

ASISA

# The Reality of Prescribed Pension Fund Assets – and other Interventions

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*Cril Lane*

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# THE SOUTH AFRICAN BOND MARKET

REPORT BY THE COMMITTEE APPOINTED TO EXAMINE  
THE MARKET FOR PUBLIC SECTOR SECURITIES

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On 13 January 1987, the Minister of Finance appointed a committee consisting of the following persons:

Dr A.S. Jacobs (Chairman)	: South African Reserve Bank
Mr P.J. Badenhorst	: Office of Financial Institutions
Mr N.Z. Badenhorst	: Department of Finance
Mr G.P. Croeser	: Department of Finance
Mr S. Davis (until 31 December 1987)	: Public Investment Commissioners
Dr B.W. Goedhays (from 30 April 1987)	: South African Reserve Bank
Mr C.J. Hyman (from 1 October 1987)	: Office of Financial Institutions
Dr A.D. Kock	: South African Reserve Bank
Mr J.A. Louboer (until 30 September 1987)	: Office of Financial Institutions
Mr H.F. Lamont (Secretary)	: South African Reserve Bank

and instructed them to examine the market for public sector securities and recommend improvements in its structure and functioning.

Signed:  (Chairman)

Pretoria, *17 May*, 1988.

1. Prescribed Assets
2. Prudential Regulations
3. Priority Sector Lending/Directed Credit
4. Local Asset Status

# The prescribed assets question

*Transform and Diversify the Financial Sector (ANC's election manifesto)*

“Investigate the introduction of **prescribed assets on financial institution funds** within a regulatory framework for socially productive investments (including housing, infrastructure for social and economic development and township and village economy) and job creation whilst considering the risk profiles of the affected entities”.

**The question:** Requirement to invest proportion of funds in instruments such as government or SOC bonds, or possibly specific projects or sectors deemed “developmental” by government.

**The concern:** Retirement funds become an instrument of state policy while avoiding the discipline of financial markets and fiduciary responsibility of asset managers and trustees, and imposing lower-than-market returns.

## Why should pension funds be concerned ?

The preamble to Regulation 28 states that:

*“a fund has a **fiduciary duty** to act in the best interest of its members whose benefits depend on the responsible management of fund assets... This duty supports the adoption of a responsible investment approach to deploying capital into markets that will earn **adequate risk adjusted returns** suitable for the **fund’s specific member profile, liquidity needs and liabilities.**”*

Given the long term nature of pension fund and guaranteed annuity liabilities, infrastructure is a prudent asset class .....

- But that is not the contentious issue
- What is contentious is whether it should be local asset infrastructure.

These may be:

- Specific projects -
  - Take or pay (availability based)
  - Demand risk (toll roads)
- General use of proceeds – Kenya/Swaziland  
*“funding of infrastructure in transport, water and energy sectors”*
- Corporate (utilities, SOEs)

# Some big numbers but not free assets

Public Investment Corporation  
Liabilities

Year	R billion						
	Government Fund	Reserve Fund (Development Programme)	Other Government Fund	Other Public Investment Fund	Insurance	Other	Total
2010	9 424	957					1 300 918
2011	9 921	870					1 308 468
2012	9 969	1 250					1 322 808
2013	11 702	1 121					1 332 212
2014	11 500	1 081					1 347 274
2015	11 202	2 271					1 348 260
2016-24	144 004			1 987 300	11 700	1 481	1 947 274
2016-27	180 942	2 194	11 457	1 702 320	12 026	2 026	1 809 965
28	188 404	4 207	9 057	1 717 205	12 086	2 106	1 944 861
29	207 989	4 238	3 273	1 789 494	12 772	2 123	2 000 954
30	218 615	2 243	6 264	1 821 410	13 611	2 111	1 965 224

PIC Liabilities  
R2,1 trillion

Long-term insurers  
Liabilities

Year	R billion												
	Life	Non-life	Reinsurance	Other	Other	Other	Other	Other	Other	Other	Other	Other	Total
2010	10 530												1 452 324
2011	12 440	2 272											1 503 780
2012	13 380	2 270	13 444	12 281	20 340	4 617 788	882 438	69 495	272 287	8 542	7 714	82 073	1 948 214
2013	15 500	2 225	21 398	22 702	26 446	1 527 320	744 374	32 177	273 484	8 429	7 474	99 280	2 150 070
2014	17 455	2 077	23 200	27 827	28 475	1 200 254	810 277	30 856	121 481	8 074	8 240	71 424	2 272 514
2015	10 660	4 248	35 447	36 434	61 948	1 384 256	899 455	7 480	183 427	8 387	12 228	73 424	2 582 022
2016	22 875	5 280	31 800	32 781	48 707	1 330 761	811 268	7 414	140 240	7 346	13 768	98 782	2 812 546
2017	35 700	4 472	21 800	33 007	44 500	1 402 080	870 287	74 207	180 720	7 122	12 126	35 432	3 011 022

Long-term insurers  
Liabilities  
R2,9 trillion

Official and private self-administered pension and provident funds  
Assets and liabilities

Year	R billion	
	Assets	Liabilities
2010	1 115	581 250
2011	11 364	597 976
2012	181 202	561 540
2013	70 260	198 084
2014	1 200 000	202 000

Official private self-administered pension and provident funds (A& L)  
R2,0 trillion

Private self-administered pension and provident funds  
Assets

Year	R billion	
	Assets	Liabilities
2010	1 115	581 250
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2013	70 260	198 084
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Private self-administered pension and provident funds Assets  
R1,5 trillion

These are not free assets but defined contribution pension funds and the liability is the NPV of future pensioner payments (at risk) 8



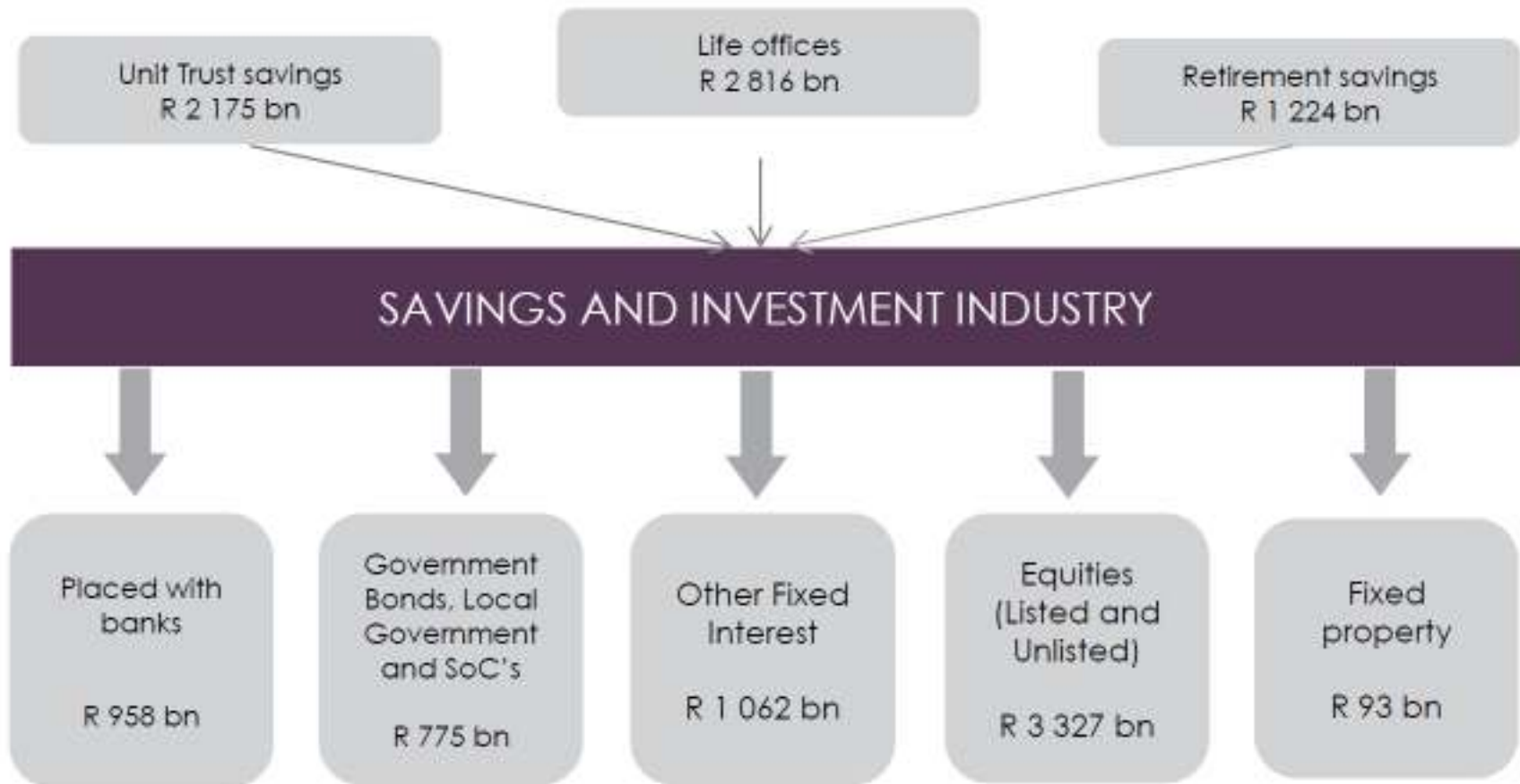
# Big numbers - stock vs flow

## **The stock numbers are big**

- Stocks of savings are accumulated over a long time period – a percentage of salary
- Any changes in asset allocation which impacts on stocks has potential systemic risks
- Sale of equities would have wealth effects across the savings industry

## **Takes a long time to build up pension fund assets (50+ years)**

- Average pension fund contribution rate +/- 12% vs +/- 20% in DB days
- Declining contribution to retirement provision in light of increased cost of death and disability cover

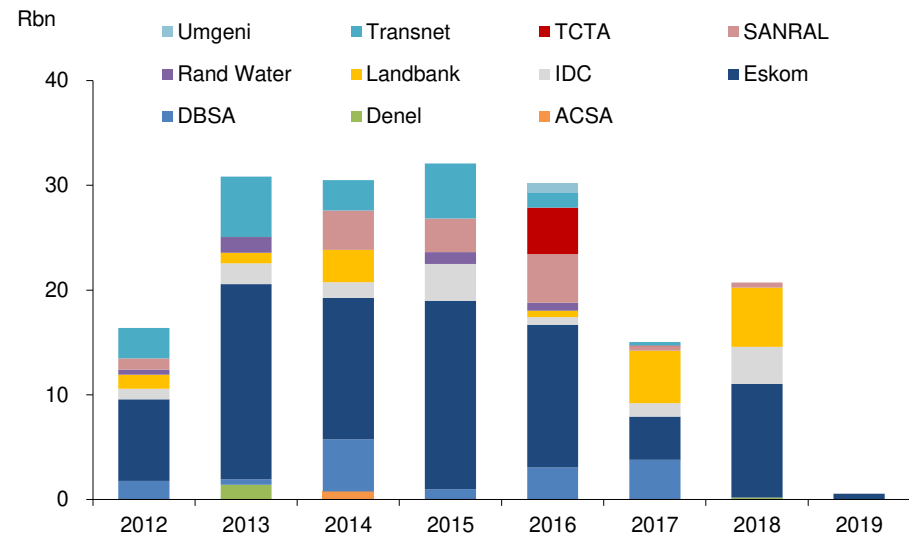


ASISA and its members support the National Development Plan (NDP) as well as the nine-point plan set out in the State of the Nation Address (SONA) 2015 aimed at achieving inclusive growth to reignite the economy and create jobs.

To date, ASISA members have deployed capital in support of the above-mentioned goals as follows:

- SA Government, Local Authorities and State Owned Companies: R775 bn
- Other Fixed Interest (listed & unlisted) and Equities (listed & unlisted) of R4 389 bn to fund corporate SA as well as the following projects:

- o Renewable energy
- o Township development
- o Affordable housing
- o Urban regeneration
- o Student accommodation
- o Water
- o Roads
- o Agriculture (emerging farmers).



# Delving into history (1958 – 1989)

**The objective:** Create funds for semi-governmental institutions, such as universities, the SABC, and for developments in the former homelands by prescribing proportion of funds to be invested in government, government-guaranteed and specified approved bonds.

## % Prescribed Assets (at book value)

Pension Funds	53%
Life Companies	33%
PIC	75%

## **The consequence:**

“Originally intended as protection for policy holders and pension fund members, the prescribed investments came to be regarded in time as an assured source of public sector funding”

*Jacobs 1988 p20*

## Section 19(1) of Pension Funds Act

	Nominal returns (%)			Real returns (%)		% held in PA	Wealth tax	Opportunity cost to Equities
	Equities	Prescribeds	Inflation	Equities	Prescribeds			
1960s	11.3	4.9	3.0	8.3	1.9			
1970s	24.5	7.3	11.3	13.2	-4.0	50	-2.0	-8.6
1980s	20.2	13.5	14.5	5.7	-1.0	44	-0.4	-2.9

## Jacobs Committee of 1988

### Investigate distortions and inefficiencies in the “gilt” market

- Dual market
- Illiquidity
- Prescribed asset requirements: outright abolition

### Establishment of :

- Primary dealers
- Financial Markets Advisory Board
- STRATE out of JSE GCC
- Bond Market Association

# Changes in asset allocation

AA % as at:	31.12.1986		31.03.1988	
	PF	LTI	PF	LTI
Cash	8.6	10.2	20.1	18.6
Govi Bonds	23.4	9.6	19.0	11.1
Local Govi	4.4	2.4	3.1	3.0
Pubic enterprises	15.7	10.0	12.4	8.2
	<b>43.6</b>	<b>22.0</b>	<b>34.4</b>	<b>22.3</b>
Shares	24.9	40.5	26.9	33.0
Other	23.0	27.3	18.6	26.1
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Prescribed asset requirements were abolished in the Budget of 1989. Showing assets as at 1986 and 1988 to reflect the market crash in 1987.

31.12.16		
PIC	Other retirement	Life Co
5.0	6.2	7.8
23.0	19.8	7.2
0.11	0.6	0.2
10.1	1.8	1.6
<b>33.2</b>	<b>22.2</b>	<b>9.1</b>
49.5	52.5	52.4
12.2	19.1	30.7
<b>100</b>	<b>100</b>	<b>100</b>

Infrastructure or Development Assets  
 PIC: **1.16%**  
 RFs and LifeCo: **2.48%**

## **Independent third party asset managers** emerged after 1989

- during the era of prescribed assets, provident funds were managed by life companies due to a 33% required vs 53% for retirements fund
- the changes in taxation of life companies

## **Investment freedom**

- funds to invest in line with their liability requirements
- growth of new products without balance sheet guarantees

## **Benchmarking and performance comparisons**

- peer-group performance of balanced pension fund assets used as a benchmark
- changed from balanced strategies to specialist multi-asset-class approaches with *benchmarked* performance
- trustees less tolerant of underperforming funds

## **Accelerated move from DB to DC funds**

## During prescribeds era:

Bonds were valued at the lower of cost or redemption value:

- most bonds were issued at a discount (very low coupon)
- trading was inhibited as a sale below cost or par created an obligation to buy additional bonds to the value of the difference
- the preference was “hold to maturity”

## 1989 changes:

### **Bond consolidation** by National Treasury

- R144, R147, R150, R153, R157 ... triple legged securities
- The consolidation was at “mark to market” except for public sector pension funds which were on a accrual basis

### **Prudential regulations**

- Regulation 28 arrived from October 1989



## Most countries have **quantitative limits on pension funds**:

- Only 8/77 have no ceilings – Australia, Belgium, Canada, Netherlands, New Zealand, UK, US and Malawi
- Upper limit on equities in 55/77 countries
- Minimum limits in equity in Zambia, Chile and Colombia
- Most have limits or forbid investment in real estate, private investment funds
- Floors on investments exist – in Israel 30% must be in earmarked bonds, in NZ 15% must be in growth assets, in Poland investment in treasury bonds and state-backed bonds are no longer allowed
- Certain countries forbid investing abroad – Dominican Republic, Egypt, India and Nigeria
- In US employer-related loans are not allowed

# Have regulations reduced investment in infrastructure ?

**“While the availability of infrastructure projects has increased, market participants continue to cite a lack of sufficient investable projects.”**

- Most countries, pension funds only have a small share of infrastructure investments. In OECD survey, investment in infrastructure via unlisted equity and debt represented only 1.1% of assets under management.
- Exceptions are found in Australia and Canada, where the average infrastructure investment by pension funds is particularly high.
- Defined contribution (DC) pension vehicles often offer daily pricing or liquidity, which may be difficult to reconcile with long-term, illiquid asset classes such as infrastructure.
- The empirical analysis and other qualitative sources suggest that the effect of G20 financial reforms on infrastructure has been of a second order relative to other factors.

# Priority Sector Lending – examples

Characteristic /Impact Area	Japan	Korea	China	Brazil	Thailand
<b>Priority Sectors</b>	Export, large scale industry, small scale industry and agriculture	Export, heavy and chemical industry	Large state owned enterprises	Rural areas, agriculture, infrastructure and housing finance	Exports, small scale industry, agriculture
<b>Implementing Institutions</b>	BoJ, govt owned financial institutions, commercial banks	BoK, govt owned financial institutions, commercial banks	BoC, policy banks	Public sector banks, commercial banks	BoT, specialised govt institutions
<b>Main source of funds</b>	Postal savings, commercial bank credit	Central bank credit, foreign debt capital	Central bank credit, foreign debt capital (mainly Chinese diaspora)	Government credit, demand deposits of commercial banks	Commercial bank credit
<b>Monitoring and supervision</b>	High level of supervision	High level of supervision	Relatively little supervision	Very little supervision	Little supervision
<b>Costs and loan losses</b>	Low costs as govt absorbed losses	High loan losses	High loan losses	High loan losses	Inefficiency in banking sector due to interest rate caps
<b>Impact</b>	Beneficial for industry but costly	High NPAs, costs borne by banks	High NPAs, high inflation	High NPAs, high inflation	Positive impact on PS only after deregulation

Experience of countries that have used directed credit programs shows that the **overall costs of implementing such programs are enormous** relative to the benefits that they generate, thus reducing the net benefits to the economy. Consequently, several countries (barring a few, including Brazil and India) **have phased out** their directed credit policies

Common outcomes – **high NPLs, inflation and misallocation of financial resources**

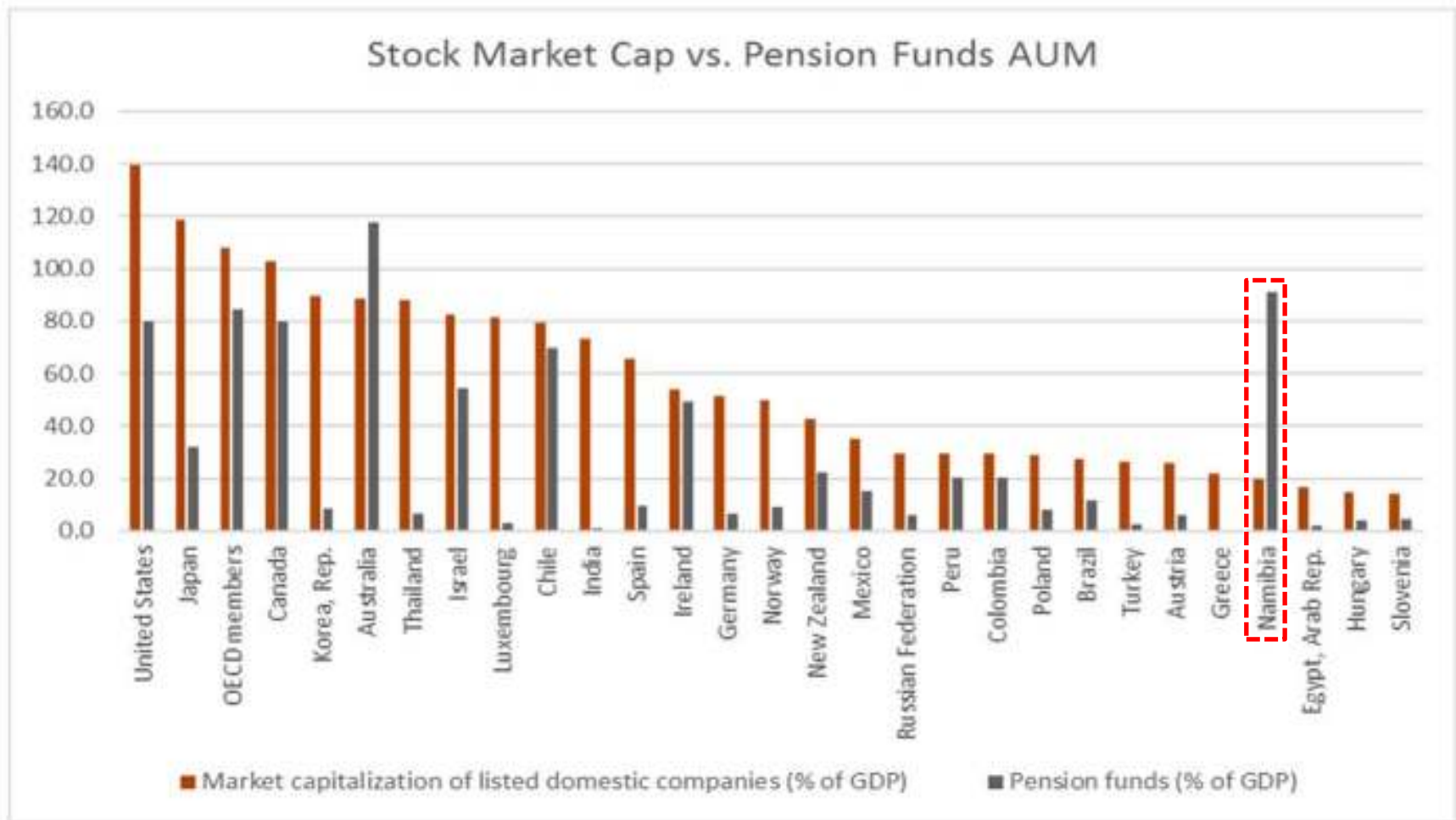
In Zambia, Nigeria, Ghana and Egypt, pension funds were forced to invest in government investment vehicles – with negative real returns resulting in bankruptcy of the savings institutions.

## Criteria to minimise adverse effects

1. Large spill over effects that cause social benefits  $>$  private benefits
2. Preferred activities should have difficulty in obtaining finance from ordinary market sources:
  - High investment risks or information costs such as SMEs, but not infrastructure
3. Cost and scope of eligible assets should be small to minimise distortions in the allocation of resources
4. Maintain positive real returns
5. Maintain fiscal discipline

Country	Local asset requirement
Ghana	100%
South Africa	75-80%
Swaziland	50%
Namibia	45%
Botswana	30%

# Namibia – Deep institutional savings pool



# Foreign holdings of LCBs

Figure 4: Foreign holdings of domestic government securities

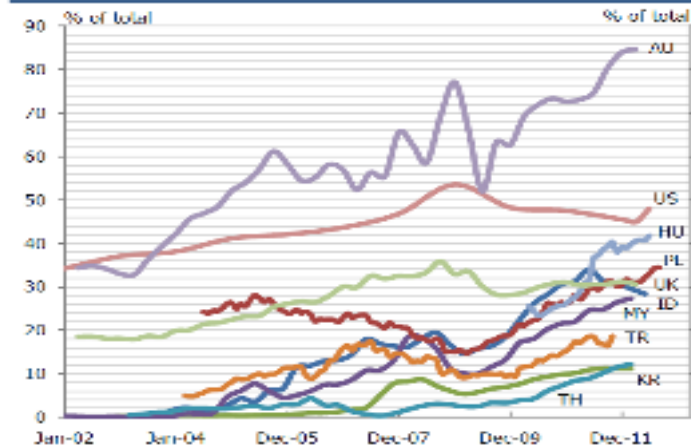
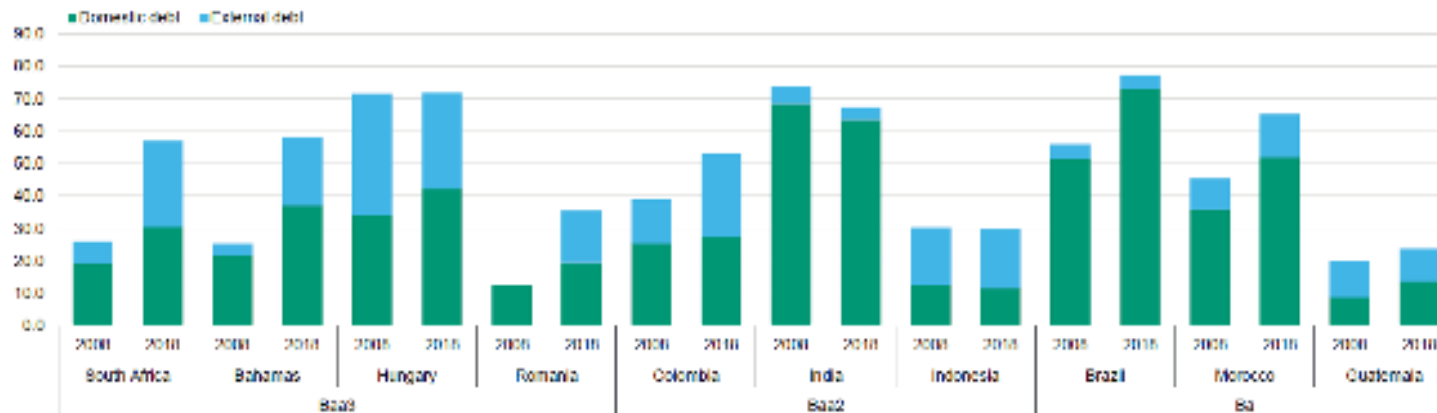


Table 1: Proportion of domestic government securities held by foreigners

	%	As of	Source <sup>1</sup>
Brazil	12	Q1-2012	JP Morgan
Czech Republic	12	Q1-2012	JP Morgan
Hungary	42	Q2-2012	National
Indonesia	30	Q1-2012	ADB
Korea	11	Q1-2012	ADB
Malaysia	27	Q1-2012	ADB
Mexico	29	Q1-2012	JP Morgan
Peru	58	Q1-2012	JP Morgan
Poland	35	Aug-2012	National
South Africa	29	Q4-2011	National
Thailand	12	Q1-2012	ADB
Turkey	17	Q4-2011	National
Australia	85	Q1-2012	National
United Kingdom	31	Q1-2012	Bruegel
United States	48	Q2-2012	SIFMA

Nonresidents hold a large share of South African government debt  
General government debt, % GDP

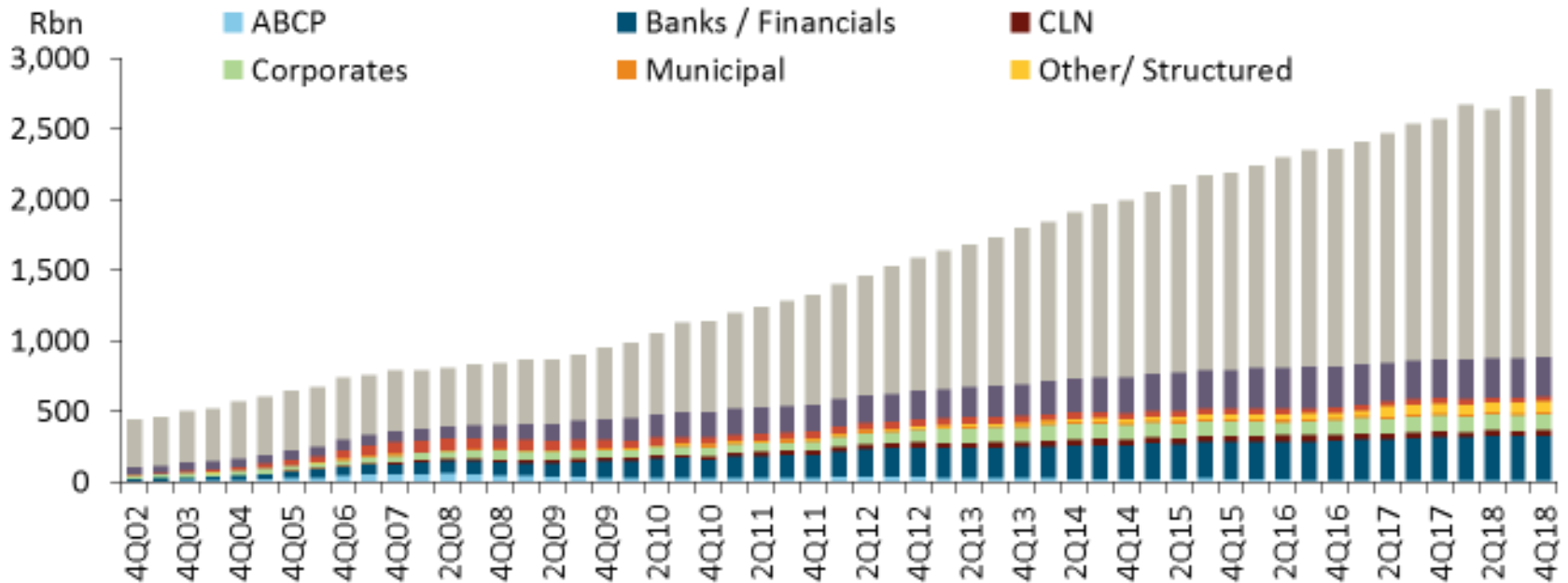


Sources: National authorities, Moody's Investors Service



# SA: Robust debt capital market

## JSE listed debt instruments - volume outstanding



**Government Bonds:** Approximately R1.9 trillion of the bond market

**Corporate Bonds:** In 2018 corporate issuers raised R34bn, outstanding R113bn

**Financial Institutions and Banks.** Total outstanding of R320bn

**State-owned companies and municipalities:** Total outstanding of R275bn

## SOCs or infrastructure?

- Corporate governance, profitability and a sustainable business model is not a new topic for SOC
- Financial institutions have **indirectly participated** in the funding of public sector expenditure through the uptake of government and SOC bonds valued at R1.3 trillion in the last 10 years.
- Banks, non-bank financial institutions and asset managers financed over **R200bn** towards 112 projects for the **Independent Power Producers Programme**.
- Direct finance through **Public-Private Partnerships (PPP)** has been in **decline**, with only R5bn in projects being finalised in 2016/17.
- Thirty-three completed PPP projects since 1998, **total value of R89.3bn** including hospitals, transport and roads, tourism and head office accommodation.
- PPP projects account for R18.5 billion – a **mere 2.2%** of the total public-sector infrastructure budget estimate of the **R834.1bn** planned for public sector infrastructure spending over the next three years

# Pre-1989 vs now – the difference?

**Then:** SA was a closed economy

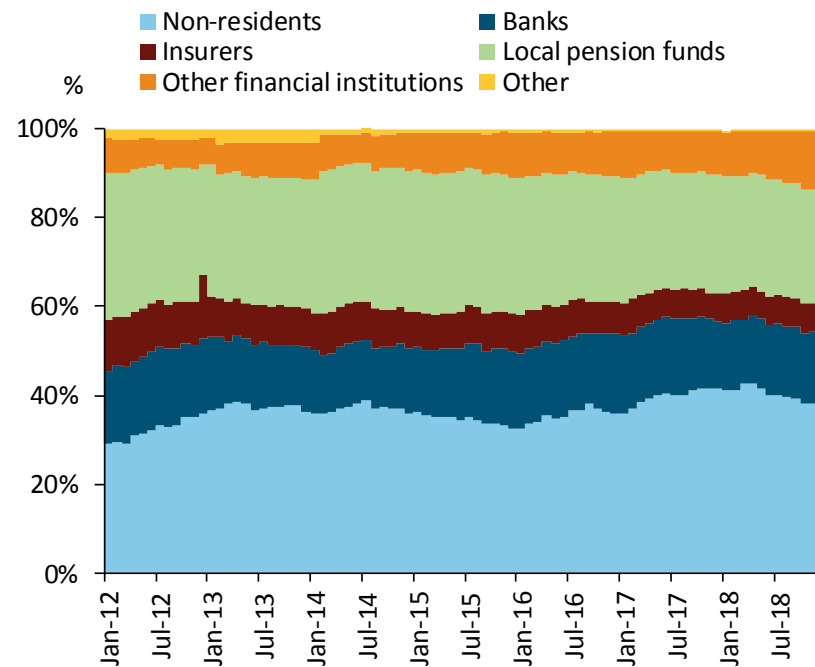
**Now:**

**World:** Interconnectedness of financial markets

**South Africa:**

- Open economy
- Diversified bondholders
  - $\pm 38\%$  of ZAR government bonds are held by foreigners
- Member of G20: Financial reforms to reduce systemic risk
  - *Basel III/IV (plus SAM)*
  - *Twin Peaks*
  - *Macro prudential tool kit*
  - *Resolution framework*
  - *Margining of OTC derivatives*
  - *Consolidated supervision of conglomerates*

## Holdings of listed bonds



## Lack of demand or lack of supply ?

*Beware unintended consequences*

Prescribed investments in developmental projects with below commercial returns will not be welfare enhancing for the economy.

They could even be wealth destructive if foreigners sell bonds, and local funds sell equities to meet the requirements.