurance of risk and an understanding of risk mitigation. Companies must be able to both manage risk and extract the benefits represented by it. Corporate culture needs to be driven by good governance if it is to restore trust in the current environment.

In terms of cyber risk, it is no exaggeration to state that corporate South Africa is at war. We do not know who the enemy is nor where they will strike, but we know the consequences will be dire. Guardrails need to be embedded into the DNA of businesses to prevent cyber-attacks. This requires real-time monitoring of threats and the ability to respond swiftly to mitigate risks. A cyber threat provides companies with the platform to create a better risk management structure and the opportunity to reap the regulation benefit.

Although mitigation of risks is costly, it provides companies with the opportunity to understand both their business and clients better.

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