THE IMPACT OF PENSION FUND INVESTMENTS ON ECONOMIC DEVELOPMENT IN SOUTH AFRICA

Student: Ayodeji Olaifa

Student Number: 209919108

Supervisors: Mr Bob Wood, Mr Idriss Mouchili and Professor Richard Haines

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DECLARATION

I, Ayodeji Haruna Olaifa, 209919108, hereby declare that the dissertation for MA Research Programme in Development Studies is my own work and that it has not previously been submitted for assessment or completion of any postgraduate qualification to another University or for another qualification.

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ABSTRACT

Pension fund investments have been under the spotlight lately, particularly on the back of the recent global financial and economic crisis that resulted in a significant reduction in pension fund assets across economies.

Increased poverty levels and high financial indebtedness abound, as workers grapple with retrenchments, reduction in retirement benefits and reduced wages. This is causing a re-assessment of investment strategies of pension funds across the globe, and increasing support for the argument that, the traditional equity/government bond asset allocation is out - fashioned in a world of lower returns and wider choices.

Pension funds by virtue of their size, can impact the society directly and/or indirectly through investments in companies that incorporate environmental, social and governance issues in their corporate behaviours, or in dedicated socially responsible investment funds or other forms of alternative investments.

This study sought to provide a link between the investment patterns of pension funds and national economic development. An in-depth literature review was undertaken, and investments impacts were assessed by looking at published reports of select funds and corporations.

Pension funds are an integral part of a nation's economy. This research work established the various dimensions in which pension fund investments can impact the socio economic development of a country, especially in developing countries, where there exists a huge infrastructural and economic gap among different sectors of the economy.

Pension funds are workers capital, and therefore should be invested in a manner that will benefit workers, and these benefits cannot be restricted to mere financial benefits, it should be able to generate social, financial and environmental benefits, and in a sustainable way.

Chapter One

Introduction to the Research

1.1 Introduction and background to the study

South Africa's Pension system is mainly based on a private pension fund system comprising over 13,000 pension funds, and about 13 million members as at the end of 2008 (FSB 2007).

Pension fund sizes generally depend both on the accumulated pension contributions and on the growth generated by the pension fund's investments. The total assets of South Africa pension fund industry is estimated to be over R1.2 trillion and a large majority of these funds are being managed by the Public Investment Corporation (PIC) [1]on behalf of the Government Employee's Pension Fund (GEPF).

The industry is presently dominated by the private sector which arguably has a paramount business agenda which leads organised labour to argue that, ideally pension fund contributors should be the most important role players in the industry but currently they have the least influence.

A significant portion of the country's pension fund assets[2] are invested in shares and in insurance policies. The recent economic crisis and consequently the rising unemployment and job loss have increased public interest in the investment of pension fund assets. With inflation of around 9% in 2008 and average performance of -12%, real loss of most pension funds within this period amounts to 21% (Sanlam 2009).

As developing economies strive to cope with the aftermath of the recent economic crisis and its attendant liquidity crisis, it has become topical that pension fund capital be designed to meet gaps in markets for small and

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[1] The PIC manages over R700billion representing assets of about 1.5million state workers (GEPF 2010).

[2] According to the 2006 FSB Annual Report, over 60% of South Africa pension fund assets are invested in equities and insurance policies.

medium sized firms in the economy, therefore effectively acting as venture capital funds.

Institutional investments in the last 50 years have been dominated by investments in the so called, traditional investment vehicles: equities, real estate, government bonds (cash). Recent years have seen a dramatic explosion of interest in alternatives from these investment vehicles, with private equity, investment grade and high yield credits, emerging markets equities and debts, hedge funds, commodities and socially responsible investments increasingly seen as useful and in many cases essential components of a balanced investment portfolio.

In developing economies like South Africa, these alternative investments[3] have gained a lot of attention as pension funds evolve towards being agents of economic development over and above their fiduciary responsibilities. It is recognised that pension fund investments can have impacts beyond the rate of return. Historically, investments policies and fiduciary responsibilities were narrowly constructed so that the secondary or developmental impacts of investments were not deemed relevant. However, some stakeholders have come to recognise that collateral benefits from socially responsible investments are important elements of a prudent investment of pension funds.

Even though a few pension funds (like some other institutional investors) are already involved in some form of domestic development, particularly in infrastructure which can offer regular long term cash flows, large scale social investments are still to be achieved.

The GEPF[4] led other South African investors in launching an investor led network as part of their commitment to the UN-backed Principles for

[3] Alternative investments have been preferably referred to as development funds in South Africa

[4] This is the 29th largest sovereign fund in the world with $74billion in assets, according to a research by P&I/Watson Wyatt (2009).

Responsible Investing[5]. The PIC makes significant investments in rural and township development as well as in national infrastructure development. It invested R2.5billion in 26 Retail developments and R19billion in refurbishing key airports in the country (Fred Hendricks 2008).

1.2 Economic Environment

The recent 2011 economic crisis in the euro zone and the re-emergence of financial risk in the world has sent further shocks to the world markets. Not too long ago, the global economy in 2007/2008 was plagued with a severe economic recession catalysed by a massive and sporadic financial crisis that had its roots from the Wall Street in the United States of America.

Many referred to it as the most severe and most synchronised since post war period, as virtually all the developed economies and many emerging markets and developing economies were thrown into deep economic recession (Charles and Robert Aliber, 2008).

Overall global GDP was estimated to have contracted by 6.5% (annualised) in the fourth quarter of 2008 from a 4% growth in 2007[6].

This incessant global financial crisis has impacted greatly on the way and manner in which institutional funds (particularly pension fund assets) are being managed. Investment in listed shares, property and interest earning vehicles which form the bedrock of traditional pension fund investments, all took a dive during this crisis, and a large number of the world's pensioners and those saving for retirement may never see a recovery of the value lost in their assets over this period.

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[5] The Public Investment Corporation (PIC), an Investment manager wholly owned by the South African Government, manages over 95% of these assets. The PIC outsources about 25% of the equities portfolio to external investment portfolio managers and the remaining is managed in-house on a passive basis or enhanced index.

[6] Although emerging and developing economies as a group were still projected to grow at a modest 1.6% in 2009.

At the peak of the economic crisis, stock markets collapsed and reached levels last seen in over a decade. In the one year period 1 November 2007 to 31 October 2008, adverse returns prevailed in all regions (from a global stock market average high of over 23% in three years ended June 2007):

- North America : -33.6%,
- Emerging market: -53.0%,
- Europe : -45.0%,
- Asia : -54.3%, and
- South Africa: -53.0%

(Allan Gray 2008, 10 - 11).

Share prices in South Africa as of 2010 were still about 20% lower than their peak[7]

1.2.1 The Bubble

Prior to this crisis, a vast majority of African economies in line with the rest of the world enjoyed a period of rising economic growth and development. Global trade increased phenomenally between 2003 and 2006. Global GDP grew by 3.5% annually, while Africa's GDP grew by an average of 6% annually. South Africa's average manufacturing exports increased from 9.1% in 1999 to 13.2% as of 2006. This represented a huge increase in foreign trade.

China and India together accounted for about 10% of total Sub Saharan African trade. According to the ministry of commerce in China, it is estimated that Chinese direct investment in Africa amounted to $6.6billion between the year 2000 and 2006. Private capital inflows to Sub Saharan Africa soared by more than 600% and the average GDP growth rate in South Africa was 4.8% in this period.

Assisted by low returns in developed economies and increasing liberalisation of the emerging markets and African economies, Foreign Direct Investments

[7] The Johannesburg Stock Exchange returned about 19.5% in one year ended 31 July 2010(Allan Gray 2010)

(FDI'S) into these economies catapulted. According to the UNCTAD world report of 2006, FDI into Sub Saharan Africa attracted US$11bn in total[8].By 2007, FDI into South Africa was US$5bn.Total Net flows to Africa in this period amounted to US$35.6bn and US$1.5trillion for the world overall inflow[9].

Increased global trading and demand for commodities pushed up foreign revenues in African economies particularly the commodities and oil rich nations. South Africa, a mineral rich economy benefited immensely from increased global trading and record high prices of minerals and metals. Manufacturing grew exponentially on the back of China and other emerging markets' huge appetite for minerals and metals. Mining accounts for 60% of South Africa exports. The country is also deep in a huge infrastructural spend: building of stadiums for the 2010 world cup, roads, housing amongst others[10].

Since liberalisation, South Africa has attracted net FDI of about 1.5% of GDP. In the period 2004 and 2007, there was a net inflow of $42bn and this has been hugely instrumental in financing the current account deficit on the balance of payments. The economy has outperformed expectations over the past five years, buoyed also by increase in global demand and a large manufacturing sector and an annual GDP growth of 5% (UNCTAD 2008).

1.2.2 The Crash

Credit and asset price booms can leave an awful lot of wreckage behind them. Financial markets and particularly securities markets usually run concurrently with rising economic booms. When foreign direct investment increases in an economy, it has the net effect of inflating that economy's securities market.

Domestic asset prices escalate in proportion as locals sell off assets to willing international buyers thereby inflating the prices of these assets. These usually spark off a new boom in the economy. Credit increases as liquidity increases.

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[8] Mostly due to the surge in prices of commodities

[9] UNCTAD 2008

[10] The boom in housing projects and construction resulted in a deepening of the construction sector, thus creating numerous temporary jobs.

The invisible hand is always at work when money flows from one country to another and adjustments automatically occur both in the countries that receive these funds and the countries that are the sources of them. One adjustment is that asset prices almost always increase. This is a bit of a chicken and egg problem: buoyant economic activity attracts foreign funds and the flow of foreign funds leads to increase in business investment because higher stock prices mean a lower cost of capital for domestic firms.

The increase in household wealth induces an increase in consumption. The United States of America recorded massive foreign inflow and high liquidity from China and a number of oil rich nations (having benefited from escalating oil prices) during late 1990's and early 2000. This is also true for the East Asian economies (when Japan expanded its economy) and Africa more recently during the commodities boom.

This trend in global economic boom began to show signs of contraction towards the end of 2007. The slowdown started with the subprime housing crisis in the US which soon engulfed the entire financial sector/industry and eventually the economy. The poison of course in no time, spread to other economies of the world. Financial institutions started to wobble across economies, growth slowed, contracted and institutions began to haemorrhage whilst millions of jobs were shed across the globe. Developed economies were distressed; GDP's recorded negative GDP growth and the world looked on to China to rescue it.

The first crisis to test the new world of finance in its height of sophistication showed that markets are so interconnected and so global that the poison can spread across markets and continents with terrifying speed. It didn't take long for the notion that African economies were adequately insulated from the upheavals in the developed economies to be discarded and new realities emerged.

Commodities and oil rich nations were hit the hardest. Global demand for resources plummeted as China's economy slowed along with other BRIC[11] economies, prices of commodities and oil fell phenomenally to record lows in

[11] Comprises Brazil, Russia, India and China, and more recently South Africa.

years. Oil fell from a high of $130 per barrel to below $50 per barrel. The same expanding trade ties which helped spur Africa's economic growth was also quick to pass on the effects of the global slump.

As revenues plummeted and foreign investors dumped assets across Africa, Infrastructural spend and economic development was threatened. Economic growth begun to slow and the financial sector started to show signs of distress notwithstanding the little or no exposure to the foreign toxic assets[12]as the case may be.

Ahead of the 2010 world cup, South Africa embarked on a huge infrastructural spend. Even though it benefitted from falling prices of oil and interest rates and increase in prices of gold[13], sharp declines in metal prices and depressed demand for cars and other manufactured goods caused a big strain on the economy. Worried by a growing current account deficit, the first in 17 years, investors became more risk averse and FDI's begun to record net outflows.

The economy in the last quarter of 2008 showed a contraction of 1.8% and was officially in recession by the first quarter of 2009. Over 400 000 jobs were lost in the mining, textile and other manufacturing sector of the South African economy by the peak of the crisis in early 2009 and these figures continues to rise as the economy struggles in the aftermath of the crisis (PriceWaterHouse 2008)..

A number of sporadic service delivery protests has been recorded in several provinces in the country with the general masses feeling despondent and betrayed by their government (Mail & Guardian, 22/07/2009, 21). Organised labour continues to call for a review of the country's major economic policies and calls for nationalisation of the mines have been heard in various quarters.

Activities associated with mergers & acquisition, private equity and venture capital have slowed in the continent from an encouraging trend in 2007 and 2008. A heavy loss in the financial sector, declining household wealth and drop in global trading threatens to thwart the longest economic developments

[12] Sub Prime and Asset Backed Securities in the US

[13] one of the country's largest exports has rallied amid dollar weakness

in Africa and South Africa in particular, as governments across nations are now faced with fiscal challenges: lack of credit, drying foreign capital, decline in company earnings and little or no domestic savings further heightens the liquidity crisis and complicates governments' financing efforts.

1.2.3 The Recovery?

Economic indicators around the globe in the last quarter of 2009 seemed to support the sentiments that the worst may be over and we may be witnessing the end of the global recession and meltdown.

According to the International Monetary Fund (IMF), annual global growth in 2010 is projected to be about 1.25% following a contraction of 3.5% in 2009.The emerging economies' real Gross Domestic Product (GDP) growth is forecast to reach almost 5% in 2010, up from 1.75% in 2009.

China seemed to be leading the world back from the dark hole of deep economic meltdown with an annual growth rate of 7.9% in the April – June 2009 period[14]. A phenomenal growth that was achieved through massive government interventions[15], increased export and local consumption/spending.

The United States in addition to its $787billion stimulus programme have also rallied economic cooperation around the world. Massive and prompt policy responses across global economies seemed to have thwarted the meltdown from what many refer to as the worst recession since the 1930's, and whilst it seemed like the worst was over, recovery is still a long road ahead amidst renewed fears of a double dip recession in 2011[16].

There were a few signs of recovery around the world, termed 'Green shoots': improvements in world GDP; and a significant rise in commodity prices and trade. With the benefit of hindsight, it seemed a bit of caution would have

[14] The Chinese economy stands the risk of overheating, and growth has slowed, combined with inflationary pressures.

[15] The Chinese government have since the crisis committed over $585billion stimulus package.

[16] The recent debt ceiling crisis in the United States and the unflattering unemployment figures have erased all initial thought that the economy may have indeed recovered and possibly on its way to some modest growth.

been in order, as economic indications today (2011) proves that it is still a far road ahead to recovery[17]. Until employment figures begin to follow output upwards and financial systems have healed enough to attract private sector capital that it needs to stand on its own, there cannot be any meaningful growth in the developed economies.

The savings rate in the United States have climbed by 7%[18] from an almost negative level and China continues to over produce. The world would only begin to see any meaningful recovery once the United States, whose consumption rate alone contributes to almost 16% of world GDP, begins to spend again and the Chinese who are the world's largest net savers, increases their rate of local consumption (The Economist, 2009).

What was hoped for was some form of economic stabilisation as a result of the massive liquidity injected into the economy by various government stimulus packages and bailouts[19]. The rebuilding of inventories will not boost firms' output for long, granted that the fiscal and monetary stimulus is cushioning the damage but the underlying problems remain.

In America and other former bubble economies, consumer spending is at its lowest and cost of capital higher than before the crunch. Stabilisation is not recovery and economies will at some point have to self- correct and that may still bring an even greater challenge.

What can be said with utmost certainty however is that businesses and the financial environment have come under more stringent regulations and supervision by government. Investments and financial instruments are being scrutinised for more transparency and less independence.

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[17] Recent fears associated with the Euro debt crisis and that of the United States of America, which led to the latter being downgraded from an AAA credit rating, saw world markets stumbling sharply. In Europe, UK FTSE100 was down 4.7%, while France's CAC 40 fell by 5%, and the USA Dow Jones fell by 3% (Business Day Online , 2011)

[18] This is mostly due to debt aversion and reduction in household consumption.

[19] Recent Euro financial crisis and America's debt and unemployment figures are indication that any sign of global economic recovery may have been overstated.

Risk profiling and full disclosure have become the “new order”. Private spending in surplus economies will not soar overnight. Financial markets may well “revert to mean”, which is a statistician’s way of saying what comes down must go up. But the next five years will not resemble the five preceding the crisis. Not every change brought by the financial breakdown will be reversed, the world economy continues to experience series of aftershocks from the 2007/2008 financial crisis, and even though it may fitfully get back to normal, it will be a “new normal”.

The world economy will rely more on governments for longer than anyone would like. How this will affect financial services and innovation is left to our imaginations. Some have suggested the end of capitalism or free trade as we have come to know it but it is beyond the scope of this work to delve into this debate but what is becoming more obvious is the advent of more regulations of businesses across the globe.

In the words of Mervyn King[20] ‘the world economy has slowed, America has slowed, China has slowed, and of course particularly the European economy has slowed.’ The economy is very much still on life support!

1.3 Pension Funds

The investment management industry is directly linked to the financial services industry and pension fund investments depend largely on the economy. There are economic, financial and social uncertainties in the current pension systems and the financial crisis has increased concerns about the retirement prospects of many. Fallen assets, job loss, unemployment, falling salaries, increasing cost of living, longevity, HIV epidemic, high indebtedness are some of the many socio economic impact of the current economic crisis on the individual workers.

The effect though smallest on younger and prime – age workers[21], job losses and high debts are forcing these groups to cash in on retirement savings

[20] The Governor of the Bank of England in a BBC interview , http://www.bloomberg.com/news/2011

[21] They have more time to rebuild their provision for old age.

regardless of the huge tax implication. The most affected are pensioners and people near retirement.

This crisis has impacted greatly on retirement incomes for workers regardless of the type of pension plan they belong to i.e. defined contribution plans or defined benefit (DB) plans as funds are forced to adjust pension promises/benefits. High unemployment and massive layoffs of workers results in huge withdrawals and benefit demands on pension funds (besides the obvious fallen asset value). Funds without adequate reserves or liquidity are forced to exercise the options they have in some investments at a loss to meet liabilities.

Savings in the form of pension funds and asset management traditionally rests on three main pillars: investment in listed shares, investment in property and interest earnings. All three pillars have cracked rumbled and in some cases tumbled. A large number of the world's pensioners and those saving for retirement may never see a recovery of the value lost in their assets during the 2007/2008 crisis. Share prices in South Africa in 2010 were still about 10% lower than their peak {The Johannesburg Stock Exchange returned about 44.1% in one year ended 31 March 2010(Allan Gray 2010)}, and with recent additional shocks to the global stock market, a significant part of these gains may have been lost again.

Markets are of great relevance to pension fund investments considering that most of these funds have significant investments in the equity markets, directly in ordinary shares of companies or indirectly through mutual funds or insurance wrappers[22].

The current chaos will impact differently on a 28 year old and a 62 year old, and also the life stage savers find themselves, will impact differently on their retirement planning. Pensioners living off their investments are probably the

[22] Total pension fund assets in South Africa is about US$208bn (>42% of GDP), the PIC administers assets worth US$98.3bn on behalf of certain funds. About 23.4% are invested in equities, 7.8% in foreign investments, 8.6% in bills, bonds and securities, over 47.6% in Insurance policies (Sanlam 2009).

worst affected as all asset class takes a big slump especially if annuities are not guaranteed for life. Depending on asset allocations, some near retirement are forced to stick it out in the workplace for a few more years or learn to live on less.

The effect on benefits or replacement value is huge also for pension promises of defined benefit funds. As governments struggle with fiscal deficits, companies cope with depressed earnings and bankruptcy (in some cases) and halved assets value, many who planned on retiring, cannot afford to do so.

The setbacks faced are such that new policies may have to be designed to make retirement funds in the future less exposed to market volatility and able to recover lost value. Voluntary retirement savings will be needed to augment the now reduced savings.

Safety nets to offset pension fund losses are being clamoured for similar to those in more developed economies[23], but with the deficit ridden economies of Africa, savers and pensioners may have to live on less if all stakeholders do nothing!

Depleting asset values put pressure on pension fund trustees to mitigate risk against returns. The legal framework in which any pension funds operate imposes strict requirements on pension fund trustees to invest funds in a prudent way, taking the interest of the plan members and dependant into account.

This generally means achieving a reasonable or in some cases, a legally defined minimum rate of return giving a certain level of risk. As most jurisdictions move towards the Defined Contribution (DC) pension fund type, the risk of poor investment returns and increasing fund cost is borne by the member and conversely, the member benefits from a good investment returns and a decrease in fund expenses. In defined benefit (DB) plan, the employer or the government in most cases bears the risk of poor returns, experiences

[23] In some developed economies, certain buffers exist to reduce the high incidence of poverty that could result from dwindling fund assets. Poverty safety nets and automatic stabilisers are built into certain pension system

show that pensioner's benefits in some publicly managed DB plan have been jeopardised as governments struggle to meet its pension liabilities, and poor returns meant little or no available funds for pensioners.

Employers also facing economic hardships and in some cases insolvency also leave hundreds of thousands of workers and pensioners stranded without benefits.

As a developing nation with a relatively limited number of investment vehicles and modest size of the capital/securities market, pension funds ability to secure adequate investments is limited. Collapsing stock markets, financial market turmoil and dearth of diverse investable instruments requires pension funds to pursue a dual /multi objectives of accruing significant financial returns and also promoting socio economic development.

Hitherto, the cheapest and most efficient way has been to diversify into publicly offered securities and more so government bonds. The growth and development of alternative investments have been relatively slow in Africa and particularly as it relates to pension funds and investment.

Even though alternative asset categories have low correlation with other asset classes,[24] private equity, venture capital, hedge funds, real estate and economically targeted investments[25] are being watched with heightened suspicion despite recordable achievements in business sectors across Africa, particularly in South Africa and some parts of Sub Saharan Africa.

A strong financial system is a powerful engine for growth and equality. They serve as a source of long term wealth creation as the contribution that a well run financial system makes to the gross domestic product growth of any economy is of high significance. More so that pension funds require a strong and diverse financial market to achieve its mandate of reasonable returns adjusted for risks.

[24] This asset class do not behave the same way that public equity or fixed income markets do, when stocks go down, investments like venture capitals may not.

[25] Also known as subsets of socially responsible investments

Pension funds that accumulate vast financial resources on behalf of workers would seem logical investors in these alternative investment vehicles. They offer diversification for pension funds and arguably safer returns on investments. Hedge funds are reputed to offer very high returns albeit at higher risk. Some of these alternative investments promote strong economic development, by fostering small business development and job creation[26]. Some have argued that it is in the interest of the plan members and dependants to ensure sustainable economic growth as this is the surest way to a substantial and reduction in absolute poverty.

1.4 Government

The roles of governments in the pension system have increased significantly in recent times, and are more often than not multi dimensional and sometimes contradictory.

Pension funds are traditionally one of the largest reservoirs of capital and are able to wield significant power in the financial market. They represent potential sources of long term finance for economic and social developments and thus can be a tempting source of deficit financing and may lead to increased government consumption.

Although pension funds may be difficult to insulate from political interference and tend to earn poor returns as they are often used to achieve objectives other than providing pensions,[27] unarguably still, the best solution to long term finance and economic development is not increased aids or loans from the World Bank, instead the long term resources of pension funds offer a more promising alternative source of long term finance[28].

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[26] California Public Employees Retirement System (CalPERS) in the United States of America is a classic example

[27] This is particularly true of publicly managed pension funds. Privately managed funds can also be regulated in a way that steers asset allocations towards public projects and lending to government at low yields.

[28] According to the 'Linear-stages-of-growth model' theory by Rostow, development is a result of efficient utilisation of both domestic and international savings (Todaro & Smith 2006, 3).

As government struggle to cope with deficits, funds with large assets and shaky independence find themselves especially vulnerable[29]. Governments across the globe are increasingly concerned about the plights of workers and pensioners in the wake of economic crisis.

There are fears similar to the above as the South African Government proposes a National Social Security Fund (NSSF) especially when unions have recently made calls for government to direct pension fund assets towards investing in infrastructure bonds, mortgage and real estate development.

Pension fund trustees and administrators are being pressurised to consider investments such as socially responsible investments, particularly economically targeted investments. Public funds are particularly susceptible to internal pressures from workers and unions in this regard.

Be it as it may, government's concerns aren't entirely baseless .Government may have a moral if not statutory duty to help protect workers capital particularly where defined contribution pension fund system are mandatory and annuitisation compulsory.

Government is faced with a broader responsibility of ensuring that savers and pensioners are not left desolate and becomes additional burden on an already fiscally challenged institution. Thus the need for effective oversight, Safety nets and increased regulation of pension fund investments, the form of which will vary according to the internal political dynamics of each state/country.

1.5 Conclusion

The world economy is still saddled with the aftermath of the 2007/8 financial and economic crisis. Early signs of recovery were dashed with recent unemployment figures from the United States and the euro zone financial crisis, leading to new clamour for more financial stimulus and government bailouts. The resultant effect is the downward pressure on world stock markets and pension fund assets by implication.

[29] Pension fund assets in Argentina were nationalised by the government in October 2008.

Chapter Two

Research Methods and Methodology

2.1 Introduction

This chapter provides the various methods and processes undertaking in the articulation of this research work. It looks at the justification and relevance of the study particularly on the back of the recent global financial and economic crisis.

2.2 Rationale for Study

Social security and pension funds are integral to Africa and particularly South Africa's development plans, especially as the deepening financial and economic crisis, continues to wreak havoc on socio - economic fabrics of both developing and developed nations across the globe.

Falling household wealth, rising unemployment, increased government deficit, company bankruptcy and job shedding, salary cuts and the increasing cost of living, are putting enormous pressure on pension funds, with a resultant implication for old age incomes in the next few years.

Increased poverty levels and high financial indebtedness abound, as workers grapple with retrenchments and reduced wages. This is causing a re-assessment of investment strategies of pension funds across the globe and increasing support for the argument that the traditional equity/government bond asset allocation is out fashioned in a world of lower returns and wider choices (Global Pensions 2008).

In order to assess the socio-economic impact of pension fund investments and especially in the aftermath of the recent economic crisis, a broader view of pension funds is needed.

Average investment losses mask a range of effects on individual workers and retirees living standards. Besides the institutions, how vulnerable are the individual savers in old age or in unemployment? What is the impact of the crisis for different groups of workers and pensioner's vis-à-vis their age, type of pension plan and investment choice, how relevant is retirement, as

conventionally defined, to the African society and more importantly how have these funds contributed to the socio-economic development of the various communities of its members?

Governments across the continent, are not only faced with the possibility of years of economic growth being eroded in a flash, if alternative financing is not guaranteed to sustain hitherto achieved growth but are also saddled with the plight of pensioners and workers.

According to Christie Lagande[30]:

'Recoveries in the world economy are being thwarted by balance sheet pressures. There is still too much debt in the system. Weak growth and weak balance sheets of governments, financial institutions, and households are feeding negatively on each other, fuelling a crisis of confidence and holding back demand, investment and job creation. This vicious cycle is gaining momentum and, frankly, it has been exacerbated by policy indecision and political dysfunction'.

She added that these crises create social tensions which are beginning to surface in the form of entrenched high unemployment, fiscal austerity that chips away at social protections, perceptions of unfairness in 'wall street' being given priority over 'main street'[31] and acute poverty and deprivation in less developed societies.

This is true of South Africa with an even bigger unemployment and poverty rates[32]. If crisis deepens without adequate policy response, they could become additional burden on an already depressed government. According to a research by National Labour & Economic Development Institute (NALEDI), if 5 to 10 percent of pension fund assets were mobilised for developmental purposes, it would amount to over R40-80billion that can be used for certain economically targeted investments (Devan Pillay, 2008).

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[30] A Speech delivered by the Managing Director of the International Monetary Fund (IMF) in a conference at the Woodrow Wilson Center, entitled 'Global Economic Challenges and Global Solutions' (Business Day 2011).

[31] Recent widespread riots in the UK and the 'occupy wall street' protest in America are indications of a growing social tension.

[32] South Africa has also experienced its share of incessant and sporadic poor service delivery protests across the country.

The socio economic cost of a failed pension fund is too huge for governments to ignore at this time[33]. Considering the fragility of African development efforts, what should be the policy response to the rising unemployment and increasing social distress to assist both individuals and institutions under stress: Should African governments be either bailing out insolvent pension funds as the case is in Israel, or a stronger old age safety nets, early access to retirement savings, automatic benefit adjustments or outright nationalisation of pension funds be the choice as seen in the developed nations?

To neglect pension funds in investigations about the economic development of Africa or South Africa for that matter will be misleading[34]. Trustees of pension funds are pressured to undertake additional responsibility of ensuring that these investable funds are well allocated to underpin growth and protect against any future risk[35].

The rise of alternative investments[36] has opened up new opportunities for pension fund investments. Thus, making the correct asset allocation decisions going forward is critical to a scheme's future health.

The critical question remains whether social or collateral benefits[37] should have a place in pension plan knowing that investments guided only by market forces tend to be more profitable than investments guided by external considerations or should pension funds exist solely to provide benefits for plan members, former members and dependants?

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[33] Economic development, aaccording to the 'State theory' of development, involves interactions between the state and social relations. Development is dependent upon state and social stability. State theorists argue that a developmental state is required for development (Hoff and Stiglitz 2007)

[34] Pension funds in South Africa already account for about 42% of GDP (Devan Pillay 2008).

[35] Alternative investment instruments are becoming popular as a potential source of achieving reasonable returns for pension funds whilst also providing collateral benefits for fund members

[36] Which includes but not limited to : hedge funds, mergers & acquisitions, venture capitals, private equity, socially responsible investments

[37] Recent widespread ('occupy wall street') mass protests across the world is a sign that businesses need to start shifting focus from shareholder value to corporate governance, socially responsible investments and more sustainable business practices. ,

Pension reforms are among the most highly influential positive determinants of socio-economic development today.

In an ideal world, pension fund assets would be strictly ring fenced and preserved for providing income on retirement, but the current situation is far from ideal. As pension funds trustees/administrators seek to diversify the investment of fund's assets, government is also looking to pension funds and social security funds as an alternative source of long term finance and a solution to economic development[38].

The Development Bank of South Africa has estimated that South Africa particularly has a funding gap for infrastructure projects to the tune of R150bn and it is believed that over half of that could be secured by "properly leveraging" South Africa's DFI'S.

2.3 Objective of study

This research intends to achieve the following:

- Examine the role of pension funds in national planning, fiscal planning and economic development by determining the pension systems' development options and a case for economically targeted or socially responsible investments (with the aim of establishing its economic viability).
- Critically analyse the role of government, labour and other public agencies in the investment and management of pension funds assets.
- Measure the extent of economically targeted investments (socially responsible Investments) and evaluate its impact on economic development in South Africa.

2.4 Scope of work

This research study will examine the historical and future role of pension funds in the economic development of South Africa by investigating the investment patterns of selected pension funds and investment managers over

[38] As mentioned earlier, effective utilisation of aggregate national savings is one of the standpoints of the 'Linear-stages-of-growth' theory of development.

a period of time. This is to lay a foundation for the qualitative and quantitative discussion of the structure, governance, investments, growth and reforms of pension funds in South Africa.

The study will explore the socially responsible investments of broadly selected pension funds in South Africa (especially in light of the recent financial and economic crisis) and experiences will be drawn from other economies.

Focus will be on privately managed pension funds with regular comparison with the Government Employee Pension Fund (GEPF).

This work will not delve into the actuarial valuation of pension fund returns even though mention will be made of the various valuation methods used in the industry. Industry benchmarks, surveys and fund Investment mandates will serve as a comparative tool to establish fund performance across various categories.

In order to provide a quality and contextual framework, this research will also look (albeit briefly) into the nature of South Africa pension funds and the proposed National Social Security Fund.

2.5 Limitations

Availability and access to recent and adequate data may pose some challenges. Also due to the scope of the pension fund industry, certain aspects of the industry may be overlooked in an attempt to focus the research.

Lack of sufficient data also prevents direct analysis of economically targeted investments (ETI's), thus the performance of ETI's are to a large extent inferred.

2.6 Prior Research

Various scholarly works have been written on the pension fund industry covering a wide range of subjects and quite a large number of these works focused on the financials of pension funds and a few others on the design and structure of pension funds. However, a developmental approach to the management of pension funds is only a recent development, particularly works focusing exclusively on pension funds in South Africa and its role in

national economic development especially on the back of a massive financial crisis as just witnessed across the globe.

Of note is the book by Gordon Clark, Pension Fund Capitalism, 2000. Clarke wrote about the direction of pension fund investments and made recommendations for alternative investment products for UK pension funds.

There is not a clear body of research in South Africa that deals with or formally assesses this issue holistically. There have been calls however and papers from several quarters, particularly labour for increased workers involvement in pension funds management and in assets targeting. The National Labour & Economic Development Institute (NALEDI) conducted various useful researches on South Africa pension funds and socially responsible investments.

The current National Social Security Fund proposal by government also provides some level of research into the socio-economic dynamics of pension funds management. The Treasury and department of social development offer some insights in this area.

2.7 Research Questions

- What is the role of pension funds in the socio-economic development of communities and nations? How should regulators and trustees adopt a broader view of their role in economic and infrastructure development?
- How have pension fund investments contributed to job creation in South Africa, housing and infrastructural development. What is the future of the investment patterns of pension funds?
- How do economically targeted investments contribute to the overall Investment performance of pension funds?
- What should be pension funds approach to a social responsibility investment policy?

2.8 Methodology and technique

This study will be a data based research study. It is an analytical research study, using qualitative techniques and analysis of historical records and documents to establish the relationship between pension fund investments and economic development in South Africa.

A qualitative analysis will be undertaken to compare the performance, investment patterns and objectives of certain privately managed pension funds, and to evaluate the nature of the impact of these investments on the socio-economic well being of the people. It employs the macro theory in understanding the greater and wider effects of pension fund investments on human development.

Parallel surveys will be designed for the pension funds and investment managers to compare and assess their alternative investments practices, characteristics (for example, size, number of members, age etc), and identify the socio-economic impacts of pension fund investments.

Meaningful comparison of pension fund investment allocations over a ten year period will also be done by analysing annual reports of pension funds.

Top ten JSE listed companies, and several other dedicated socially responsible investment funds have been selected for the purpose of this research.

This research will also make use of secondary sources. Study will be based on literature review, information available on the internet, annual reports of pension funds, industry benchmark surveys and discussions with experts in the industry. Relevant activities and publications of the Development Finance Institutes and the International Monetary Fund, World Bank and other development agencies will also be reviewed.

Furthermore, case studies focusing on regulations and investments of pension funds vis-à-vis economic development from economies in North America, Europe, South America and eastern Asia will be undertaken.

2.9 Overview of the chapters

The rest of the research work is structured as follows: Chapter three provides a literature review of works on pension funds and development studies, with the aim of providing a conceptual link between economic development, social responsible investments and pension funds. Then chapter four focuses on a detail and contextual background to the work. It looks at the nature and structure of pension funds in South Africa, and how pension fund investments are regulated.

Chapter five examines the rise of alternative investments (AI's) and its growing relevance to pension fund investments. It further explores the relationship between AI's, pension funds and labour unions.

Chapter six takes a more in-depth look at the nature and pattern of pension fund investments in South Africa, with particular emphasis on its socio-economic development impact. It examines certain funds and corporations with socially responsible investment considerations.

Pension fund reforms usually have an overriding effect on the socio-economic wellbeing of the people, thus chapter seven focuses on the proposed social security and retirement fund reforms in South Africa. And finally chapter seven presents the main conclusions of this research work.

Chapter Three

Literature Review

3.1 Background

There are increasing demands for a more sustainable and responsible investment of pension fund assets across the globe[39].

In the words of the GEPF, 'We have entered a new era that requires us to change our ways for the better in order to promote real and inclusive long-term growth, shared real prosperity and decent job creation, and a greater global economy' (Greater Good, 2010).

The Freshfields' report of 2005 and 2009 paved the way for a deeper look at the investment patterns of institutional funds and its impact on society. It was instrumental in the promotion of the integration of environmental, social and governance (ESG) issues into institutional investments. The report argues that:

"through the integration of ESG issues into investment policymaking and decision – making, institutional investors and the companies they invest in will be able to sustain their wealth creation role and play their fundamental role in the creation of a more sustainable global economy that invests in real and inclusive long term growth, genuine prosperity and job creation" (Freshfields 2005, 17).

These investors are becoming aware of the need to take into account ESG issues particularly pension funds and others with the intention of taking a long term perspective, the question is how?(UNEP-FI, 2009). The next section focuses on a conceptual clarification of the term economic development and economic growth.

3.2 The concept of economic development vs. economic growth.

Economic growth has been widely defined by various authors. It is a concept used to categorise nations and sometimes refers to the measurable wealth of

[39] As earlier mentioned , the widespread mass protests witnessed in some of the developed countries are indication of the extent of the public's discontentment with 'business as usual' attitude of corporations and their ways of doing business.

nations and individuals in the form of Gross Domestic Product or Gross National Product.

For practical purposes however, economic development will be seen as those activities that promotes national growth through the promotion of, individual wealth, job creation and poverty alleviation. The International Economic Development Council (IEDC) puts it better as follows: “it can be described by objectives of which the most common are the creation of jobs and wealth, and the improvement of quality of life. Economic development can also be described as a process that influences growth and restructuring of an economy to enhance the economic well being of a community” (IEDC n.d).

Wikipedia describes it as the development of the economic wealth of countries or regions for the well being of their inhabitants. According to Sper (2009, 4),” It is a process of raising the level of prosperity and material living in a society through increasing the productivity and efficiency of its economy”

Economic development is therefore different from economic growth, which is measured by an increase in per capita income, increase in Gross National Product or Gross Domestic Product. Economic development implies a more progressive change in the socio-economic lifestyle of the people[40].

This view is supported by Friedman who defines economic growth as “an expansion of the system in one or more dimensions without a change in its structure and economic development as an innovative process leading to the structural transformation of social systems, development is a phenomenon which occurs over a long period of time”(Ibid).

According to Sen (2000,3,4), and in a further attempt to explain economic development not just in terms of income and wealth ,” development requires the removal of major sources of unfreedom, poverty as well as tyranny, poor economic opportunities as well as systematic social deprivation, neglect of public facilities as well intolerance or over activity of repressive states.”

[40] The Human Development Index (HDI) is used to measure the quality of life among a particular group of people or country.

Furthermore and according to Seers (1967), development is about outcomes i.e. development occurs with the reduction or and elimination of poverty, inequality and unemployment within a growing economy. Todaro (1981, 23) sees three objectives of development:" (1) producing more life sustaining necessities such as food, shelter and health care and broadening their distribution, (2) raising standards of living and individual self esteem, and (3) expanding economic and social choice and reducing fear".

In order to focus the debate around the role of pension funds in economic development, written works and opinions around infrastructure and economic development will be articulated in the next section.

3.3 Infrastructure and Economic Development

In the context of this research and further to the aforementioned, economic development can be described as those infrastructural projects (construction of roads, airports, railroads, electric power plants etc) that enhance the production of goods and services and job creation in any country. Similarly, social investments will be considered as investments in projects that are deemed to have some ethical considerations or that enhance its social value, for example hospitals, schools and universities (Alonso et al 2009).

As states grapple with the aftermath of the economic and financial crisis, and worsening financial deficits, some experts are of the opinion that exploring alternative usage of domestic savings by essentially redirecting them towards investment in infrastructure could help to reduce the existing lags and have an important impact on economic growth.

International experience provides outstanding evidence , not only regarding the impact that this type of financing can have on the economy but also with regards to the clear advantages that the participants in pension funds could earn in return for incorporating infrastructure related financial assets in their portfolios. Infrastructure investments tend to show outstanding profitability while allowing for the reduction of the portfolio aggregate risk and at the same time balancing the horizons of long term assets and liabilities managed by these industries (Inderst 2009).

Aschauer (1989, 11) contends that private investment financing of infrastructure spend among other things:

- (1) "Allows for the fiscal consolidation of the public budget, freeing resources for other social expenditure or reduce tax burdens.
- (2) Improves the allocation of resources, transferring the cost of infrastructure projects to the user or beneficiary, thus improving the efficiency and equality of use and,
- (3) That the social nature of pension funds offers an added advantage, the potential benefits of private management of infrastructure projects with the financial support of pension funds, translates into improvements in the well- being of the population itself by increasing the living standards of the retirees".

However, he suggests that the pool of domestic assets (savings) should be invested in assets that meet some condition of risk/returns that are appropriate to the purposes for which they were created. In this sense direct investment in infrastructure projects by pension funds can be a very reasonable option if the necessary and sufficient conditions are present. Factors such as regulation, risk coverage, assets and adequate financial markets are elements that need to be optimized so that these conditions are met. Trustees as well as government are likely to accept this type of mutually beneficial collaboration if the above conditions are met. The next section examines the opinions around the roles and responsibilities of pension funds in economic development.

3.4 Pension funds and economic development

As mentioned in the introductory section of this chapter, pension fund investments and its role in national economic planning has become crucial consequent to the global economic and financial crisis, and the growing recognition by investors and society at large, of the economic, social, and environmental challenges facing individual countries.

The social malaise created by the economic crisis of 2007/2008, and worsened by new realisation of a deeper crisis in 2011, has renewed calls for an all inclusive approach to development.

The notion of the developmental state in the 60's and 70's was such that economic development was considered strictly a state project, and that real

and sustainable development is not possible without redistribution of income. A theory largely predicated on the assumption that there was a less developed entrepreneurial class and suspicion that foreign capitalists would accumulate wealth and not uses it for the benefit of the country[41]. However, as a result of numerous shortcomings inherent in this theory, it has been established that economic development cannot be left to the state alone; it has to involve the participation of society and business (Simutanyi 2006. 2).

According to Shunmugam (2010, 2), 'it is quite important that the development state ensures that there is appropriate regulatory actions to prevent greed-driven individual and institutional participants from building up collective irrationality in markets'.

With the realisation that the Bretton wood's prescribed 'liberalised economy model' for most developing countries, in the form of a structural adjusted programme (SAP) had failed to solve the economic problems of most African countries (in some cases, SAP has been established to have contributed to the economic woes of these countries in the 80''s and early 90's), a bigger role for the state in the economy has begun to gain traction ,albeit in the form of a state directed economic development[42].

The issue is no longer that economies grow or need to grow, but how they grow. In this sense, financial tools such as institutional investments have the power to affect social, economic and environmental outcomes (Giamporcaro, 2010).

The case for a direct impact investment is made for developing countries such as South Africa as they face more pressing social priorities such as unemployment, social transformation and infrastructure development[43].

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[41] This is the crux of the developmental state theory of development.

[42] A development that was once frowned upon by the western world and the Bretton wood institutions (IMF and the World BANK), but has now apparently been adopted by these countries and institutions in the aftermath of a global financial and economic crisis that continues to send shockwaves to the markets, and which was partly due to insufficient or lack of government oversight.

[43] According to Whaites (2008, 3),'the private sector is the engine of economic growth. Domestic and foreign private enterprise and capital have a crucial role to play in ensuring a sustainable economic development in South Africa.

Economic development in South Africa will not be sustainable and meaningful without the inclusion of the mass of the population. Economic policy even if market oriented, should aim at redistribution of wealth (Simutanyi 2006, 5).

Sadly though, it has been observed that these development goals in most of the developing nations often are prioritised at the expense of environmental issues. Giamporcaro suggests that environmental concerns are not mutually exclusive, as the long term investment performance is highly dependent on the activities of today's behaviours and its impact on sustainable development. "The long-term interest of fund members or beneficiaries will not be best served if the value of benefits paid out in future is eroded by the resultant impact of climate change and environmental footprint" (ibid, 11).

According to Alonso et al (2009, 6), pension fund investments in economic development projects can take two forms:

- Indirect Investments: pension funds invest in fixed income instruments or equities of companies linked to the construction or management of infrastructure projects. Indirect investments of this nature provide the asset portfolio with some particular characteristics of risks and profitability that are specific to this sector; meanwhile the acquired assets can belong to listed or unlisted companies. With regard to listed companies, economic and market crisis can have important effects on pension funds, reducing their value and associated benefits as witnessed in the recent global financial and economic crisis. And as for unlisted companies, the valuation of their assets is much more complicated and therefore participation of rating agencies is necessary.
- Direct investments – As pension funds seek new categories of assets that would diversify their asset portfolio in order to limit their exposure to market volatility, they are beginning to focus on the direct investment in infrastructure projects. Through project finance or a public-private partnership model, the pension funds acquire assets linked to the return provided by a specific infrastructure, which can more or less be insured by the state or international financial institutions. In turn, the direct investments use asset targeting models or community investing models

often times referred to as socially responsible investments Another more direct effect of infrastructure projects on the economy is how they affect families. The availability of certain facilities such as schools, hospitals, public sewage, access to drinking water, electricity telecommunications etc are elements that have a direct impact on the well being of households. These infrastructural projects are not only used as a means of production, but also have an important social function that translates into economic development.

The United Nations Environmental Program's Financial Initiative (UNEP-FI) and its Principles for Responsible Investment (PRI) initiative are the major promoters of pension funds adopting a more responsible investment practices and the integration of economic, social and governance(ESG) issues into the mainstream investment practices of pension funds. The PRI initiative was launched in 2006, and has a total of more than 700 signatories representing more than US$21trillion in combined assets. In becoming a signatory to the PRI, investors commit to acting in the best long-term interests of their beneficiaries, first in their fiduciary role, as ESG issues can affect performance of portfolios, and second, applying the principles better aligns investors with the broader objectives of society [44](Cranston 2009).

The next section looks at the social responsibility of pension funds investments, as this is increasingly becoming a key imperative of any type of capital outlays.

3.5 What are Socially Responsible Investments?

Socially responsible investments (SRIs) are a very broad concept, and are sometimes referred to as ethical investment (EI) or more recently as Responsible Investments (RI)[45]. SRIs involves investments that are aligned with the investors' values.

[44]In South Africa, the Government Employee Pension Fund (GEPF) is a signatory and has indicated its willingness to act as a responsible investor

[45] The concept has taken numerous forms in recent times and often times refer to investments with social and economic benefits.

According to the Social Investment Forum (2008, 1), 'these values may be of a religious, social, cultural or other nature'. SRI advocates the integration of personal values and social concerns with investment decisions, in a way that asset classes can earn competitive returns while building a better tomorrow. In the words of Heather Jackson, It can be described 'as investing with your heart' (Cadiz 2010).

De Cleene and Sonnenberg (2004, 5) defined SRIs as "investments that combines an investors financial concerns with its commitment to social concerns, such as social justice, economic development, peace, or a healthy environment"

SRI activities can be traced to the 1950s and 1960s in the United States, where trade unions deployed multi employer pension funds monies for targeted investments. The United Mine Workers Fund invested in medical facilities for example, and the International Ladies Garment Workers Union and International Brotherhood of Electrical Workers financed union- built housing projects. Certain 'screening' policies were also adopted by most of the United States investors by refusing to invest in South African companies during apartheid. These efforts played a crucial role in bringing the concept of SRI into the international scene (Giamporcaro 2010).

Since the late 1990s, SRI has become increasingly defined as a means to promote environmentally sustainable developments. Although there are differing manifestations of socially responsible investments, all involve the inclusion of social standards in investment decisions (Bruyn 1987, Carmichael 2005, Ellmen 1989).

According to Quarter et al (2001, 16) "investment decisions are not simply based on the rate of return (the typical standard) but also on some social criteria (e.g. impact on the community) that may interact with the rate of return". The next section looks at the three distinct forms of social responsible investments

3.5.1 Subsets of Socially Responsible Investments

SRI can be divided into three categories namely: Assets screening, Asset targeting and Asset management.

3.5.2 Asset screening

It involves the application of social screens, either negative or positive, to investments. Negative screens or sanctions occur where the funds prohibit particular investments. Where asset screening is positive, investments are directed to a fund with a positive social goal, for example to encourage the quality of the environment or to pursue more general ethical objectives.

3.5.3 Asset Targeting

There are two elements of asset targeting by pension funds:

- Economically targeted investments (ETIs) refer to a strategy where a fund targets one or two percent of its assets for specific social goals e.g. affordable housing for low income earners (Carmichael 2005, Jackson 2004). This form of responsible investment is predominant in less developed countries. In South Africa, it involves infrastructure development, Black Economic Empowerment and other forms of social transformation.
- Community investing, a sub set of socially responsible investment allows for investment directly into community based organisations. Community investing institutions use investors' capital to finance or guarantee loans to individuals and organizations that have historically been denied access to capital by traditional financial institutions. These loans are used for housing, small business creation and education or personal development. Money invested in a community development financial institution may be used by that institution to alleviate poverty and inequality or create more accessibility to capital and financial markets.

In addition to direct investments in economic development, pension funds are using credit enhancement as a way of lending credit rating so projects can move forward in a way that may take the form of venture capital funds (Hagerman et al 2005).

3.5.4 Asset Management or shareholder activism

It involves both individuals and funds that are concerned about issues typically related to the governance of companies in which the fund invests. Activist shareholders use an equity stake in a company to put public pressure on its management. This is one of the major criticisms of pension funds, and SRIs centres on the fiduciary duties of pension fund trustees and the 'prudent rule' governing the investment of pension fund assets[46]. There are divergent views on what constitutes the ultimate interest of the fund members, beneficiaries and dependant's vis-à-vis the investment of pension fund assets. The next section articulates the varying opinions in this regard.

3.6 Fiduciary Duty of Pension Fund Trustees

The management of any big pension fund can be a daunting task for trustees as it has a direct effect on the financial sustainability and potential benefit levels of its members, and even a more profound impact on the overall economy (Iglesias and Palacios 2000).

As mentioned earlier, there are divergent views on the role of pension fund trustees in the management of assets. All pension Funds are fiduciaries because they manage assets on behalf of others are required to be prudent in the management of pension fund assets, by always seeking the best possible rate of return for the plan members. To avoid conflict of interests between the fiduciary and that of the plan members, the Pension Fund Acts of most jurisdictions, imposes a high standard of conduct on a fiduciary's behaviour and investment decisions.

3.6.1 International Experience

SRI's have grown quite popular internationally, even though it is more prominent in some parts than others. Below are some of the international trends in SRI's.

3.6.2 The Canadian experience

In the words of Carmichael and Quarter (2003, 1)

[46] Companies over the years have continually focused more on shareholder value at the expense of other stakeholders. Pension funds by virtue of their size can make a significant difference in the economic activities of the companies in which they invest in without necessarily sacrificing financial returns for their members.

"Canadian legal opinion on this matter has been heavily influenced by the 1984 decision of the court of the queens bench of England, the widely cited Cowan v Scargill case, Cowan v Scargill {1984} 2 All E.R .750, in which union trustees for the coal miners fund insisted that there should not be investments in energy industries in direct competition with coal. Justice Megarry, writing for the court, ruled against the trustees, stating that when the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests are normally their financial interest, the trustees must not refrain from making the investments by reasons of the views they hold".

Consequent to the above ruling in Canada, trustees of pension funds have been very cautious about making investments that do not maximise the returns of the plan members. Carmichael (Ibid, 13) notes further in his report that:

"the former chair of the Ontario securities commission, issues a warning that probably reflects the norm for the social investments for pensions in Canada,, if ethical choices do not lower investment returns, the practical (and legal) reality is that trustees are unlikely to face judicial interdiction regardless of their motivation. If investment returns are lowered, trustees are in trouble".

Andrew Jackson, a former senior economist at the Canadian labour congress, takes the point further and suggests that a fund "invests for a positive rate of return but that the fund does not have to compete with best rate of returns" (Jackson 1993,2). In his opinion, there can be an acceptable trade off between maximising financial returns and doing good.

3.6.3 The United Kingdom's experience

In some of the key findings of the Freshfields report of 2005 and 2009, Quayle Watchman Consulting cited the commentary from the House of Lords of the UK Parliament, specifically those made by Lord McKenzie during the passage of the Pensions Bill in 2008 in relation to pension fund considerations and the duty to have regard for ESG issues:

" There is no reason in law why trustees cannot consider social and moral criteria in addition to their usual criteria of financial returns, security and diversification. it is an obligation on pension fund trustees not simply a right or option to state in their statement of Investment Principles what the funds guidelines are on responsible investment and to what extent social ,environmental or ethical considerations are taken into account" (UNEP-FI 2009).

Quayle Watchman Consulting is cited further in the report as saying

“ it should also be noted ,at the very least by way of assuaging the fears of those who foresee a need to build legal bulwarks against litigation for breach of pension fund fiduciary duties, that it is clear that investment, financial and business institutions have adopted a number of voluntary obligations which provide for ESG considerations to figure highly in investment ,financial and business decision making without legal challenge or concerns being voiced over a breach of fiduciary duties. For example, the Principles of Responsible Investments, the Equator principles and the UN Global Compact Principles have been adopted by over 550 investment institutions.”

Under current UK Company Law legislation, the Companies Act 2006 imposes duties on company directors to report on the environmental and social impacts of their business activities. The Department of Trade and Industry (DTI) Companies Bill guidance on the duty of directors to promote success of the company under section 172 of the 2006 Act[47], also adds that ‘success’ is to be judged in terms of long – term increase in the value of the company rather than short – term gains.

UNEP-FI (2009,23) contends that if one considers the above statements and the example of the 2006 Act on directors duties and uses it as a precedent or model for the duties of all those who invest in the future prosperity of companies, it is arguable that the duties of pension fund trustees are similar to company directors common law statutory fiduciary duties, but if anything, because of the special relationship between trustees and beneficiaries, are more extensive and more long-term than the duties of company directors.

Responsible investments as mentioned earlier in this work, also imposes even a more duty of care on the trustees of pension funds in the process of investment decisions. The Freshfields report (2005, 24) also noted that:

“there is nothing inconsistent with the fiduciary duties of pension funds in taking into account ESG considerations in investing or divesting assets, and that it may be an unlawful breach of fiduciary duties for pension fund trustees, or on behalf of the trustees by the asset manager, to fail to consider ESG considerations where there is a material nexus between investment value and an ESG consideration or considerations. Such examples include investing in coals, oil and gas companies, in a way that does not take into account climate change mitigation measures such as carbon emission allocation and trading schemes.”

[47] This Act is the principal replacement duty for the common law fiduciary duties of company directors

3.6.4 South African experience

The South Africa Pension Fund Act of 1956 regulates the affairs of all pension funds and trustees. This duty of care imposed on the trustees is also known as the "prudent man rule". This rule as contained in the PF Circular 130 compels trustees to examine all reasonable options, deliberate carefully and record their deliberations in order to justify their final decisions. These requirements mean that all assets held for the benefit of others must be prudently managed for the exclusive benefit of the plan member.

Recently, the Economic Development Minister, Ebrahim Patel hinted that government will mandate pension funds to invest up to 5% of their assets in SRIs, particularly ETIs[48]. Adding momentum to Patel's announcement, the GEPF officially launched its policy on Responsible Investing. The GEPF believes that integrating ESG issues in investment decisions can assist in creating more ethical companies and ultimately offer improved long-term risk-adjusted returns (Greater Good 2010).

In order to focus the research work, ETIs[49] will form the bedrock of the SRI debate, and thus the next section deals with some of the academic opinions around economically targeted investments (this is a brief introduction into the subject as a detailed study will be done later in chapter four of this study).

3.7 Background to Economically Targeted Investments (ETIs)

ETIs are dual purpose investments with the investment decision made in the joint interest of the society and plan members. Dual purpose investing involves the investment of assets for two goals:

(1) 'Achievement of a risk/adjusted market rate of return and

(2) Achievement of some social or other economic gain external to the investment projects cash flows' (Marr, Nofsinger & Trimble 1995, 11).

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[48] Pension funds currently invest less than 1% of total assets in socially responsible investment vehicles.

[49] Economically targeted investments are a sub set of SRI investments; it refers to investments in specific infrastructural projects within a country or region.

Presently most money managers and plan sponsors of pension funds in the private sector have largely avoided an ethical dilemma of trying to serve two masters.

The first widespread mandate for investment managers of public pension portfolio to share their fiduciary duty occurred with the divestiture of firms from their portfolios that did business in South Africa during the apartheid period[50].

ETIs only emerged in the late 1980s. Data and empirical analysis of these investments are scarce. ETIs are investments that are designed to stimulate economic development, growth or job creation for a specific group or region. These investments often take the form of mortgage programs, construction loans for projects with union workers, venture capitals, commercial development programs, private equity.

Many divergent views exist on the role of pension funds in the growth and development of a nation. Some authors on pension fund management have suggested that large publicly managed funds are often used to achieve objectives other than providing pensions. However the current trend in pension fund investments is to combine both retirement benefits and collateral benefits as part of the fiduciary duties of the funds. More and more scholars are accepting the alternative investment model as a subject worthy of academic consideration.

The influence of government can be harmful when investment policies are influenced by objectives unrelated to pension provision. Often if the fund is large enough, there are important fiscal policy ramifications and temptation to use the fund as sources of deficit financing. Private voluntary pension funds rely on favourable tax treatment and are often subject to certain restrictions on investments and withdrawals.

Mandates and restrictions are not always explicit; they can also take the form of investment principles or guidelines that steer the portfolio toward social and

[50] Earliest form of socially responsible investments involved asset screening by major companies and institutional investors in the United States and the United Kingdom, who refused to invest in South African companies or companies with interests in South Africa during the struggle against apartheid system in South Africa.

economic development objectives. Guidelines in Mauritius for example provide that 30% of the portfolio should be invested in areas with a "social dimension" and even specifies the acceptable loss of return from this type of investment. In South Africa, allowance is made for about 5% to be invested in socially responsible investments, even though in reality only about 1% is actually invested (Greater Good, 2010).

3.8 Rate of return

The criticism against responsible investment strategy centres around the rate of return, and that investment in SRIs by pension funds are likely to reduce these rates, yet there does not appear to be any evidence to support this point of view. Although there is the tendency that public funds that are subject to political interference may be forced to make investments that do not yield the best rate of returns particularly in the absence of strict regulations, however supporters of ETIs contend that the low rates of return (should that be the case) can be justified by the added economic benefits.

Others feel ETIs can provide both competitive market rates of returns and additional collateral benefits. Whereas opponents of ETIs believe that fiduciary standards of the "exclusive benefit" rate must remain solid and feel that most ETIs fall into the role of the state[51].

Many ETIs are designed to create or keep jobs for the local economy. Proponents argue that, investments in the local economy as an ETI have low correlation with traditional pension investments (like stocks and bonds), and will therefore lower the risk of the investment portfolio. Opponents on the other hand, argue that ETIs may have low correlation with traditional investments but they are very highly correlated with the local economy, when the local economy suffers, government employment costs increases while tax revenue decreases.

[51] The notion of the development state in the 60's and 70's was such that economic development is a state project and thus the state should take the lead in infrastructural development projects.

As is usually the case in developing countries and more recently in most developed countries (subsequent to the financial crisis), ETI projects often cannot get financing from private sources or from local state or federal governments struggling with budget deficits. The debate in the industry is therefore whether pension fund assets should be used for projects with dual purpose goals i.e. financial and social objectives:

"If an ETI expects a market rate of returns for its expected risk – level, then there is clearly no conflict between the social objectives and the member's interest. If the ETI expects a below market rate of return, could a fiduciary prudently fund the investment?" (Nofsinger et al 1995, 23).

Some make the argument that pension funds should be allowed to accept a below market rate of return if adequate "externalities"[52] accrue to the plan members especially as both private and public pensions have grown dramatically over the years. Some observers began to see these funds as a mechanism for achieving socially and politically desirable objectives., and thus investments that would foster social goals such as economic development and home ownership became desirable (Rifkin and Barber 1978 and Litvak 1981).

Community investing, particularly in housing projects are a very important area of development that pension funds can have a great impact. ETIs recognize the inefficiency of the market for housing finance and thus providing an opportunity for impact investing through innovative forms of housing financing.

The works of Munnell and Sunden (1999, 33) lends credence to the growing relevance of pension funds in addressing the acute poverty and lack of access to financial markets prevalent in developing economies, the authors agree that "public pension funds can do little if markets are perfect but can improve the allocation of capital if gaps exist due to redlining, discrimination or the absence of a secondary market". The Ferlauto and Claybourn study

[52] Externalities refer to certain social and collateral benefits other than the financial returns that accrue to the pension fund members. For example ,a plan member may be satisfied that his assets are invested in building community link roads that invariably creates jobs for his unemployed children .

(1993, 6) also points out that a successful ETI programme requires a sensible investment selection procedures as well as a commitment to market reforms. They identify three practices as necessary for success:

" Firstly, state legislatures can authorize ETI activity but they should not be involved in picking specific investments. The latter decision must rest with the retirement system. Secondly, ETIs cannot be considered in isolation, they must be incorporated into an overall fund strategy of geographic and asset diversification. Thirdly, the retirement system must institute regular evaluation of ETI investments".

Examples of ETIs of pension funds can be found in every region and in countries of every income level, where pension funds are often directed toward infrastructure projects or state enterprises. Varying levels of government's intervention in the investment patterns of pension funds can be found in Turkey, where the state planning board directly intervenes in investment policy.

In Jordan, the board that manages pension fund investment tries to meet criteria which include those established within the framework of the national development plan. Also in Tunisia, the government required investment in "equipment bonds", and the Egyptian and Moroccan reserves are invested through development banks (Iglesias and Palacios 2000).

3.9 Conclusion

This chapter stressed the fact that SRI's and particularly ETI's are highly controversial, and so is any study undertaken in this area. More so as it deals with issues for which there is not yet a body of research in South Africa.

The recent financial and economic crisis has shown that pension fund investments in traditional asset classes, tend to overreact especially during times of extreme market volatilities, such as that seen in 2007/2008. Global equities lost an average of over 40percent of their values and most developed nations were forced to slash interest rates drastically and in some cases to zero percent.

It was also established that investments in hedge funds, mergers and acquisitions, venture capitals, private equity and socially responsible

investments, popularly known as alternative investments has thus created new opportunities for pension fund investments to achieve good returns adjusted for risks, whilst also ensuring that pension funds realign their objectives with that of the larger society.

The chapter also debated the issue of trustee's fiduciary duties and asks that perhaps it is time that trustees of pension funds, particularly in developing nations begin to rethink their fiduciary duties, and consider incorporating ESG issues into their investment patterns, if any long term and real benefits is to be achieved for its fund members in an environment where a meaningful and sustainable economic development can be guaranteed.

Many ETIs are designed to create or keep jobs for the local economy and there are numerous examples of developing countries particularly in Africa where governments have had to direct pension fund investments towards certain identified infrastructural projects. Critics of ETIs wonder if such targeted investments are indeed beneficial to the fund members, for whom the fund exists in the first place.

The recent Draft Code for Responsible Investing by Institutional Investors and The King Report on Corporate Governance South Africa (King III) in South Africa further lends credence to the ever increasing demands on companies, asset managers, trustees and all stake holders, for more responsible investment patterns.

In order to provide some structural background to this study, the next chapter will look at the nature and structure of pension funds in South Africa.

Chapter Four

Nature and Development of Pension Funds in South Africa: Structure, Design, Governance, Investments and Taxation.

4.1 Introduction

Pension funds are an integral part of a nation's social security system, and for a great number of people, personal retirement savings usually account for the biggest percentage of their lifetime personal wealth.

Pension funds could also serve as an additional safety net[53], particularly in the face of a dwindling personal wealth consequent on a severe financial and economic crisis such as seen in 2007/2008.

Furthermore, and on a macro-economic level, pension funds greatly contribute to the deepening of national financial markets and overall economy through the investments of its assets. Therefore an understanding of the world capitalist economy or more specifically, an investigation into the impact of the financial markets on any given economy cannot ignore the role of institutional funds such as pension funds.

Despite the varying nature of pension funds across nations, it is acknowledged that all pension funds exist to provide some form of benefits to fund members and their dependants as a protection against poverty in later years.

Thus any meaningful assessment of the impact of pension fund investments on a nation's economic development will among other things, explore the existing institutional and structural framework, and its socio-economic relevance.

This chapter therefore seeks to undertake an investigation into the pension fund structural framework with a view of identifying the strengths and weaknesses, gaps and challenges that are facing the industry. It will serve as

[53] This will depend on the structure and investment patterns of these funds. Typically pension funds are required to be prudent in their investments and are therefore expected to be a little more protected from losses arising from stock market crashes.

a forerunner to the chapter on the proposed National Social Security Fund (NSSF).

4.2 Background to the structure of South Africa's pension fund industry

The South Africa pension fund system is multi-layered in structure. It comprises non – contributory, means- tested public benefit program; various pension and provident fund arrangements; and voluntary savings also known as retirement annuities.

Historically, South Africa operated the Pay- As- You- Go (PAYG) system which was also unfunded[54], and converted to a fully funded pension scheme just before the end of the regime of the National Party in the early 1990's.

The current pension fund system allows for privatised arrangements based on occupational and individual forms of cover, with a supplementary means-tested old age pension acting as a safety net. The old-age grant provided by the government[55]is the main source of income for 75% of the elderly population in retirement (Global Investor 2010).

Private pension funds accounts for over 44% of current world Gross Domestic Product (GDP), and in South Africa, both private and public pension funds account for over 31% and 48% of GDP respectively (Tausch 2010, 3).

The industry consists of numerous defined benefit (DB) and defined contribution (DC) funds (broadly known as pension and provident funds), retirement annuity funds, umbrella funds and preservation funds.

[54] Pay- as- you- go system refers to a pension system where the contributions made by current employees and employers go directly to finance the pensions of retired workers, it is usually an unfunded system.

[55] South Africa has a high poverty rate which cuts across the young and old members of the society, exasperated by a high level of unemployment in the country. A large proportion of the country's budget goes into funding its social welfare system.

This chapter is divided into four main sections; the first section looks at the definition and the regulatory framework of pension funds in South Africa; the next section discusses the various types and the broad categories of pension funds; the third section will examine the regulation of pension fund investments; and the last section will look at the issue of retirement and withdrawal benefits of pension funds, and the taxation of pension funds.

4.2.1 Definition and regulatory framework

Retirement funds are a pre-retirement savings plan, generally designed to provide workers with lump sums at retirement and an income when they are no longer earning a regular income from employment. It is also a tax deferred savings vehicle that allows for the tax-free accumulation of savings for later use as a retirement income

Pension funds may be set up by employers, insurance companies, governments or other institutions.

The Pension Funds Act No. 24 of 1956 (hereafter referred to as the 'Act') defines retirement fund, or a "pension fund organization" as:

"(a) any association of persons established with the object of providing annuities or lump sums payments for members or former members of such association upon reaching their retirement dates or for the dependants of such members or former members upon the death of such members or former members : or

(b) any business carried out under a scheme or arrangement established with the object of providing annuities or lump sum payments for persons who belong or belonged to the class of persons for whose benefit that scheme or arrangement has been established, when they reach their retirement dates or for dependants of such persons upon the death of those persons" (Botha et al 2009, 865).

The above definition however only refers to occupational schemes and non-occupational schemes[56]. This definition was amended by the Financial Services Law General Amendment Act No 22 of 2008 to include a third type of pension fund organization, namely:

[56] Occupational schemes are funds which have been established by an employer for the benefits of its employees, and non- occupational schemes refers to funds where there is no employer /employee relationship such as Retirement Annuity Funds.

"(c) Any association of persons or business carried on under a scheme or arrangement established with the object of receiving, administering, investing and paying benefits, referred to in Section 37C on behalf of beneficiaries' payable on the death of more than one member of one or more pension funds" (Ibid ,865).

This amendment refers to beneficiary funds[57].

4.2.2 Legal entity

The Act sets the requirements for the registration of a fund and its subsequent recognition by the Registrar of Pension Funds[58].

The effect of this recognition is that the fund acquires a legal identity and therefore has the power to enforce its decisions, rules and activities under the law, capable in law of suing and being sued in its own name.

Furthermore, a retirement fund is a trust fund, which means that it is subject to the basic principles of the common law of trusts that specifies important codes of behaviours for the trustees of that trust. The board of trustees therefore has real responsibilities of which the trustees are liable in law for its decisions and actions (Downie 2008, 9).

4.2.3 Governance

Pension fund legislative landscape is quite diverse and comprises different acts and regulations.

They are governed by more than 60 pieces of legislation including but not limited to:

- The Pension Funds Act No. 24 of 1956- the first legislation to recognise and supervise pension funds

[57] Beneficiary funds were established following the debacle associated with Fidentia Asset Management (Pty) Ltd, an unregulated trust fund, in 2007 and the misappropriation of benefits belonging to widows and orphans of deceased mine workers.

[58] The industry also comprises 'official funds', which are not supervised by the 'Act', but are established by special laws for employees of the state and certain parastatals, acquire their subsequent recognition and legal status under such special laws.

- The Collective Investment Schemes Control Act
- Exchange Control Regulations
- Income Tax Act
- Financial Intelligence Centre Act
- Long Term Insurance Act
- Financial Advisory and Intermediary Services Act

Pension funds as trust funds are also required to have their own set of rules commonly referred to as the 'Rules of the fund'.

Regulations governing pension funds are onerous and are forever changing. Some of the seemingly high costs of administration associated with certain pension funds have been attributed to the cost of complying with the numerous and frequently updated regulations.

4.2.4 Fund management

Pension funds in South Africa are mostly privately managed and even public funds such as the Government Employee Pension Funds (GEPF) which is managed by the PIC, a publicly owned company, still operates in a manner comparable to any private company.

According to Hendricks (2008, 12):

"Pension privatisation has taken on a variety of different forms in South Africa. It encompasses the private management not only of employee's benefits, but also of a whole range of interlocking private controls over the investment of public funds. In confirming this trend, the Annual Report of the GEPF states quite clearly that the GEPF has grown and now operates very much like any large private sector business".

There have been numerous concerns in the industry on the future role of private fund managers regarding the proposed National Social Security Fund (NSSF)[59]. However the National Treasury has come out strongly to reaffirm the private industry's continuing participation in the management of pension funds. The NSSF will be discussed in detail in Chapter Five.

[59] The proposed National Social Security Fund comprises four savings pillar, and will be publicly managed but with some private participation most likely in the areas of asset management.

4.2.5 Summary

Retirement funds can either be set up by the employer or can be voluntary, and are required to be registered by the applicable authorities or bodies. The next section looks at the various types and classifications of pension funds albeit under very broad categories.

4.3 Types of pension funds in South Africa

The pension fund industry landscape is very diverse and intricate in nature. It is made up of numerous types of funds sharing a similar goal of providing some form of benefits to members and dependants.

According to Botha et al (2010, 869): "The Act does not distinguish between the different types of retirement funds. These differences are contained in the Income Tax Act 52 of 1962, which also governs the manner in which contributions and benefits are paid and taxed. Accordingly in order to take advantage of tax deductions in a particular year of assessment, all retirement funds, irrespective of the type of fund are required not only to be registered by the Registrar of Pension Funds but also to be approved by the South African Revenue Services".

Notwithstanding the complex nature of the industry, some categorisation of pension funds can still be achieved albeit broadly. They can be categorised according to the nature and type of sponsor; funding-type; benefits; contributions; and how they are supervised/regulated.

The following are some of the broad categories of pension funds:

4.3.1 Individual schemes

These are available for those members who do not belong to an occupational scheme, who wish to make additional retirement savings outside of an occupational scheme and /or wish to preserve monies paid out from an occupational fund. Individual schemes often are known as retirement annuity funds.

4.3.2 Occupational schemes

This refers to retirement plans that are set up by the employers for the benefits of the employees (however occupational retirement plans are limited to those employed in the formal sector).

Employer-based retirement plans have a long history in South Africa and have been in place since 1956 when the Act was passed. Pension and provident funds are sometimes referred to as occupational funds.

They are essentially the two types of retirement funds used to provide occupational retirement plans. Both plans are similar but differ with regards to tax exempt contribution limits and retirement benefit options.

Provident funds may provide retirement benefits in one lump sum payment, while pension funds are only allowed to provide a maximum of one third of the total value as a lump sum.

Both employer and employee contributions to a pension fund deductible for income tax purposes are subject to limitations, whereas in a provident fund, only employer contributions qualify for deduction for income tax purposes.

4.3.3 Defined Benefit (DB) and Defined Contribution funds (DC)

Retirement plans may also be categorized as DB or DC plan depending on how the benefits are determined.

According to Wikipedia;

"A DB plan refers to a retirement fund that guarantees a certain payout at retirement, according to a fixed formula which usually depends on the member's salary and the number of years of membership in the plan".

"A DC plan refers to a fund that provides a payout at retirement that is dependent upon the amount of money contributed and the performance of the investment vehicle chosen".

These plans are discussed in detail below.

4.3.3.1 Defined benefit plans

Traditionally retirement plans have taken the form of DB's. Many DB plans include early retirement provisions to compensate employees who retire early (Usually in the form of employee's contributions plus a low interest).

DB may be either funded or unfunded. In an unfunded DB plan, no assets are set aside and the benefits are paid for by the employer or other pension sponsor as and when due. Pension arrangements provided by government in most countries are unfunded, with benefits paid directly from current workers contributions and taxes. This method of financing is known as Pay-as –you-go (PAYG).

In a funded DB plan, contributions from both the employer and the employees are invested towards meeting the benefits. The future returns on the investments and the future benefits to be paid are not known in advance, so there is no guarantee that a given level of contributions will be enough to meet the benefits required. Typically the contributions to be paid are regularly reviewed in a valuation of the plans assets and liabilities, carried out by an actuary to ensure that the fund will meet future liabilities. In DB, investment risk and rewards are assumed by the sponsor/employer.

4.3.3.2 Defined contribution plans

In a DC plan, contributions are paid into an individual account for each member. The contributions are invested and the returns (positive or negative) are credited to the individuals account. On retirement, the member's account is used to provide retirement benefits, sometimes through the purchase of an annuity. Money contributed can either be from employee salary or from employer contribution or both. Benefits for DC on retirement = contributions less expenses plus growth (or diminution).

In a DC plan, investment risks and rewards are assumed by each individual employee/member /retiree. Despite the fact the participant on a DC plan typically has some sort of input over investment decisions; the plan sponsor retains a significant degree of fiduciary responsibilities over investment of plan assets, including the selection of investment options and administration providers.

DC plan are by definition funded, as the "undertaking" made to employees is that a specified (defined) contributions will be made during an individuals working life.

The table below shows the main differences between a DB fund and a DC fund.

Table 4.1

Defined benefit vs. Defined contribution funds.

	Defined benefit	**Defined contribution**
Contributions	Contributions are deducted from salaries and/or made by employers on behalf of employees.	Contributions are deducted from salaries and/or made by employers on behalf of employees. These contributions go into individual accounts and accumulate with investment returns over the person's life up to retirement.
Choice and flexibility	Members have no choice in the investment selection	Because a DC system has individual accounts, and risks are borne by the employee, it is possible in some cases to allow people to choose their own investments, typically in the form of unit trusts. Most DC systems have default investment and a limited range of choices.
Amount at retirement	The benefit is pre-defined based on formula such as a percentage of salary for each year of service, or in some cases, a fixed monetary amount.	The benefit at retirement is unknown in advance and depends on the extent of contributions and the investment returns earned.
Payout structure	The benefit payout structure is pre-determined, e.g. either as	Most national DC systems allow retirees to use their retirement savings to buy regular income and

	a lump sum, or more often as a regular income. There is a specified formula for calculating the pension benefits.	to take a portion as a lump sum.
Who bears the risk?	The employer bears the risk that contributions over time may not be sufficient to meet the liabilities. However members face the risk of reduced benefits or indirectly higher cost through increased taxes over time.	Each member bears their own investment risk and 'lifetime earnings 'risk.

Source: Allan Gray (2010, 20).

Today the majority of employees in the private sector are covered by DC schemes while those in the public sector enjoy coverage under DB arrangements.

The shift from DB to DC dramatically took place during the 1980's and 1990's[60] when the so called provident funds were newly established. Despite the risk transfer from the employer to the employee, the shift was mainly viewed as advantageous for the employees.

In case employees with DB changed jobs, their contributions were refunded with a low rate of interest and employer contributions could only be included after a long period of service, depending on the rules of the fund. DC pension arrangements either appear in

[60] There was a massive move away from DB occupational funds to DC pension and provident funds in the 90's This move was mainly driven initially by trade unions and was only later supported by employers.

the form of a provident fund or pension fund established in terms of the Act. Both plans need approval by the Registrar of Pension Fund and the South African Revenue Services (SARS).

4.3.4 Funds which are supervised under the Act:

As mentioned earlier in the chapter, not all pension funds in South Africa are governed by the Act or registered with the Financial Services Board (FSB), majority of public pension funds are governed by a separate legislation. Funds registered with the FSB are as follows:

4.3.5 Privately administered funds

These are funds investing their assets on their own behalf, with bodies and institutions in the public and private sectors of the economy.

4.3.6 Underwritten funds

These are funds operating exclusively by means of insurance policies, issued by registered insurers in the Republic. These funds are required to register under the Act, but in terms of section 2 (3) (a) of the Act, they may be exempted from any other provisions of the Act the Registrar deems necessary.

4.3.7 Foreign funds

These are funds with head offices of the participating employers located outside the Republic. In terms of Section 2(2) of the Act, these funds are exempt from certain provisions. They are required to apply for registration in terms of section 4 of the Act and furnish security (guarantee) for the payment of benefits that may become payable to their members who are South African residents.

4.3.8 Official funds

In contrast to underwritten and self – administered funds, the Pension Fund Act does not supervise official funds. These are funds established by special laws for employees of the state and certain parastatal institutions. For example, Government Employees Pension Fund (GEPF), Temporary Employees Pension Fund, Associated Institution Pension Funds and Provident Funds, Transnet Funds, Telkom Pension Fund, Post

Office Pension Fund, Bargaining Council Funds (BCF).They are not under the Pension Funds Act[61].

Over the years, pension funds have also been further classified into exempt and non exempt funds:

4.3.9 Exempt and non exempt funds

In terms of administration, any person who administers the investments or payment of benefits on behalf of a fund must be registered with the Registrar of Pension Funds. Funds which perform these functions themselves are not required to register (It can be assumed that the pension fund is already registered by the FSB).

In the changes made to the Regulations to the Act during 1993 and 1994, the distinction between private and underwritten became obsolete[62]. Funds are now classified as "fully exempt", audit –exempt, "valuation exempt", or "non-exempt".

According to Downie (2008, 14):

"Under section 9 of the Act, a pension fund organization must appoint an auditor and in terms of section 15, the fund must, within six months of the expiry of its financial year, furnish the registrar with audited financial statements"

Section 2(3) (a) of the Act provides that the Registrar may exempt a fund from one or both of this requirements. Funds can thus be:

- Audit - exempt
- Valuation exempt

[61] However, there are a significant number of BCF that have voluntarily registered with the Financial Services Board (FSB) and are supervised under the Act (FSB 2006, 4).

[62] Funds used to be categorized as "underwritten" or "private" funds. The terms were always very confusing. The main difference lies in the manner in which the fund's assets are invested. In a privately administered fund, the assets may be invested in any assets provided they meet the requirements of Section 19 and Regulation 28 of the Act. An underwritten fund is that which invests its assets through an insurer and in policies of insurance (Botha 2010, 903)

- Both audit and valuation exempt.

"However the Registrar's discretion to exempt a fund from the audit requirements under the Act has been repealed so that as from May 2006, no fund can be exempt from audit. Funds which are both audit and valuation exempt no longer exists and only underwritten funds can be exempt from valuation" (Ibid 15).

Another type of funds that is worthy of mention here, are the umbrella funds:

4.3.9.1Umbrella funds

An umbrella pension or provident fund is a single fund which is established and usually managed by a life insurer. Any employer or a group of employers can apply for membership as a participating employer. The umbrella fund makes it possible for smaller employers who otherwise would not have been able to form their own funds, to join a fund. It carries the benefits of higher free group cover limits and lower administrative fees[63].

4.4 Preservation funds

Preservation funds are a form of retirement funds used to preserve a member's contribution over his/her working life. It can either be:

4.4.1 Pension preservation fund

It is essentially a Pension Fund and all the rules of the pension fund still applies, i.e. only one third lump sum may be taken at retirement.

4.4.2 Provident preservation fund

Similarly, the rules of the provident fund still apply, i.e. all the benefits may be taken as a lump sum at retirement[64].

Once again it must be noted that all the provisions of the Income Tax Act and the Pension Fund Act that applies to pension and provident funds also apply to

[63] Umbrella funds are becoming increasingly popular as administration costs of smaller pension funds continue to skyrocket. It is hoped that a large number of smaller funds will migrate to umbrella funds in order to take advantage of the economy of scale that these funds offer, and more so as the proposed NSSF kicks in.

[64] There are indications that provident funds may be increasingly phased out as government moves towards compulsory preservation of funds.

preservations funds. It must be approved by SARS as either a pension or provident fund.

4.5 Summary

As can be deduced from the above**,** the pension fund industry is highly fragmented, and according to the FSB (2006, 10-11), there are about 13 143 pension funds in South Africa ,with a total of about 11,191,877 members, and a total assets of about R1.6trillion. Please see appendix 1, 2 &3 for a detailed statistics on the pension fund industry.

The next section will examine briefly, the largest public pension fund in South Africa. Even though it is not a 'type' of pension fund as those listed above, it represents a significant part and history of South Africa's retirement fund evolution and a study of the country's pension fund industry will not be complete without mentioning this fund.

4.6. Public Funds

As mentioned earlier, South Africa pension funds comprise both private sector and public sector funds. All government employees whose conditions of service fall under the Public Service Act belong to the South African Government Employees Pension Fund.

4.6.1 The South African Government Employees Pension Fund (GEPF)

The GEPF is the 29th largest sovereign fund in the world with $74billion in assets, and over 95% of these assets are managed by the Public Investment Corporation (PIC), a parastatal investment management firm wholly owned by the South African Government (Watson Wyatt, 2009).

4.6.2 History of the GEPF:

The apartheid system in South Africa resulted in a highly differentiated system of pensions. Each Bantustan government and every quasi-department had its own pension funds for various arms of the government, with no uniformity at all.

"Since there was a wide variation in the benefit of each of these funds, a Task Team on Restructuring Pension was appointed by the democratic government (1994) to make recommendation on ways in which the benefits could be standardized. The Task Team was representative of a range of constituencies, including members of the government, the security services, the education sector, other employer organization and an actuary"(Hendricks 2008, 11).

Subsequent to the recommendations of the Task Team, all the public sector funds were merged into a huge GEPF IN 1996, directly accountable to the South African National Assembly.

"This rationalization of the various apartheid-era pension schemes followed a provision of the interim constitution of the Republic of South Africa (Act No 200 of 1993), which entitles all public servants, to a fair pension and provides for the establishment of a pension fund to manage them" (Ibid ,12).

The GEPF continues to play a significant role in the pension fund industry, not only because of its size but also because of its commitment to responsible investing and broader SRI issues.

The next section examines how pension fund assets are invested, and the regulations governing the investments of these assets.

4.7 Pension fund investments

The investment of pension fund assets understandably represents a vital aspect of a pension fund business. Not only do the future benefits of members and dependants of the fund depend on the efficient and prudent management of these assets, the investments of these assets could also have an overriding impact on the financial markets and overall economy.

In order to meets its objectives, pension funds assets are invested in a manner that ensures the best possible overall return on investment at an acceptable level of risk.

The pattern of investments depends on a numerous factors, such as the size of the fund, the risk profile, expertise of the trustees, the fund sponsor etc. Pension fund assets can be invested in different investment vehicles ranging from unit trust

investments to pooled portfolios. The investment industry comprises numerous vehicles to cater for these different needs.

However, given that pension funds are trust funds, the trustees are obliged to be prudent when exercising their fiduciary duties, and to comply with the investment parameters for the assets of the fund as set out by the Act (Botha 2010, 908).

The next section looks at the various regulations governing the manner in which pension fund assets are managed.

4.7.1 Prudent Investment Requirements

The Registrar of Pension Funds has laid down certain investment requirement and guidelines in order to avoid cases of inappropriate balance between risk and return. These directives are contained in:

- The Pension Funds Act, Section 19
- Regulation 28 of the Act
- Circulars from the FSB

4.7.2 Section 19 of the Act

, This Section governs issues such as:

- The condition under which a fund may invest in the Employer's business
- The conditions under which a fund may grant loans, such as deposits for a house for its members.

4.7.3 Regulation 28

The Regulation 28 lays down the prudent investment requirements for the investment of the assets of funds governed by the Act, and was promulgated in 1962. (This regulation is also referred to as the prudential investment guidelines, [PIGS])

This regulation is described in the works of Botha et al, (2009, 911) as follows:

"Regulation 28 prescribes certain maximum limits on the various types on investments in which a pension fund can invest. The maxima relate to the fair value of the assets of the fund under the direct control of the trustees, and exclude from consideration insurance policies:

- That provide any form of guarantee or
- Where performance is linked to the performance of underlying assets and the investments of the underlying assets complies with the requirements of regulation 28.
- Unit trusts which conform to the requirements of regulation 28".

Table 4.2

Regulation 28 Requirements

Asset category	**% of maximum assets**
Ordinary and preference shares	75% (of which no more than 5% in any unlisted company or Development Capital Market Stock and no more than 10% in any listed company with a market cap. Of less than R2bn and no more than 15% in any listed company with a market capitalisation of more than R2bn)
Property, property shares and property trusts	25% (of which no more than 5% in any one property)
Shares and property as above combined	90%
Claims secured by mortgage bonds on immovable property	25% (of which no more 0.25% for any one individual)
Krugerrands	10%
Cash, fixed deposits, gilts and semi-gilts	No limitations except that no more than 20% of the fund may be invested

	in any one institution
Assets outside South Africa	20%

Source: Botha et al (2009, 250).

As at the end of 2006, 22% of total pension fund assets were invested in equities and another 8% in bills and bonds and 10% in foreign investments, compared to 23.3% and 8.6%, and 7.8%in 2005 respectively[65].

Due to the growing assets of pension funds, and given that there are more investment vehicles open to retirement funds, there has been numerous calls for a review of the Regulation 28[66]. According to the National Treasury, (2010, 3) 'Innovation and other developments since 1998, and the recent financial crisis, necessitates the urgent amendment of this Regulation'.

In light of the above, National Treasury recently presented a draft amendment to the Regulation 28 and has been submitted to the industry for comments.

4.7.4 The draft Regulation 28 of the Pension Funds Act {which gives effect to Section 36(1) (BB) of the Act}

The current Regulation 28 was last amended in 1998

The draft recognised a number of elements which have become applicable to pension fund investment vis-à-vis:

- The draft Regulation 28 will refer to Acts other than the Pension Funds Act that bear reference to Pension Fund assets and investments.
- Alignment of the definitions, asset categories and the limits applied to pension funds must be consistent between all applicable legislation.

[65] See appendix 4 & 5 for details on the total pension fund assets invested in line with the Regulation 28 of the Act.

[66] Particularly following the 2007/2008 financial crisis

- Recognition is given to the fact that investment channels have significantly changed with developments in derivatives, structured products and foreign investments.
- The exclusion from the requirements of Regulation 28 for insurance policies which incorporates guarantee has allowed funds and investments to by-pass the requirements of Regulation 28.
- No recognition is currently given to Islamic-compliant pension fund investments
- The global crisis has exposed pension funds to greater risk.

In response to the draft released with the 2010 Budget, and after receiving 31 comments, the final draft of the new regulation 28 was published on the website of National Treasury[67] on 23 February 2011. The effective date is 1 July 2011.

The new version of the regulation will ensure that;

- the regulatory response is proportionate to the specific risks identified;
- asset categories with similar/equivalent risks should have similar/equivalent limits;
- investment in riskier assets should not be banned outright, but the risks should be mitigated; and
- the true nature of the asset should be reported.

The National Treasury has also just recently (December 2010) eased exchange controls. Pension funds, unit trusts, asset managers and insurers could invest five percentage points more of their assets offshore, although it is unclear when these limits would take effect.

Government will also ensure that the investment framework for public pension funds like the GEPF are updated in line with Regulation 28 and current institutional limits.

[67] www.treasury.gov.za

The draft Regulation is quite important especially considering that pension funds are only allowed to invest a maximum of 2.5% of total assets in investments classified as "other assets", which includes derivatives; private equity investments; hedge fund investments; SRI's etc.

More flexibility is now afforded to funds in that specific reference is made to hedge funds and private equity funds[68].

According to the FSB report (2007), investments in other assets by pension funds accounted for 1.7% of total pension fund assets. Little wonder therefore that trustees of pension funds pay little attention to SRI investments as it only constitutes a minor part of the fund's total assets.

If SRI considerations are to become a significant part of pension fund investment policy, regulation must be amended to allow for a higher percentage allocation of assets into SRI's, especially when one considers that traditional investments have been shown to react aggressively to times of extreme financial and economic crisis. Perhaps, it is a good boost that government recently hinted that pension funds might be forced to allocate a minimum of 5% of total assets to SRIs.

However, what will be more desirable is not for government to prescribe for pension funds, but a case where trustees are able to broaden their fiduciary duties and begin to give a bigger attention to SRI issues in their investment policies[69].

4.7.5 FSB Circular

The Pension Fund Circular 130 requires every pension fund to have an investment policy statement which should be communicated to all stakeholders. This policy document amongst other things will set out who the fund's investment advisers are, the targeted performance benchmarks vis-à-vis each asset manager, whether the fund has a Socially Responsible Investment (SRI) policy and what this should entail.

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[68] The limit for each of these types of funds is 10% and for other assets not mentioned elsewhere 2.5% - the overall limit for investments in hedge funds, private equity funds and assets not mentioned elsewhere is 15%.

[69] See appendix 6 for the detail of the draft Regulation 28

The prudent investment requirements have been quite successful in mitigating the investment risk of pension funds[70], despite a number of criticisms from the industry regarding the seeming restrictive nature of the regulation. It is perhaps timely that government has proposed an amendment to the Regulation 28.

4.8 Summary

The GEPF continues to be a force in the retirement fund industry and particularly in its pioneer role regarding socially responsible investments.

Pension fund investments are therefore the focus of legislation and further reforms. The next sections looks at retirement fund benefits and the taxation thereof, as prescribed by the Act.

4.9 Retirement fund benefits

Having examined the various structure and types of retirement funds thus far, what is even of great importance is to examine the purpose of retirement funds.

Retirement funds exist to pay benefits to the members, or dependants of the fund members. The Act provides that all pension funds must provide minimum benefits to the members or their dependants. These benefits arise in cases where a member withdraws from the fund, retires or is deceased.

4.9.1 Retirement and withdrawal from pension funds:

In relation to pension funds, “retire” means to retire from employment and become entitled to the payment of an annuity or lump sum from the fund. The minimum retirement age will therefore depend entirely on the rules of the fund. With Retirement Annuity, the minimum retirement age is 55years. In relation to provident fund,” retire”

[70] The average pension fund have achieved a real return above inflation of about 5% annually over time, a total return of 11%, assuming 6% inflation(Business Day 2010, 22).

means to retire from employment and to become entitled to the payment of full benefits in terms of the rules of the fund[71].

For pension and provident funds, it is not possible for an employee who is member of his/her employer's pension fund and provident fund, to retire from the pension fund and to continue to contribute to the provident fund. When a person retires, he/ she retire from his/her employment and his membership of the pension and provident fund.

Paragraph 4(3) of the Second Schedule of the Income Tax Act provides that a member of a retirement fund cannot retire from the fund before he /she attains the age of 55years. Any lump sum benefit received from the fund before that age will be treated as a withdrawal benefit for income tax purposes unless directed otherwise by SARS (Botha 2010, 895).

[71] Provident funds are about to be treated like pension funds, which means that at retirement, members may only be allowed a third as lump sum.

Table 4.3

Retirement fund lump sums benefits

Withdrawal Benefits	**Retirement Benefits**
Any amount assigned under a divorce order and deducted from "minimum individual reserve'. (Paragraph 2 (1) (b) (IA)) of the Act .This amount accrues on date of election in terms of Section 37D.	Amount derived in consequence of retirement , and post – retirement conversion of annuities to lump sums
A withdrawal benefit transferred to another fund (a pension fund to a provident is an example (paragraph 2 (1) (b) (1B)) of the Act. The amount accrues on the date of transfer.	Amount derived from death.
Amounts paid out on withdrawal or resignation from the fund or other lump sum benefits – not as in paragraph 2 (1) (a), 2 (1) (b) (1A) and 2(1) (b) (1B) of the Act. In other words cash withdrawals.	Amount derived in consequence of the determination of the members employment due to Retrenchment of Redundancy (only for occupational funds)

Source: Adapted from Keith and Haupt (2010, 608-609)**.**

4.9.2 Death Benefits

One of the main purposes of a retirement fund is to provide benefits to the dependants and beneficiaries of a deceased member. The rules of the fund will typically stipulate the manner of payment on the death of the member.

Section 37C of the Act governs how the trustees should manage the payment process.

The death benefits will depend of the type of plan. Many pension plans also contain an additional insurance /risk benefits that pays benefits to survivors or disabled beneficiaries. This is over and above the minimum benefits payable.

The next section will discuss the taxation of pension fund benefits according to the Income Tax Act.

4.9.3 Retirement Fund Tax

Pension funds are regulated by the Income Tax Act[72] for tax purposes, and thus all benefits thereof are taxable in the manner as determined by SARS.

4.9.3.1 Taxation of lump sum benefits derived from a retirement fund:

As mentioned previously, benefits from all retirement funds arise in one of three ways, and may be paid in the form of a lump sum, an annuity or a combination of both. This section will deal with the taxation of lump sum amounts received as a result of resignation from the fund, retirement or death of the member.

4.9.3.2 There are two types of lumps sums dealt with in the Second Schedule, each with its own tax table. These are lump sums arising on:

- Retirement, death, or retrenchment (paragraph 2(1) (a) of the Second Schedule).
- Withdrawal, divorce, or transfers between funds (paragraph 2(1) (b)of the Second Schedule)

The first type is called a 'retirement fund lump sum benefit', and the second type is called a 'withdrawal benefit'. (Keith and Haupt 2010, 608)

The second schedule to the Income Tax Act determines how much of any lump sum benefit derived on death or retirement from a retirement fund is free from tax and the balance in excess of the tax-free portion constitutes "gross income" in terms of the income tax act.

[72] The Income Tax Act in South Africa defines and distinguishes between the various pension funds.

Paragraph 6 of the Second Schedule specifies the Tax exempt portion of lump sum benefits payable on withdrawal from a pension, provident and retirement funds.

"The benefits for retirement funds can generally be taken in the form of a lump sum benefit, an annuity or a combination of the two. An amount received by way of an annuity is fully taxable at normal income tax rates".

The amount payable as tax on lump sum from retirement fund depends on:

Whether it is a retirement fund lump sum benefits or a retirement fund lump sum withdrawal benefit and whether the tax payer has previously received a taxable lump sum benefit from a retirement fund.

"Paragraph (e) of the definition of "Gross income" in Section 1 of the Income Tax Act specifically includes the following in the "gross income" of a tax payer (subject to certain formula): A retirement fund lump sum benefits or retirement fund withdrawal lump sum benefit" (Ibid, 850).

Lump sums from official funds[73] are also taxable with effect from 1 March 1998, and are calculated in terms of paragraph 2A of the Second Schedule, and Formula C[74].

Table 4.4

Taxable income from lump sum withdrawal benefits:

Taxable income from lump sum	**Rate of tax**
Not exceeding R22 500	0 percent of taxable of income
Exceeding R22 500 but not exceeding R600 000	18 percent of taxable income exceeding R22 500
Exceeding R600 000 but not exceeding R900 000	R103 950 plus 27 percent of taxable income exceeding R600 00

[73] State and local authority pension funds.

[74] See appendix 7 for details on the tax treatment of retirement funds in general.

Exceeding R900 000	R184 950 plus 36 percent of taxable income exceeding R900 000.

Source: SARS 2009, 1.

Table 4.5

Taxable income from retirement lump sum benefits:

Taxable income from lump sum	**Rate of tax**
Not exceeding R315 000	0 percent of taxable of income
Exceeding R315 000 but not exceeding R630 000	18 percent of taxable income exceeding R315 000
Exceeding R630 000 but not exceeding R945 000	R56 700 plus 27 percent of taxable income exceeding R630 00
Exceeding R945 000	R141 750 plus 36 percent of taxable income exceeding R945 000.

Source: Ibid, 1.

Taxation of pension fund benefits remains a very topical and complex issue; it is as wide as the industry itself. The issues discussed above are therefore by no means exhaustive, please see appendix 8 for a comprehensive work on the taxation of pension fund benefits. The next section will look into the permissible tax deductions for all pension funds.

4.9.4 Tax deductions

Government currently subsidises retirement provisions through two mechanisms: the first involving allocations from general tax revenue to fund the means tested old age pension, and the second is a system of Tax Expenditure Subsidies (TES's) for individuals contributing to private retirement arrangements (RA's).

A significant amount is actually forfeited by government in the form of pension fund tax subsidies. Coutts (2010, 2) writes that:

"The effective total contribution subsidy for retirement provided was estimated at R17.8bn (net of deferred taxation) in 2005.Combining both the contribution subsidy and subsidy on retirement investment income gave a figure of R28.5bn or 1.9% of Gross Domestic Product".

In order for any contributions to a retirement fund to qualify for tax deductions under the Income Tax Act, such a retirement fund must be approved by the SARS as either:

- A pension fund
- A provident fund
- A pension preservation fund
- A provident preservation fund
- A retirement annuity fund

Employer contributions to approved pension and provident funds are tax deductible up to 10% of the employee's remuneration[75]. In practice SARS allows up to 20%.

Employee contributions to Retirement Annuity funds are deductible to the greater of:

- R1750
- R3500 less deductible contributions to pension fund in terms of the Income Tax Act: or
- 15% of essentially a non salary income or that salary income in respect of which no pension fund contributions are made.

The same deduction applies for employee contributions to pension funds except only 7.5% of pensionable salary is deductible. No deductions are allowed for employee contributions to provident funds.

The new amendment (referred to below) now provides for the deduction of any retirement annuity fund contributions in the hands of an employee, even if paid by the

[75] Government is proposing a uniform tax deductible amount for all retirement funds.

employer on behalf of the employee within the set limits above, and the employer contributions to retirement annuities are also tax deductible within the set limits.

Section 11(n) was amended with effect from 1 March 2010 where (ii) was added to the section, allowing an employee to qualify for a deduction on an amount contributed to a RAF by his/her employer on behalf of the employee, but only to the extent that this contribution is included in the gross income of the employee as a fringe benefit in terms of the Seventh Schedule (i.e. in terms of par (i) of the definition of gross income in section 1).

The contributions made by the employer to a RAF on behalf of his/her employee will be allowed as a deduction in the employers' tax calculation in terms of s 11(a), the general deduction formula.

4.9.5 Summary

The South Africa's National Treasury is tasked with constantly streamlining the pension fund taxation system to ensure that people who save for retirement are encouraged to preserve their savings until retirement, and some form of punitive tax measures put in place to discourage early withdrawals of retirement savings. This task is even more challenging when one recognises the effect of the recent global economic crisis on employment and socio-economic conditions of the average South African worker, a situation that's made early withdrawal of retirement savings more of a survival factor than anything else. Thus, government is forced to balance this socio-economic reality with its long term objective of compulsory preservation of retirement savings.

4.9.6 Conclusion

This chapter described the entire nature and structure of South Africa's retirement fund industry. It is evident that the industry is constantly evolving and is quite multi-faceted, with many layers comprising non – contributory, means- tested public benefit program, various pension and provident fund arrangements, and voluntary savings (known as retirement annuities).

The issue of governance and investment of pension fund assets as shown in the chapter remains the focal point in the industry. Supervision of the funds varies according to the legislation or Act establishing the funds. With over 13 500 private pension funds in South Africa, consisting of occupational pension funds, provident funds and retirement annuity funds, it is indeed a great task managing the affairs of these funds, thus the diverse nature of the legislative landscape.

The Investments of pension fund assets have also come under intense scrutiny, as shown in section 4.3. The Regulation 28 , which governs the way pension fund assets are invested have been criticised for being too restrictive and not dynamic enough to offer alternative investment patterns especially during times of extreme financial and economic crisis such as seen in 2007/8. The recent amendment to the regulation increased pension assets allocation to 'other' assets from 2.5% to 20%, a significant improvement from previous years.

The various calls from the industry for the review of the Regulation 28 gave rise to the recent draft amendment to the regulation, submitted to the public for comments.

The Chapter also looked at retirement fund benefits: withdrawal; retirement; and Death benefits and the taxation thereof. Government has built in various measures to streamline the way in which withdrawal and retirement benefits are taxed, replacing the hitherto complex tax tables with a much simpler one.

The deductibility of contributions to pension funds by employers and employees have also been streamlined, employer contributions on behalf of the employee to retirement annuity funds are now deductible for tax purposes. Recent draft amendments (effective

March 2012) propose a uniform tax deduction rates for all retirement funds, set at 22.5%.

Coutts (2010, 2) mentioned in this chapter that the overall contribution subsidy for retirement savings, including subsidy on retirement investment income is estimated to be about R28.5bn in 2005 only.

It was also established that the manner in which pension fund benefits are taxed remains critical to the achievement of government's goal of ensuring that a large majority of South African workers preserve their benefits at retirement.

The next chapter discusses the concept of alternative investments (AI's) and also examines the role of workers union and involvement in pension fund investments.

Chapter Five

Development of Alternative Investments (AIs) and increasing labour interest in social investments

5.1 Introduction

Chapters three and four dealt with the nature and structure of pension funds and the debates around pension funds and SRI's.

This chapter examines the correlation be drawn between SRI's and Alternative Investments (AI's) as they relate to pension fund investments.

Although AI's are not necessarily a new development in the investment industry, they have become popular after the massive loss in asset value during the 2007/08 economic and financial crisis, and also as pension funds increasingly move into new asset classes in search of yields.

The extreme volatility of the markets, combined with a growing pension liabilities linked to the growing number of older people worldwide [76] continues to drive pension funds into AI's.

AI's provide new sources of returns and better risk diversification in investment by offering pension funds better protection against market volatilities, inflation and interest rate risks (Inderst 2008, 4)[77]. Generating strong returns from a portfolio invested in equities is of little use if all the gains are subsequently wiped out. In the worst performing months for equities between January 1991 and December 2009, AI's,

[76] Number of people worldwide 65 and older may jump to 1.3 billion by 2040, from 506million in 2008 (Stewart 2007, 20).

[77] These view was supported by Alan Greenspan in his 2004 book 'The Age of Turbulence; Adventures in a new world. Greenspan highlighted the nervousness of the market, and warned that investors are in for a lot of volatility, and by implication further risks for traditional investment portfolios of pension funds.

particularly hedge funds and commodities, regularly outperformed equities, mitigating the drawdown in investor portfolios (State Street Global Advisors 2010, 2).

Further to the above, pension funds and other institutional investors alike are looking for more responsible ways of investing, especially as the issue of sustainable investments and environmental considerations begin to gain momentum[78].

This point t is buttressed by Kieman:

'Indeed there is a now a compelling body of both academic and empirical evidence that a sophisticated, return oriented analysis of ESG performance and strategic positioning can indeed enhance investor returns and /or reduce risk. Going forward, the most successful investors will be those best able to combine fundamental, qualitative, and the newly emergent,' non-traditional' sources of alpha i.e. out performance' (UNEP-FI The working capital 2007 , 19).

ESG considerations rest on a fundamental principle of sustainable investments: Institutional investors indeed seek to secure long term returns so they are able to keep the pension checks flowing to members. But long term investment returns cannot be secured without a healthy economy, and a healthy economy cannot be secured if the natural resources it depends on are not there 20 years down the road (UNEP-FI 2007, 32). According to Watson Wyatt (2010), only about 0.28% of the total global pension fund assets (416.2trillion) are invested in SRIs which underscores the huge gap in responsible investment by institutional investors globally[79].

Taking a leaf from Chapter 1, the need for comprehensive social welfare in emerging economies means that there is a growing expectation from business to take on the challenges, and Institutional investors because of their sheer size, also need to leverage

[78] Particularly following the corporate governance scandals of the early 21st century involving Enron; Arthur Anderson; WorldCom etc. that saw millions of workers and pensioners assets diminished vastly.

[79] In an attempt to correct this, 200 major investment managers with assets over $10 trillion, and including South Africa largest pension fund (GEPF), had committed to the principles of responsible investing (PRI) by 2007. This is indeed a testament to the fact that the world largest investors understand that integration of ESG issues is fundamental to good business and thriving societies" ('UNEP FI 'The working capital' 2007, 3).

their indirect control over investment and management decisions to influence business into aligning with broader goals' (UNEP-FI 2007, 40).

This Chapter is divided into two sections, the first section deals with the concept of Alternative Investments (AI's) and the various types of AI's used by pension funds. It also highlights some of the impact of AI vehicles on national economy. The second section actually addresses the uniqueness of South Africa pension fund membership and the ultimate beneficiaries, by examining the role of labour union in the investment of pension fund assets.

5.2 What are Alternative investments (AI's)?

AI's include physical assets such as real estates, complex or novel investing methods such as hedge funds, and private equities. It could also refer to responsible investment strategies that make use of asset classes different from traditional stocks, bonds and cash (Jefferson Capital Partners 2010, 1).

For the purpose of this research, AI's is examined in the context of a broader SRI strategy i.e. how AI's (Real estate, Private equity, fixed income, hedge funds) are used as vehicles for economically targeted investments (ETI) by pension funds. The next section looks at the justification for AI's inclusion in pension fund portfolio.

5.2.1 Case for AI's: Portfolio Diversification

Integral to the development of AI's and its adoption by institutional funds, is its ability to enhance portfolio diversification. As discussed in Chapter Two, traditional asset classes tend to correlate with one another and the overall markets during periods of significant market volatility.

AI's seeks to achieve returns both in bullish and bearish markets alike by exploiting financial market inefficiencies. It aims to deliver absolute returns and not merely outperform a benchmark index. Over time, AI's have achieved risk-adjusted returns higher than those of traditional asset classes.

For example Ai's have outperformed US equities by an average of 11% in eight of the last 10 years between 2000 and 2010, and globally, they have outperformed traditional

asset allocation by an average of 8.5% in nine of the last 10years (CMG 2010, 5, 87). There are two elements to the argument for the inclusion of AI's in pension fund portfolios: the risk/return argument and the modern portfolio theory.

5.2.2 Risk and Return

In an efficient market, risk is inversely related to returns. The main purpose of designing and managing an investment portfolio is to maximize total returns while keeping overall risk at an acceptable level. SRI's or AI's as the case may be, can pursue investment opportunities which have less correlation to traditional asset classes[80].

Behavioural science points out that psychological phenomenon leave investors subject to systematic errors which are then reflected in asset prices. The term sentiment is used to describe these errors. These sentiments may cause some assets to be mispriced, and can impact the relationship between risk and realized returns.

Diversification therefore seeks to build a portfolio with investment asset classes that offer different levels of risk and react differently to market events, by so doing the investor strives to reduce overall risk and improve overall performance (Global Impact Investment Network, 2011).

The Sharpe ratio is one of the numerous ways in which portfolio or investment risks are measured[81].

The table below shows the returns on AI's and traditional investments over a 10 year period, comparing each asset class performance in relation to the respective level of risk (Sharpe ratio) and volatilities (Standard deviation).

[80] Correlation measures the strength and direction of a linear relationship between the price movements of two asset classes over time.

[81] Sharpe ratio is used to measure and rank historic portfolio performance. Sharpe ratio divides the average annualised differential returns of a fund by its annualised standard deviation. The higher the ratio, the better the fund has performed.

Table 5.1 Returns on AI's vs. Traditional assets as of March 2007(Global USD)

	Asset Class	1 Year	3 Year	5 Year	10 Year	10 Year Std Dev	10 Year Sharpe
Traditional Assets							
	Public equity (MSCI EAFE)	20.7%	20.3%	16.2%	8.7%	21.0%	0.261
	Fixed income (Lehman global aggregate)	8.1%	3.4%	8.3%	6.0%	6.2%	0.317
AI's							
	Real estate (FTSE EPRA)	32.7%	28.5%	27.0%	13.7%	19.5%	0.480
	Infrastructure (UBS Infrastructure)	42.9%	33.6%	29.7%	14.2%	20.1%	0.492
	Hedge funds (Credit Suisse)	11.6%	10.3%	10.4%	10.3%	7.4%	0.766
	Private equity (Thomson venture economics)	22.6%	20.7%	12.8%	15.2%	26.9%	0.519

(Source: RREEF 2007, 5)

Over the ten year period ending 2007 as shown in the above table, all four AI's yielded higher returns than traditional equity and fixed income, and these returns were yielded at a much lower volatility than public equity, and consequently had higher Sharpe ratio than the traditional assets.

5.2.3 Modern Portfolio Theory (MPT)

This is an economic theory developed by Harry Markowitz in 1953. It argues that investors should focus on selecting diversified portfolios based on their overall risk-reward characteristics instead of merely compiling portfolios from securities that each individually has alternative risk-reward characteristics, that is, investors should select portfolios and not individual securities.

MPT rests on two pillars: portfolio return is the proportion weighted combination of the constituent assets' returns and; platform volatility is a function of the correlation of the component assets.

MPT therefore proposes that volatility is non –linear as the weighting of the component assets changes. An investor is able to reduce portfolio risk by simply holding a combination of assets that are non- correlated.

If correlation coefficient is less than zero {Correlation coefficient -1 < (r) <1)} the assets are inversely correlated; the portfolio variance and thus the volatility will be less than if the correlation coefficient is zero (FRM 2010, 5).

The Modern prudent investor rule redefines the standard of prudent investment to include: the duty of loyalty and the duty to diversify investment and; determine the prudence of an investment at the time it was made, using modern portfolio theory. Therefore investments are not assessed individually, but only in the context of their contribution to the overall portfolio (Global Impact Investment Network, 2011).

In an exercise conducted by the real estate and infrastructure division for the asset management activities of the Deutsche Bank AG (RREEF) in 2007, showing the returns/ performance of both a traditional portfolio[82] and a sophisticated/alternative portfolio[83] , It

[82] which allocates 60% to stocks and 40% to fixed income

was found that the traditional portfolio would have delivered strong results up to 1998, with sharp losses in 2000 during the Asian and IT bubble crisis, while the alternative portfolio was relatively insulated (RREEF 2007, 8).

It established further that between 1998 and 2006, a portfolio that included alternative investments would have better withstood economic shocks and market volatility, delivering a 9.6% annual total return compared to 8% generated by traditional portfolio. And at the same time, the alternative portfolio would have reduced risk, with a volatility of 12.0%, 170 basis points lower than the volatility of the traditional portfolio for the same period (Ibid ,9).

The next section now examines the two common types of AI's and its role in pension fund investment pattern.

5.3 Types of AI's

AI's comprises physical assets such as real estates, complex or novel investing methods such as hedge funds, and private equities.

5.3.1 Private equity (PE)

Private equity investing differs from most other forms of investments. Unlike lending or investing in publicly listed equities, PE combines both the provision of capital and expertise. The British venture capital association (BVCA) in 2006, defines PE as the 'equity financing of unquoted companies , at many stages in the life of a company from start up to expansion, together with management buy - outs and buy - ins of established companies that have real growth potential and which can be enhanced with PE support (Missankov et al 2006, 56).

Creating an environment where private equity capital is available helps spur economic development and supports the formation of strong and well managed companies. Little wonder that In North America, the average allocation to private equity by pension funds

[83] which allocates 45% to stocks, 25% fixed income and 30% to AI's

amounts to 8.2% of assets (New York State Retirement Fund in-State Private Equity Investment Program 2010, 10)

In South Africa, socio economic development is largely promoted by PE through Black Economic Empowerment (BEE) management and participation. BEE dominates the PE industry and is promoted in two ways:

Firstly through the ownership and managerial structure of the PE companies and secondly, through the funding sources for PE transactions which takes place in the market (Missankov et al 2006, 57).

PE investments are relatively illiquid and usually a long term investment (five to six years). PE investments can be classified as follows:

- Venture Capital (VC) - This refers to investments in companies that are at an early stage of development. It ranges from seed investments designed to develop a concept, funding to complete development of a product, to late stage investing, where expanding a firm's customer base is the investment goal. VC is frequently deployed in technology oriented companies. It's the highest risk form of investing, since the success of a portfolio company is affected by numerous risk factors- financial, market, operational and technology They are however capable of providing spectacular return.
- Buyout/Corporate Finance- Investments in existing operating business make up a large portion of the PE investment universe. These investments may include helping new owners finance the acquisition of a business, expansion of existing business, or to recapitalize a business to provide it greater flexibility to operate.
- Mezzanine- These are a form of corporate finance where the investment has characteristics of both a loan and an equity investment: debt and equity financing (Ibid ,14)

South Africa has one of the most sophisticated PE industries among the emerging economies[84].

As mentioned earlier, PE's are alternative investment vehicles for pension funds and in recent times, a significant portion of PE funds have been sourced from institutional investors such as pension funds.

Although PE's are well known for maximizing profit, they contribute immensely to development. As a long term provider of risk capital, they contribute to economic development by building sustainable businesses, increasing private sector participation in the economy, attracting private sector capital to the region and adopting world class levels of corporate governance (Development Bank of Southern Africa 2009, 2).

According to data from Venture Economics and Bloomberg, PE firms around the globe delivered on average 39.1 % annualized returns, between 1980 and 2005. This is an outstanding performance, and has helped strengthen several major public pension funds and defined benefit programs.

Despite declines linked to the 2007 economic crises, PE performances through the third quarter of 2008 surpassed the performance of equity markets. Five year PE investments were highest with an annualized returns rate of 12.2%. One year performance for PE in the period ending 30 September 2008 was - 8.2% compared to -21/.4% for the NASDAQ, and -22% for the S&P 500 Index (KPMG 2008, 2).

The table below shows some of South Africa's pension fund's asset allocation to PE transactions.

[84] The Southern African Venture Capital and Private Equity Association (SAVCA) has over 62 full members and 28 associate members.

Table 5.2 Private Equity Investment by South Africa pension Funds

Fund	Size of fund	Allocations
GEPF	R552bn	3.5%
Metal Industries	2 funds, total size R64bn	1%
Transnet	3 funds, total size R49bn	3% to 5%
Eskom	R40bn	3%
FNB Pension fund	R15bn	0.67%

(Source: KPMG 2008, 3)

According to SAVCA (2005), Independents (institutional investors) accounts for 50.6 % of PE assets under management as at 31 Dec 2009.

5.3.2 Impact of private equity investments

A unique role of PE in South Africa is its facilitation of BEE. Most of the PE deals concluded in recent years have a significant BEE component[85].

In an unpublished SAVCA – commissioned PE economic impact study in 2005, it was found that PE generally boosted economic growth in South Africa and was superior when compared with other forms of funding. PE's enabled higher gearing, and sometimes represented the only source of funding for companies facing solvency. Some of the impacts of PE investments in South Africa[86] according to the study over a three year period, from 2006-2009 includes achieving:

[85] As at December 2007, 69% of total funds under management were classified as black-influenced i.e. transactions with at least 5% black ownership.

[86] The largest social impact of PE investments can be seen in BEE deals, leading to BEE ownership of 26% of the JSE listed companies.

- an annual employment growth rate of 9%
- employment of 5% of formal sector employees (427,000 jobs).
- an average domestic employment growth rate of 10% per annum compared to 1% across all other businesses in South Africa.
- pre- tax profit growth of 16% per annum compared to 14% for listed companies
- super growth in exports of 31% per annum on average compared to 24% national figures.
- average research & development growth of 7% compared to 1% of JSE listed companies (Development Bank of Southern Africa 2009,3).

5.3.2.1 PE cons

PE's like other AI vehicles are relatively a more risky asset class, and are often criticised for their poor marketability and low liquidity.

PE's are a long term investment with an average of about 10-20 years investment period, thus making it difficult to exit the fund in the short term. This somewhat poses a concern for certain pension funds with high liquidity requirements[87]. Although in the case of South Africa pension funds ,such concerns may be limited given that funds allocation to PE's and other alternative investments alike are limited by the Regulation 28 (amended) to maximum of 20% of total fund assets, and thus reducing any tendency for liquidity concerns as a result of funds investment in PE funds.

Further to the above is also the issue of valuation. PE's typically invest in unlisted equities, and most of the underlying investments are often subjectively valuated. Having said that, there are new attempts to standardise the valuation of PE investments, and organisations like the International Private Equity Association, and the South African Venture Capital Association helps promote valuation guidelines (Missankov et al 2006, 26).

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[87] This will be true for funds with a higher number of pensioners or members exiting the fund due to retrenchments or retirements.

5.3.3 Hedge Funds

Hedge funds and mutual funds typically perform the same economic function, hedge funds however exist because mutual funds historically do not deliver complex investment strategies, and are relatively strictly regulated.

However, following the recent financial and economic crisis, hedge funds are becoming heavily regulated as well, and the bulk of the industry is experiencing some convergence towards the more traditional mutual fund model. Ironically, mutual funds have begun to experiment with more complex investment strategies.

Hedge funds can be used to manage, reduce and indeed hedge such liability risks, it allows for risk reduction via increased diversification away from traditional asset classes, and increase returns (Stulz 2007, 7).

Hedge funds have undergone a period of intensive growth in recent years, reaffirming the importance of hedge fund in portfolio diversification for institutional investors. Early modern portfolio theory by Markowitz, even before hedge funds became popular, showed how holding short positions in a diversified portfolio can enhance the efficiency of the portfolio.

Hedge funds like other AI's, are able to provide returns that are uncorrelated to traditional asset classes. For instance during the market crash of 2000, the MSCI World Equity Index fell close to -50%, while in contrast the hedge fund industry was able to preserve capital and generate modest positive returns during period of asset inflation, and genuine capital preservation during periods of declining asset values' (Stewart 2007,32).

The 2000 Harvard study by Elizabeth Dart, established further that adding hedge funds to a long only balanced portfolio (similar to that prescribed by the Regulation 28 of South Africa Pension Fund Act) significantly increases the efficiency of that balanced portfolio.

The 2007/8 financial and economic crisis tested the hedge fund industry as an alternative investment. The hedge fund industry approximately lost -19% in 2008,

marking the worst performance in the industry, and calling into question its validity. Subsequent to the crisis however, hedge funds had to adapt its model to the change in market behaviour, by scaling back on operations to refocus on fresh investment opportunities that inevitably, are from such periods of market dislocation.

The result of this adaptation is reflected in the performance of the industry in the 1st quarter of 2009. International hedge funds provided a modest positive performance of 0.52% against further deterioration of global assets, which left the MSCI World Equity Index down -11.8 % (Stewart 2007, 33).

As a means of mitigating the relatively high investment risk in hedge funds (discussed below), many institutional investors now invest in funds of hedge funds[88], rather than an individual hedge fund. These funds usually seek to beat cash by at least 3% and at low levels of volatility.

5.3.3.1 Hedge funds in South Africa

According to the Financial Mail (2010) hedge funds in south Africa are still in their infancy stages, with just about R32bn assets under management.

Pension funds have not followed the trend towards alternative investments to the level as seen in the developed countries, a phenomenon due largely to the restrictions placed by the Regulation 28 of the Pension Funds Act[89].

Top hedge funds in South Africa returned 8.65% in the 3 year period ending 2009, average return was 5.75%, and worst performance was -6.35%.This performances were superior to the returns the JSE/ALSI in the same period, with an annualised returns of -11% (Financial Mail, 2010, 1).

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[88] A fund of hedge funds is a hedge fund which invests in individual hedge funds and monitors those investments, thereby providing investors with a diversified portfolio of hedge funds, risks management, and the ability to share the due diligence costs with other investors.

[89] Until the recent 2011 amendments ,Regulation 28 as discussed in chapter 2 , allowed only 2.5% of pension fund assets to be invested in 'other assets' category, that included hedge funds and other asset types.

5.3.3.2 Hedge fund cons

Hedge funds particularly have come under stringent criticisms following the recent financial and economic crisis. They have been accused of manipulating the markets and in some countries; hedge funds have now been subjected to more regulations than before.

Hedge funds are a non transparent, loosely - regulated, and expensive investment vehicle. They have been criticised as having a high portfolio concentration, often over leveraged and providing investors with limited rights to redeem or transfer shares.

Having examined the impact of pension fund investments and the development of AI's and its role in national economic development, the next section looks at the current trend in pension fund investments vis-à-vis SRI investments.

5.4 SRI trends in South Africa

As discussed in Chapter one, SRI in South Africa is still in its infancy. According to the Sanlam Benchmark Survey on Retirement Funds (2010, 48), only about 14% of umbrella funds have a SRI policy in place, up from 8% in 2009. And about 9% of funds surveyed invest up to 28.6% in SRI vehicles while the majority of funds (89%) invest only about 7.1% in SRI's.

The figures are a little different for stand - alone funds, where 17.5% of funds have a SRI policy in place, up from 10% in 2009. 59% of funds surveyed invest 5.7% in SRI vehicles, and only 9% invests up to 17% in SRI portfolios.

In another study on asset managers, 89% of asset managers surveyed had no formal SRI strategy for managing pension fund assets, while only 11% had some formal strategy in place. To put into perspective, only about 11% of R2.3trillion of assets managed by asset managers in South Africa may be managed under some formal SRI strategies[90] (Giamporcaro 2010, 31&49).

[90] These include direct investment in dedicated SRI funds and indirect SRI investments i.e.companies with ESG considerations.

5.5 Summary

The ways in which pension assets are invested have attracted a lot of attention in recent times from investors, regulators and society at large. Investments in SRI's and AI's continue to gain momentum as pension funds seek for better yields and less volatility on one hand, and more responsible and sustainable investments on the other hand.

The main drawback for pension funds has been the restriction on permissible percentage investment in AI's, according to the Regulation 28 of the Pension Fund Act. However recent amendment to the Regulation 28 of the Pension Fund Act has further given impetus to the growth of SRI in the country , and provides a welcome opportunity for institutional investors to significantly increase their allocation to 'other' asset category which includes PE, Hedge Funds etc, perhaps to the maximum percentage of 22,5%. It is reflective of Governments intention to encourage pension funds and other institutional investors alike to invest in development projects.

The next section examines labour union's involvement in pension fund investments, particularly in South Africa. The size of union sponsored funds and the unique prevailing inequalities and challenges facing the majority of South African workers (whose funds constitute a significant portion of total pension fund assets) are a natural attraction for union's involvement in the management of pension fund assets.

5.6 Labour's involvement in pension fund investments

Rising unemployment, stagnant wages, globalization and severe economic crisis have resulted in labour unions increased interest in how pension fund assets are being managed, thus the role of labour unions in this regard have evolved over the years, from mere focus on workers benefits to a broader SRI focus. According to Carmichael and Quarter (2003, 8):

'Unions in the public and private sector worked hard to win better benefits for their members, whether or not they had the right to negotiate. For a long time, the focus was on the actual amount of the pension level of benefits. The 'administration' of these funds itself was left to employers. Within the last two

decades, there has been a huge shift, from benefit and entitlements under the plan, to one where the health of the pension fund is considered the major factor in attaining one's benefits, and therefore control became a critical need'

Even more so, unions are looking to have more effective control in order to make more fundamental changes in the financial system. The financial system includes the stock market, and in labour's perhaps exaggerated view, stock values have often been known to fall when unemployment comes down, possibly because too many workers with so many jobs may not be 'good news', as it could possibly result in inflation. Slavery, sweatshops, environmental negligence and other forms of corporate abuses can be very profitable for companies, as they reduce costs, and augment the corporate bottom lines.

"Therefore short- term profits becomes the overriding goal, even if they result from violating human or labour rights, polluting the environment, or damaging the long term well being of families and communities. The question therefore was whether to use workers money in an investment system that is anti-worker and anti-society?"(Carmichael and Quarter 2003, 13).

According to the Congress of South Africa Trade Union (COSATU), the majority of pension fund members in the country are low income earners who live in the rural townships. Socially responsible investments will impact the lives of these workers greatly, considering that the cost of retirement in a less developed township could erode the pension fund benefits of these members faster than other pension fund members in more affluent areas. Thus, to this particular category of workers, investment returns as important as it is, must be evaluated in terms of its real benefit and sustainability.

Labour argues that in addition to returns and diversification goals, pension funds should target investments to benefit the economic climate where the fund beneficiaries live and work, in other words, sustainability should inform all investment decisions

In defined benefit (DB) plans, technically speaking, unions are only concerned with the ability of the plan to generate sufficient revenues to pay the benefits agreed upon, however if the investments yield an insufficient returns to meet the liability of the fund, or if investments generate a surplus, unions become involved.

With the growth of defined contribution (DC) funds however, unions have become more concerned, as the risk of investment and ultimately of retirement, is borne by the workers.

The growth of SRI has taken unions a step further and involves them in formulating actual investment policies. Unions are perhaps more willing to become involved in shareholder activism, where corporate culture is called into account. Some unions are also willing to use a small portion of their pension fund assets for SRI Investments. These strategies have proven practical in generating both jobs for unions, ad also in yielding a good rate of returns for the pension plan members (Ibid 14).

According to the 2003 annual report of the National Labour and Economic Development Institute (NALEDI), pension fund investments affect growth through improved economic efficiency and resource allocation, and capital market development. Both prices and quantities of long term financing may be favourably affected by such investments which can in turn raise productive investments and improve resource allocation[91] (Clark and Hebb 2003).

Labour unions were created to protect and advance not simply the financial returns of worker's funds, but also their social welfare, and the social and economic welfare of the communities in which they live (Jackson 2004, 7).

Croft (2009,13) argues that pension funds are by definition a deferred wages of workers, and can be called workers capital, as it primarily refers (in most cases) to the assets accumulated in collectively funded schemes in order to provide workers with financial security at retirement.

Investment managers that support SRI's make decisions using more information than available to most investors. They take into account the quality of labour relations, the impact on environmental quality and sustainability, and effect on communities as clues to potential risk and profit. They aim to earn large and sustainable returns by considering factors other investors are missing from ordinary analysis (Croft 2009, 13).

[91] This is the viewpoint of proponents of both the Macro and the Developmental State theory of economic development

In South Africa, the widening gap between the rich and the poor lends credence to the gaps created in market failures. Despite periods of economic growth, South Africa remains one of the most unequal societies in the world, with about 25% unemployment rate, and perhaps an even higher rate among youths with less than Matric (High School) qualification (Africa Investor 2010, 1).

And with only about 1% of the $320bn worth of pension fund assets in South Africa allocated to SRI investments, labour unions increasing interest in ETI's and decent job creation continues to grow (Ibid, 1).

Pension funds own a large share of corporate stocks and therefore can drive markets. Labour is well aware that market failures may result in capital gaps that have significant impacts on specific sectors of the economy, employment and workers rights[92]. These market failures result in a systemic lack of access to capital by not only the micro-enterprises, isolated regions, inner cities and labour-intensive sectors, but also among the unemployed (Ibid ,15).

As mentioned previously, AI's and specifically ETI's include investments that expand employment opportunities in a particular geographical region, increase the availability of affordable housing, strengthens capital infrastructure, revitalize urban neighbourhoods, help rural economies, develop small and medium size companies or support green industries.

International trend is in favour of unions supporting the mobilization of government resources and domestic savings for the purposes of investments in sustainable development and poverty reduction, with special attention to protecting core labour standards.

However, labour often finds itself in difficult position regarding its position on certain SRI objectives and how to balance certain seemingly conflicting interests. For example a company that is seen as socially irresponsible, or a mining company that has no real

[92] The capital gaps created by these markets failures can also yield significant investment opportunities, and that's where AI's become relevant.

anti -pollution strategy, employs a significant number of union jobs. Labour is usually cut in between, as it therefore becomes a case of job creation vs. environmental concerns.

Bruce Cameron, writing on socially responsible investments, highlighted this sometimes conflicting position of SRI proponents:

"Trade Unions and even local communities will be likely to support the development of mines as being a social investment, because it provides jobs and alleviates poverty. The green lobby however is more likely to oppose it, as it could potentially be detrimental to the environment. What this shows is that SRI issues are not mutually exclusive and must be viewed as a whole in investment decision making. A mining project could create jobs and also be green. There are no trade - offs in SRI investments" (Personal Finance 2010).

Accordingly, SRI goals or activities are not mutually exclusive, as a matter of fact; achieving environmental goals should not be at the expense of a financial or social goal. There can be ways to incorporate all three bottom- lines[93] in investment decisions, and that is exactly the purpose of ETI investments. A mining company can successfully be energy efficient and still create jobs for the community.

5.7 Summary

There is an increasing recognition by the trade unions globally that the investment of workers capital should reflect the fundamental interest of workers, not only by bringing competitive financial returns, but also by contributing to the long term viability of the economy, social standards, societies and the environment. Alternative investments can do that, and that's where the worlds of workers capital and ETI's meet.

[93] Tripple- bottom line investing refers to investments with environmental, financial and social objectives.

5.8 Conclusion

Section 1 of the Chapter examined the concept and growth of Alternative Investments particularly on the back of the recent financial and economic crisis. Investments in SRI's and AI's continue to gain momentum as pension funds seek to achieve better yields and less volatility on one hand, and more responsible and sustainable investments on the other hand.

AI's have not only provided pension funds with more efficient portfolio diversification and better returns with less volatility, but have also contributed greatly to the overall economic development, particularly private equities.

As shown in Section 1 of the chapter, PE's have contributed greatly to social and economic transformation in the country through its numerous BEE backed transactions. It has also provided seed capital to numerous start-up businesses and helped sustain a lot more small and medium-sizes=d companies.

Recent amendment to the Regulation 28 of the Pension Fund Act has further given impetus to the growth of SRI in the country , and provides a welcome opportunity for Institutional investors to significantly increase their allocation to 'other' asset category which includes PE's, hedge funds etc, perhaps to the maximum percentage of 22,5%. It is reflective of Governments intention to encourage pension funds and other institutional investors alike to invest in development projects.

Section Two delved into trade unions and their role in pension fund investments. The section created a link between the purpose of labour unions and the ultimate objective of pension funds. It created a link between workers interest and pension fund benefits.

The section established that there is an increasing recognition by the trade unions globally that the investment of workers capital should reflect the fundamental interest of workers, not only by bringing competitive financial returns, but also by contributing to the long term viability of the economy, social standards, societies and the environment. Alternative investments can do that, and that's where the worlds of workers capital and ETI's meet.

The size of union sponsored funds and the unique prevailing inequalities and challenges facing the majority of South African workers (whose funds constitute a significant portion of total pension fund assets) are a natural attraction for union's involvement in the management of pension fund assets.

The next chapter will examine the patterns of pension fund investments i.e. type of investments, strategies employed and the investment vehicles used, and its impact (either directly or indirectly) on national economic development.

Chapter Six

Pension Fund Investments

6.1 Introduction

The rapidly growing size of pension fund assets and the investments thereof, have made pension funds an integral part of every nation's fiscal and economic planning. As mentioned in the Introductory chapter of this research work, pension fund investments have become topical in recent times, particularly as they suffered huge asset losses during the 2007/8 financial and economic crisis.

This crisis fuelled the development and widespread growth of Alternative Investments (AI's), which as discussed later in the Chapter, seeks to offer investors inter alia, more efficient portfolio diversification and superior returns (with less volatility) relative to the traditional asset classes of equities, cash and bonds.

Also linked to the effects of market volatilities are the increasing demand by investors and some stakeholders, for a more conscious and responsible investing by fund managers. Traditional investments could also be socially responsible to the extent that it incorporates environmental, social and governance (ESG) considerations in its investment decision making process.

AI's comprise investments in private equities (PE's), hedge funds and real estate. AI's usually represent vehicles used for socially responsible investments (SRI), but not exclusive to it. AI's have come into the spotlight particularly for pension funds looking for superior returns or to further enhance their portfolio diversification, and as mentioned earlier AI's as an asset class behave differently to traditional asset classes, which are known to react extremely to market volatilities.

For the purpose of this research, AI's will be examined in the context of its role in facilitating pension funds investments in ETI, and the impact thereof on economic development in South Africa.[94]

[94] AI's in this context will be interchanged regularly with other concepts like ETIs, SRI's, ethical investments, impact investing, social investing or responsible investing as they all seek to achieve the same goal in general terms.

Impact investments or economically targeted investments take two forms:

Direct impact investments which are made through investments in private debt and equity structures, specifically PE's;

And indirect investments or impacts which are made through investments in publicly listed securities or traditional investments as it were.

It is not within the scope of this research to engage in a detailed and quantitative analysis of AI's, but rather, to explore how pension fund investments in both traditional and alternative investment vehicles have contributed to the socio-economic development of South Africa.

Suffice to say that the focus (as indicated in opening chapter) is therefore on economically targeted investment type SRI's, given the wide scope of the SRI industry[95].

Pension assets represent a significant size of global gross domestic product (GDP) and the manner in which these assets are being managed are crucial to global and more importantly national socio-economic development.

The over two trillion rand pension fund assets in South Africa, representing about 21percent of GDP, plays a major role in the development of the financial market, and the overall economic development. These assets are able to support infrastructural development, create jobs, and enable good labour practices, responsible investing and sustainable developments (Watson 2010, 5).

As previously noted, SRI investments seeks to serve a distributive role in the economy by increasing incomes and assets for the poor and vulnerable, creating jobs and improving labour relations, mitigating the effects of climate change, and ensuring that

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[95] The main thrust of SRI is that institutional investors incorporate environmental, social and governance (ESG) issues in their investment decision making processes.

future generations are not prejudiced by the consequences of today's investment activities.

And the role of pension fund investments or the outcomes thereof should include expanding access to basic services for people- water, schools, housing, roads, electricity, health services and all other forms of infrastructural developments; or through production processes that benefits society; providing quality jobs, enhancing energy efficiency, facilitating local assets accumulation (Employment Equity and Black empowerment initiatives), purchasing inputs from local or small businesses or local service providers.

The United Nation Environment Program-Finance Initiative (UNEP FI) have taken the lead in highlighting this significant role by large investors in the economic development of nations by adopting the principles of responsible investing (PRI).

The concept of socially responsible investments, and the various terminologies used in the industry to refer to social investments were discussed in Chapter one.

Chapter Five looks broadly into the investment patterns of pension funds in South Africa vis-à-vis their impacts on economic development. And for the purpose of this research work, efforts will be concentrated on those investments that have both direct and indirect impact on the economic development of the country.

This will be achieved by looking at the investment patterns of some pension funds, representing the 'demand' side, and on the supply side, it examines some of the asset managers (pension fund) assets allocation, SRI strategies and SRI funds.

This Chapter consists of two sections; the first section focuses on the nature of pension fund investments in South Africa; the various investment vehicles used and the socially responsible investment patterns of pension funds; investment impact classification and measurements. And the second section examines the growth of SRI's and AI's as vehicles for economically targeted investments vis-à-vis pension funds, by looking at select case studies of some of the dedicated SRI funds in South Africa.`

6.2 Pension fund investment patterns in South Africa

Pension funds have traditionally invested in equities, cash and bonds, and have only in recent times begun to venture into other asset classes referred to as AI's.

A number of countries have set limits for pension fund asset allocation to certain asset class as a means of ensuring that workers monies are duly protected and not exposed to excessive risks[96].

In recent years however, pension funds have begun to look for AI's as a mean of ensuring more efficient diversification of their portfolios and also a means of generating superior returns in the face of an increasing pension liability brought about by huge asset losses during financial and economic crisis.

According to Watson (2011, 25), AI's share of total pension fund portfolio have grown from 5%, 16 years ago (1995) to about 19% in 2010 globally.

6.2.1 Pension fund asset allocations

Average global asset allocation for pension funds as at December 2010 were as follows: 47% equities, 33% bonds, 1% cash and 19% AI's (Ibid 6).

What has become noticeable is the reduction in global equity asset allocations by 2% over the past 15 years in aggregate, to 47%, and an increase in allocations to AI's, especially real estates and to a lesser extent, hedge fund, from 5% to 19% since 1995. The US, Canada and Australia have been the major drivers in AI growth, having increased their total AI investments from nearly 8% in 2000 to more than 20% in 2010 (Ibid, 2).

And domestically, pension fund holdings in local equities have declined steadily from 72% in 2005, to 67% at the end of 2009 (Alexander Forbes 2010).However, there has not been an equal increase in pension fund allocation to AI's relative to the recorded

[96] In South Africa, Regulation 28 of the Pension Fund Act sets the limits for pension fund investments in South Africa (as discussed in Chapter Two).

global trend, mainly due to the Regulation 28 prescribed limit of 5% for AI's (recently increased to 20%)

The table below shows the asset allocation of South Africa pension funds over a 20 year period.

Table 6.1 Investment Patterns of Self Administered pension Funds.

Assets	%of Total Assets (2006)	%of Total Assets (1998)	%of Total Assets (1990)	%of Total Assets (1986)
Immovable properties	0.5	4.2	5.7	7.0
Bills and bonds	8.0	14.3	11.2	20.6
Participating Mortgage bonds	0.0	0.0	0.7	3.2
Debentures	0.5	0,2	4.5	9.7
Loans	0.1	0.6	1.2	3.6
Equities(local listed, equity – linked instruments, preference shares and unlisted equities)	22.0	37.4	0.6	5.6
Collective Investment Schemes	5.2	4.8	24.7	18.3
Insurance policies	47.3	26.1	27.6	-
Deposits and Krugerrands	4.8	6.4	10.2	4.6
Foreign Investments	9.9	NA	NA	NA

Other assets[97]	1.7	6.0	13.6	27.4
total	100	100	100	100

(Source: FSB 2006, 16, 1998, 20 and 1990, 33)

[97] These are hedge funds, private equities and other forms of AI's.

What is interesting to note is the significant increase of equity allocations from 1986 low of 5.6% to a high of 37.4% in 1998, subsequently dropping to 22% in 2006. And the substantial reduction in the allocation to the 'other' assets category (AI's) from a high of 27.4% in 1986 to 1.7% in 2006, prior to the financial and economic crisis of 2007[98].

What is equally important to see is how pension fund investments are being managed on the supply side i.e. asset managers. In line with international trends, asset managers in South Africa have reduced their equity allocations for pension funds from the maximum permissible allocation of 75% to an industry average of 51%[99].

The next table shows how some of the domestic asset managers have responded to the asset allocation developments as shown above. This is interesting to know because as far back as year 2001, Investec, Coronation, Sanlam investment managers (SIM), Old Mutual, Allan Gray and RMB asset managers controlled over 60% of total retirement fund assets amongst them[100] (Money & Investments 2011, 55).

[98] With the introduction of Regulation 28 of the Pension Fund Act, pension funds were forced to limit their exposure to 'risky' assets.

[99] In reaction to the increasing market volatility and higher yields in fixed income funds, some of the funds also increased their foreign exposure to take advantage of cheap foreign assets and the strong Rand.

[100] These figures excludes multi- managers who manages the majority of assets of retirement funds, these assets are in any case sub -contracted by the multi -mangers to other managers such as those listed.

Table 6.2 Top Investment Managers Asset Allocation of Balanced Funds as at 31 December 2010

Investment Managers	SA equities (%)	SA Bonds (%)	Listed Properties	Physical Property	SA Cash (%)	SA 'Other' (%)	Total SA Assets	Foreign
Allan Gray	45,29	10,67	0,62	0,00	17,09	3,59	77,26	22,74
Coronation	45,21	18,26	3,94	0,00	7,20	0,00	74,61	25,39
Foord	59,26	1,61	7,29	0,00	7,86	5,23	81,25	18,75
Investec	58,71	9,81	4,07	0,00	10,07	0,00	82,66	17,34
Metropolitan	60,57	8,77	0,00	10,68	2,94	0,00	82,96	17,04
Oasis	56,26	14,07	0,00	6,58	4,36	0,00	81,26	18,74
Omigsa Macro Strategy	52,70	7,19	6,61	0,00	15,24	0,64	82,37	17,63
Prudential Global Balanced	50,70	14,99	4,19	0,00	10,76	0,00	80,65	19,35
RE:CM	45,05	4,11	0,00	0,00	31,91	0,00	81,07	18,93
RMBAM	56,86	9,34	2,38	0,50	12,03	0,00	81,11	18,89

SIM Global Unique	54,17	8,11	4,56	0,00	10,77	3,71	81,32	18,68
Stanlib	51,48	8,68	3,55	0,00	20,71	0,06	84,48	15,52

Average equity allocations by these top asset managers falls well below the maximum percentage allocation (75%) allowed by the Regulation 28 of the Pension Fund Act. This is in line with international trends which see pension funds gradually reducing their exposure to volatile assets.

The table below further breaks down the asset allocation trend discussed above by pension fund type in South Africa at the end of 2010.

Table 6.3: Average % portfolio asset allocation by pension funds

Fund Type	Domestic cash	Domestic Equities	Domestic fixed interest	Domestic property	Offshore equity	Hedge Funds
Employer Sponsored Funds	11	55	17	4	12	1
Umbrella Funds	8	55	15	10	11	1
Union and Parastatal funds	22	44	14	4	11	5

(Source: Financial Mail, 2010, 31).

As to be expected, Union and parastatal funds have the highest allocation to hedge funds. While employer sponsored funds and umbrella funds have bigger weightings to domestic equities.

As mentioned in previous chapters, pension funds interest in AI's have fully metamorphosed into the broader SRI (or ETIs as the case may be) as they begin to embrace the concept of triple line objectives.

ETI's can be categorised as follows:

- Real Estate Investments - direct investment in physical properties or property shares.
- Pooled funds that make equity and debt investments- private equity (PE) funds or venture capitals (VC). Pooled real estate funds or property related fixed income projects are liquid, easy to evaluate and offers competitive returns.
- Mortgage backed securities
- Fixed income funds - investments are made in projects and organizations providing social and environmental services ,this includes debt based real estate product investing in affordable housing, infrastructural bonds ,micro financing- covers a wide range of investment activities including community lending, micro – loans, and community equity investments.
- Public equity – asset managers and pension funds integrate environmental, social and governance issues into investment management process, and are active in positive shareholder activism
- Cash- cash deposits or investments are made in community development and environmental banks.

According to the Development Bank of Southern Africa (2009,11), institutional investments in PE firms have sometimes provided the capital to enable a series of ownership-transition initiatives and to share the ownership of in-country corporations with historically disadvantaged citizens known as empowerment initiatives (BEE). These initiatives are meant to increase black ownership and control of targeted companies[101].

There are only a few SRI funds available on the supply side, notably amongst which are supplied by Cadiz asset managers and Old Mutual. On the demand side, the GEPF remains the largest proponent of SRI. The PIC [102]dedicates 3.6% of its portfolio to AI's to create jobs and infrastructure with additional allocations to property investments and

[101] Black ownership of JSE listed companies as at 2010 amounted to about 25%.

[102] The PIC manages funds for the GEPF and other institutional investors.

affordable commercial housing, representing the largest amongst pension funds in South Africa (Godeka et al 2007, 51).

6.3 Summary

Pension funds across the globe have begun to embrace the concept of SRIs in their investment decision making process. As shown in the above section, asset allocations to volatile and traditional investment vehicles are increasingly being reduced, and alternative investment vehicles that promise more efficient portfolio diversification and superior returns are beginning to benefit from an increasing allocation from pension funds, even though at a rather cautious rate as determined by the regulators. The next section looks at pension fund investment impacts and its various classifications.

6.4 Investment Impacts

All SRIs or ETIs are by nature intended to be impact investments. These are investments intended to create positive impact beyond financial returns, and as such require the management of social and environmental performance in additional to financial risk and returns.

Impact investments comprise both traditional investment vehicles such as debt, equity and cash, and Alternative Investment vehicles such as PE's, hedge funds and real estates.

In order to fully comprehend the potential impact of pension fund investments globally and domestically, one only needs to assess the size and growth of pension fund assets over the past years.

Global Pension fund assets in major markets increased by 12% during 2010, reaching a new high of $26trillion (Watson 2010 ,1) this is a continuation of the growth witnessed in 2009 , when assets grew by at least 17% in contrast to the a 21% fall during 2008.

Total Global pension assets have grown 66% since 2000, when the value stood at $16trillion, and now amounts to 76% of the global GDP. The US, Japan and the UK

represent the largest pension market in the world, accounting for 58%, 13% and 9% respectively of total global pension fund assets. Over 10 years, South Africa was next only to Brazil with 13% growth, and Brazil had the highest growth of 15%.

6.4.1 Classification of investment impact

For the purpose of this research work, investment impacts will be classified according to the nature and type of the investments, and how it impacts on the economic development of the country.

Pension fund investments could be classified into those investments that have direct and/or indirect impact on the economy.

6.4.1.2 Direct Investments/impact

Direct Impact in this context refers to investments that directly generate specific desired outcomes e.g. units of housing created, number of children immunized, kilometres of roads built etc.

Pension fund investments are able to have direct impact on society and the economy, through investing in alternative investments ,structured SRI Funds, and/or investing in listed companies that incorporates ESG issues in their business activities e.g. pension funds that decide to invest in the JSE SRI Index companies.

Investments with direct impacts usually take the form of direct holdings in private equities, private debts, and for liquidity purposes, investments are channelled into money market instruments at the highest performing community development and environmental banks.

Transformation is achieved by investing directly in ventures and debt instruments in companies or enterprises that seek to solve the most pressing social and environmental issues of core importance to the fund and its member's[103].

About 11% of R2.3trillion of assets managed by asset managers may be managed under some formal SRI strategies (Godeka et al 2007, 49)[104].

[103] Issues like BEE, affirmative action, climate change and global warming.

[104] See appendix 9 and 10 for the detail list of the JSE listed SRI funds.

6.4.1.3 Indirect Investments/Impact

Indirect impact involves investments in publicly listed equities, fixed income securities and cash instruments.

Even though some pension funds may not have specific SRI allocations, the size and manner of their investments in traditional asset classes, and specifically listed companies, have a significant impact on the overall economy. Pension funds investments enhance the financial market development, create jobs and contribute to overall GDP of a nation. These types of investments are also capable of promoting sustainable development and good corporate governance in a nation, considering the huge influence pension funds wield over companies that they invest in vis-à-vis shareholder activism.

A significant aspect of such an indirect impact is in the form of guarantees. Pension funds can use assets as collateral to provide security (guarantee) to an organization based on this collateral, thereby service as agents of development finance[105].

6.5 Summary

Impact investments can be classified as direct or indirect investment impact depending on the nature of the investment.

As discussed previously , SRI investments seeks to serve a distributive role in the economy by increasing incomes and assets for the poor and vulnerable, creating jobs and improving labour relations, mitigating the effects of climate change, and ensuring

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[105] An example of such financial services impact is the recent partnership between the Nairobi based Alliance for green revolution and SA Standard Bank .By committing 10million dollars to cover potential losses in targeted loan portfolio, the alliance induced Standard Bank to commit 100million dollars in loans to farmers in Africa, who would otherwise be unable to access financing (Godeka et al 2007).

that future generations are not prejudiced by the consequences of today's investment activities.

Measuring the impact of pension fund investments can be somewhat challenging, particularly for indirect impact investments. The next section examines the role of Pension fund investments or the outcomes of pension fund investments vis-à-vis the expansion of access to basic services for people - water, schools, housing, roads, electricity, health services and all other forms of infrastructural developments; or through production processes that benefits society – providing quality jobs, enhancing energy efficiency, facilitating local assets accumulation[106].

6.6 Measuring Impacts

Measuring the impact of pension fund investments are by no means a straightforward exercise. Even though there are efforts to standardize the measurement and reporting of SRI Investments globally[107], there is still a long way to go in achieving a standardised and universally accepted method.

Having said that, there are varying ways in which impacts can be assessed ranging from quantitative measurements (outputs-based) to qualitative (outcomes-based) measurements[108].

A combination of both outputs and outcomes based impact measurements is adopted in this research work, however emphasis is placed on the outcomes-based impact assessments method[109].

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[106] Local asset accumulation involves BEE, and empowerment initiatives), purchasing inputs from local or small businesses or local service providers.

[107] Such as the efforts of the Impact Reporting and Investments Standards (IRIS), an Initiative of The Global Impact Investment Network.

[108] Outputs refers to the actual quantities of impacts e.g. number of housing units built, number of roads constructed etc, while outcomes refers to the ultimate changes desired and the quality and improvement thereof in the lives of the people.

Impact of pension funds investments is therefore the total outcomes occurring as a result of the activity over and above a predicted outcome.

The broad outcomes of SRI Investments or impact investments include but not limited to:

- Increase in availability /accessibility to affordable housing.
- Development of small and medium enterprises
- Revitalization of inner cities- roads, community development projects i.e. shopping centres etc
- Rural economic development, micro- financing, housing projects etc
- Growth of undeserved markets - informal sector development, micro- financing
- Growth in non traditional industries – renewable energy, green projects etc.

(Croft 2009, 12)

6.7 SRI Vehicles and Impacts

As mentioned earlier, direct impacts comprise both investments in dedicated SRI funds/AI and investments in listed companies albeit with ESG considerations[110].

Equity makes up the most allocation in the domestic SRI funds with 36.84%, and Balanced fund category with 26.12%. Fixed interest is 18.42%, while alternative asset category and property funds make up 15.78% and 2.63% respectively[111] (Alexander Forbes Manager Watch 2010, 13).

According to Godeka et al (2007, 5), pension funds can play a huge role in impacting the economy by using a combination of different SRI tools including active ownership

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[109] The research focuses on economic development as against economic growth, outcome based developments as against outputs. It looks at how the overall quality of life's of the people of South Africa has been improved by pension fund investments.

[110] Local institutional Investors (Pension funds, life companies etc) own 28% of the JSE, and the biggest shareholder on the JSE is the PIC with 12.2% (JSE LTD Annual Report 2009).

[111] see appendix 8 and 9 for detail list of the domestic SRI funds and their performances

strategies (shareholder activism), and positive or negative screening methods, “The goal here is to ensure that the fund’s portfolio reflects its values and mission, mitigate risks and makes optimum use of assets to encourage or discourage specific corporate behaviour”.

Direct investments in SRI funds could take the form of private equity funds with SRI objectives or investments in dedicated SRI funds[112]. According to Jackson (2004), the impacts generated by these types of investments can be categorized as follows:

- Financial Impacts
- Risk adjusted rate of return on investment, compares with benchmarks for investment type and asset class.
- Collateral impact
- Direct provision of capital for firm growth
- New and decent jobs
- Economic multipliers in the country
- Urban re-development
- Payment of taxes by companies and employees
- Increased affordable housing stock
- Improved environmental technologies
- Improved infrastructure.

On the supply side, some asset managers have developed clear SRI objectives and SRI offerings to pension funds with clear SRI Mandates, e.g. Old Mutual and Cadiz. However, there are others who, even though may not have specific SRI Funds offered

[112] This type of investment is dealt with in detail later in the chapter

to pension funds, but have incorporated some ESG issues into their investment behaviours ,which also impacts directly , as discussed earlier on the overall society[113].

The next section looks at the various SRI funds offered by asset managers and the various target or achieved impacts of these funds. It looks at some of the impacts of select SRI funds in South Africa and the impact of these investments on the society, by examining a number of top 10 publicly listed companies on the JSE (representing a broad equity allocation of the average pension funds asset manager in the country).

6.7.1 Case studies of some of the impact Investments in South Africa

There are quite a number of SRI Funds being offered by asset managers in South Africa today[114] , however it is noteworthy to mention that The GEPF still takes the lead in SRI investments in the country.

With assets over R778bn and representing about 30% of the total pension fund assets in South Africa, its overriding influence cannot be overemphasized[115]. Below are some of the SRI funds and their various impacts.

6.7.1.2 Greater Capital

Greater Capital entered a joint venture with Cadiz Asset Management Company in 2008, with a view to identify and promote SRI opportunities. The Joint Venture kicked off with an initial R10million investment in the Kuyasa Fund.

Kuyasa fund provides microfinance services to poor communities. The funding priorities of the joint venture are housing, water and sanitation provision, public health and welfare services, public transport, public recreational facilities, education and training,

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[113] For example, Allan Gray Ltd supports good corporate governance, and will, if required, enforce its influence on companies invested in, to comply with good governance practices. Allan Gray believes that those placed in a position of trust by investors, and this includes retirement fund trustees and investment managers, have a duty at all times to safeguard their funds investments' (Allan Gray Quarterly Commentary 2003, 6).

[114] see appendix for list of SRI funds

[115] More than 90% of the country's food is manufactured by groups part-owned by the fund. It owns about 15% of Tiger brands, and a big chunk of the retail shops in the country (Financial Mail 2010, 36)

environmental protection, social enterprise, agricultural businesses, and other infrastructural developments.

Over R157million has been allocated to these projects since inception in 2008. Adjusted for cost of guarantees, housing investment has yielded well above similar commercial investment[116].

6.7.1.3 Harith Fund Managers

The Harith Fund was founded in 2007 as the appointed manager of the Pan African Infrastructure Development Fund (PAIDF)[117],with the objective to pursue the vision of investing Africa's investable pension fund capital on the continent, to develop Africa's infrastructure.

Its offices are based in Sandton, South Africa, and shareholding is spread between the management of Harith, the PIC, Old mutual and Absa bank.

The fund complements other development finance agencies such as the Africa development bank. The GEPF is the largest participant in the fund with $250m of committed capital[118].

The fund has discretion to invest 30% of its assets into investments that fall outside the strict definition of infrastructure. It invests primarily in Greenfield projects and notable among its projects is the construction of a road from Maputo to Gauteng.

6.7.1.4 GEPF /Isibaya Infrastructure investment fund

The GEPF through the PIC has a number of specialist SRI funds to achieve its goal, one of which is the Isibaya fund[119]. The fund invests in mergers and acquisitions, infrastructure and community investment projects, and the Pan African Infrastructure Development (PAIDF).

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[116] Greater capital SRI fund offerings are listed on the South Africa Social Investment Exchange (SASIX).

[117] A private equity fund with a 15year life span

[118] Eskom pension and provident fund has about $5m invested.

[119] Isibaya fund represents the largest private equity fund in South Africa

The objective of the fund is to finance the emerging sector of the economy and promote economic growth through infrastructure investment in Africa. The fund invests in BEE private equity investment opportunities in new energy such as wind and solar that presents viable revenue generating opportunities, and BEE private equity that focuses on developing township business parks, services and infrastructure and present viable revenue generating opportunities.

Isibaya Fund manages 3.6% of PIC allocation to AI's. The Fund has assets of R30bn, and as of March 2007 had completed R274, 5m in investments for the year.

As at end of 2009, investments in the Isibaya fund represented 2% of total GEPF investments[120], and the fund achieved a return of 36% as at March 2007 and 26% as of March 2006.

Some of the SRI investments of the fund include;

- a major investment in South Africa's largest Telecom Group. The PIC paid R6.6bn to foreign shareholders to acquire a 15.1% stake in Telkom, and subsequently restructured the deal and sold 6.7% to the Elephant group which is a women empowerment group;
- a BEE Investment in Major mining operation in October 2004, it provided financing to the Savannah Consortium, a BEE initiative, to purchase a 29.5% stake in Aquarius Platinum South Africa and thirdly;
- an investment in an Agri-Nomalanga Project in Kwazulu Natal. The PIC approved funding to the tune of R38.25m for the Agri-Nomalanga project with the objective of expanding the diversified farming activities to include cattle breeding and an abattoir, forestry, production of citrus, berry varieties, vegetables and other crops using both field and hydroponic production. Old Mutual is a partner in this project. The project also included commercial housing development for workers.

The Agri-Nomalanga project particularly generated the following impacts:

[120] The goal is to increase this to about 5%.

- Increase total shareholding by communities to 80%.
- Mainstream historically disadvantaged individuals in the agri - sector, current beneficiaries include 186 adults and 164 children
- Ensure long term economic benefits from the land reform program with an initial creation of 539 jobs
- Rural poverty alleviation
- Contribute to domestic food security and foreign currency earnings through a small amount of exports.
- Improve the waning contribution of agriculture to SA GDP.

(Croft 2009, 46-48, Government Employees Pension Fund 2009, 3)

6.7.1.5 Future Growth Asset Management

Futuregrowth is a specialist asset manager with over R39.5bn assets under management. Its diverse SRI funds include:

- Infrastructure and development Bond Fund- the largest SRI debt fund in Africa. Its objective is to invest in projects facilitating infrastructural, social, environmental and economic development in southern Africa
- Infrastructure and development equity fund- similar objectives, targets the pension fund industry, its long term return target is CPI+10%.
- Community Property Fund- launched in 2006, it funds the development of retail shopping centres catering to the needs of underserved communities throughout South Africa.

Some of Futuregrowth's SRI Activities include:

- Funding of the National Urban Reconstruction and construction Housing Agency (Nurcha). Futuregrowth extended a R45m loan to the guaranteed capital pool .Nurcha has built more than 100,000 houses, worth more than R1.5bn.
- Extension of funding to the Bible Church through its infrastructure bond fund. Futuregrowth in 2001 invested in, and led the development of a commercial

multi-purpose centre in Soweto. The building accommodates 5000 people and used for church services, courses in adult education, computer skills and HIV/Aids awareness. The community members were rejected by banks in their bid for R13m loan to build the centre. The centre now boasts one of the largest private community centres in Soweto was expanded in 2008. Futuregrowth also participated in a new R30m sports and educational facility that was built on a 13 000msquare site that sits next to the original church.

- Futuregrowth and the PIC also partnered in a community property fund (CPF) in excess of R1bn focusing on property developments in rural and urban townships across South Africa. The CPF is currently invested in 17 retail properties spread across 'second economy' urban and rural localities, including eight provinces in Mafikeng, Kanyamazane, Thulamahashe and Mkhuhlu. This new development generated a number of impacts including:
    - The development of 138 547 m square of gross rentable retail area in rural areas, secondary towns and traditional townships.
    - Provision of rural services to 7m people over 15% of the population
    - Provision of direct employment for 3 750 people and indirect benefits to 16 250 people, and
    - The development of local entrepreneurs

(Croft 2009, 49- 51)

6.7.1.6 Old Mutual Community Growth Fund (CGF)

Old Mutual Investment Group (OMIGSA) manages the CGF, a fund that invests in South African companies committed to sustainable developments and triple bottom line reporting. CGF integrates ESG factors into its investment decisions and processes.

The CGF Equities Fund had annual returns of nearly 20% for the year end 2008, and 29% for three and five year periods.

CGF negative screening methods and shareholder activism has seen a number of companies being excluded from its portfolios[121], these companies were seen not to submit to CGF's social audits. The result has been that many companies excluded have had to reform their ways to gain entrance into the CGF universe.

6.7.1.7 Cadiz SRI Infrastructure Fund Portfolios

Cadiz numerous SRI activities include:

Communicare – This represents Cadiz social rental housing fund and makes up 38.8% of the Infrastructure fund portfolio. Tenants are chosen according to the National Housing Policy, indicating that beneficiaries of social housing should earn below a certain threshold.

Kuyasa Low Cost Housing – This is the micro finance arm of Cadiz SRI Fund. It was established in 2000, with about R35m assets under management. It makes up 10.4% of the total infrastructure fund portfolio

Small Enterprise Foundation (SEF) - This makes up 6.0% of the entire portfolio, and it seeks to promote increases in household income and empowerment for SEF clients. The Fund boasts of over 54,866 self employed clients and a loan book worth R730million.

TUHF – This is a housing finance initiative to provide finance and advice to local businessmen and women falling outside the formal banking sector and to acquire run-down properties and upgrade these into affordable rental stock. The fund makes up 14.9% of the infrastructure fund portfolio and has approximately 8000 housing units financed since inception in 2003.

NURCHA – This represents a bridging finance to small or medium size building contractors or developers involved in subsidy and affordable housing, community facilities and infrastructure development.

[121] Some of the companies excluded were Aspen Pharmacare and Sun International

80% of the clients are black and 85% are emerging contractors. The Fund has a loan book value of R1.3bn, and has constructed over 213,000 homes. The fund makes up 29.9% of the entire portfolio (Cadiz, 2010, 3).

The next section looks at the impact of traditional equity investments of pension funds.

6.8 Non - SRI specific vehicles and Impact measurement

As mentioned earlier, pension funds are also able to impact the economy albeit indirectly, through its investments in publicly listed equities.

Perhaps one of the most notable impacts has been an increased in black ownership of JSE listed companies. According to a study conducted by Trevor Chandler and Associates[122], black investors currently own 18% of the available share capital in the top 100 companies listed on the JSE, the top 100 companies represent 85% of the total market capitalization of the exchange (IAC 2011).

Pension funds invest over 20% of total assets in the JSE, and over 80 percent are invested in the Top 10 JSE listed companies. The impact capabilities of such investments are best depicted in the sustainability report of the various companies benefiting from such huge inflows from pension funds.

The table below lists the Top 10 companies[123] and examines the various socio-economic impacts generated by these companies.

[122] They are an independent research house. The report has however been rejected by the Black Management Forum (BMF) as inflating the actual percentage of black ownership of the JSE.BMF

[123] These companies make up the biggest beneficiaries of pension fund allocations.

Table 6.3 Top 9 JSE Listed Companies and Enterprise Development 2009/10[124]

Company	Sector	Impact
BHP Billiton	Resources	BHP south Africa workforce represents 25% of its total global workforce, and 24% of total contractors engaged globally. BHP paid a total of $327m in 2009 to the government, representing income tax and royalty related taxes. BHP spent over $1.317m on the King Edward Hospital Paediatric Ward in Durban, aimed at improving the quality of children's health services in South Africa.
SAB Miller	Industrial	SABMiller has always been a front runner in the area of social investments. Its Kick Start scheme established in 1995 to promote entrepreneurship and business skills among the youth, recently celebrated its 15th year of operation, and have helped over 22,000 young people since its inception. SABMiller also promotes responsible consumption of alcohol. It signed up to the Global Action on Harmful Drinking in 2009, and has invested over R6.5m in setting up five Alcohol Evidence Centres across the country in conjunction with local law enforcement agencies. It invested $44m in CSI activities across all its operating enters in 2010,

[124] Excerpts from respective companies reports on sustainability and corporate governance.

		representing 1.2% of pre-tax profits. SABMiller also announced a significant Broad-based-black economic empowerment (BBBEE) programme in 2009, which saw 8.45% of SABMiller shares (worth over R7bn) placed in black ownership. This empowerment created approximately 40,000 new shareholders among groups including employees and local communities.
Anglo American Plc	Resources	Anglo America's Enterprise Development Initiative supported over 3,700 businesses and sustained nearly 13,000 jobs. South African owned businesses accounted for 39.7% of total available procurement spend. And 46% of employees at management level are historically disadvantaged south Africans. Anglo American employs a total of 7,394 permanent employees in South Africa.
Sasol	Resources	Sasol established The Inzalo Foundation in 2009 to facilitate all its community development programmes. Sasol has invested over R386m in employee's training and development. It concluded a broad based BEE transaction in 2009. Sasol has created over 2000 jobs since the start of the Sasol Business Incubator Programme. It also aims to achieve energy efficiency by investing R100m on energy efficiency projects.
Sanlam	Financials	Sanlam has numerous SRI Funds and was rated fourth out of the nine

		measured SRI compliant equity funds, and second out of the five measured bond funds according to an Alexander Forbes Investment Performance Survey for the year ending 2010. Sanlam contributes immensely to empowerment initiatives and BBBEE procurements. 80.46% of Sanlam's RSA's procurement on a weighted basis comes from BBBEE certified suppliers. The Group spent R19.3million on community and social investments in 2010, representing 0.52% of the Group's net profit after tax. Sanlam spent over R3.2million on various resources efficiency initiatives at its head office. The group is committed to ESG based investment decision-making, and is a volunteer to the UN principles of responsible investing (UN-PRI) initiative. Sanlam generated R4.3billion for its shareholders and retained RR2.1billion for future growth in 2010. Its RSA operations boasts of 60% black staff of total staff complement, and 86% of new appointments made during 2010 were blacks. Sanlam invested R58, 476,431 in employee training and skill development. The group has an employment equity score of 6.74, an improvement from 4.04% in 2009.
Netcare	Industrial	Netcare spent over R57m on social investments in 2010, and over R100m since 2008. Netcare is the most empowered healthcare company in South Africa. Total wealth distributed in 2010 was 15,6bn,

		and 48.8% was distributed to employees in form of salaries and wages, and other benefits. Taxes paid to government amounted to 4.1% (R650m), up from 3.8% (R610m) the previous year.
Standard Bank Group	Financials	Standard Bank continues to play a leading role in the socio-economic development of South Africa. It provides finance to individuals, small and medium sized companies, as well as the agriculture sector, through its responsible lending programme. As an emerging bank, it continues to develop credit solutions to the challenges of the 'unbanked' and undeserved sector of the economy. It spent R90.9m in 2009 on social investments .Standard bank directly and indirectly sustain around 150 000 jobs in the broader economy. Total wealth created in 2009 amounted to R41bn, 40% of this was paid to employees through salaries, wages, and other benefits. R6.4bn was paid to government in the form of taxes and rates.
Sappi	Industrials	30% of Sappi's South Africa business is Broad Based Black empowered. Sappi now produces the average sheet of paper with less fossil-based energy and water, and with less impact on landfill than it did three years ago.
MTN Group	Industrial	MTN invests greatly in host communities as a means of helping create a better future in emerging markets. MTN's community investment is

		facilitated by its Foundation and Staff Volunteer Programme (21 days of Yello Care). MTN SA employs over 6000 staff. And through its Academy, continues to invest in people .The Academy placed over 76 graduates in 2009, and offers full time bursary to deserving students.

The majority of South African pension fund equity investments are in Sasol shares, it makes up about 5.38% of the average pension fund portfolio, and according to Alexander Forbes Manager Survey(2010,1), is held as a top -10 share in 16 of the 18 portfolios.

The next most widely held are BHP Billiton and Standard Bank., Standard bank accounts for 6, 03% of average pension fund portfolios.

SAB Miller is strongly supported by Allan Gray, and it accounts for almost 15% of the equity portfolio in its global balanced fund. Investec and Coronation holds 6, 1% and 4, 8% of SABMiller shares respectively, in the equity components of their balanced funds.

The average balanced fund manager has about 50% of equity investments in industrial sector, and around 27% in resources and financial only accounting for 23 % (Allan Gray Research 2010)

6.8.1Summary

Measuring pension fund investment impact can be as onerous as the management of pension funds itself. However, for simplicity, investment impact can be categorised as direct and indirect impacts. Funds that invests directly in dedicated SRI funds or in publicly listed companies which takes SRI or ESG issues into consideration in their investment decisions will have a more direct impact on the economy, while funds that do not have specific SRI policies but invests in publicly listed companies could have indirect impact on the economy, through the deepening of the capital market and overall financial system.

6.9 Conclusion

This Chapter examined the development of SRI's and AI's in relation to pension fund investment behaviour. The first section examined the development of SRI's, the different SRI vehicles and its adoption by pension funds. The section showed that pension funds across the globe have begun to embrace the concept of SRIs in their investment behaviours, by showing the shift from volatile and traditional investment vehicles to a mix of alternative investment vehicles that promises more efficient portfolio diversification and superior returns.

The next section delved into the measurement and classification of pension fund investment impact on the economy. Bearing in mind that measuring pension fund investment impact can be as onerous as the management of pension funds itself. The Chapter chose for simplicity, to categorise investment impact as direct and indirect impacts. Funds that invests directly in dedicated SRI funds or in publicly listed companies which takes SRI or ESG issues into consideration in their investment decisions will have a more direct impact on the economy, while funds that do not have specific SRI policies but invests in publicly listed companies could have indirect impact on the economy, through the deepening of the capital market and overall financial system.

Section 2 specifically showed case studies of some of the SRI funds in South Africa, highlighting their impacts on the socio-economic development of the country. It also looked at some of the sustainable development goals and achievements of some the Top 10 JSE listed companies, as a means of establishing pension funds indirect impact on the economy via the equity investments of pension funds in listed companies.

The impact of pension fund investments in South Africa or anywhere for that matter cannot be adequately assessed without evaluating the socio-economic impact of pension fund reforms in affected countries. Pension fund reforms impact economies from a fiscal equilibrium standpoint to an increase in

national productivity and total contribution to growth[125]. The next chapter therefore focuses on the proposed National Social Security Fund (NSSF).

[125] Pension fund reforms usually lead to the deepening of capital and financial markets, encourages formalisation of labour, and increases cumulative national savings (International Federation of Pension Fund Administrators 2006, 465).

Chapter Seven

National Social Security Fund (NSSF)

7.1 Introduction

Chapter six dealt with pension fund investments and the varying impacts on the economy, focusing on SRI and AI's activities of pension funds.

As the global economy grapples to recover from the recent financial and economic crisis, most countries have implemented several varying fiscal and economic measures in order to revitalise their ailing economies and prevent threatening mass old age poverty, in the face of dwindling pension assets and increasing pension liabilities.

While some of these countries are convinced that increased public and private spending, combined with an expanding credit (amongst other things), is the way to jump-start the economy out of recession, others believe that more spending under the present circumstance will increase fiscal deficits, and thus detrimental to the economy in the long term[126]. In line with the latter, most European nations are cutting back on public spending, and subsequently a widespread reform of pension funds, and overall social welfare system, such as seen in France, UK and Ireland recently, are underway.

South Africa may not have been as hard hit by the economic crisis relative to the developed nations, but has also been embattled with some degree of fiscal imbalances, growing economic hardship and widespread poverty, that threatens to erode most of the economic developments achieved during the five year period of economic boom (2002 to early 2007).

South Africa has a history of entrenched social inequality and widespread deprivation. According to the World Bank's Development Indicator Database

[126] The more recent (2011) Euro debt crisis and the American debt ceiling crisis are signaling fears of a double dip recession , and have sent shock waves to the global stock markets. It is evident that reduced spending from both the private and public sector will not be healthy for the economy, and policy makers are being challenged to find some ingenious ways to increase liquidity, bailouts and infrastructural spends.

(2010, 3), South Africa has a gini coefficient[127] of 0.72 compared to an average of 0.4 for the BRIC Nations (Brazil, Russia, India and China) such that it's economic development initiatives are impaired by the increasingly reduced levels of social participation despite periods of strong economic growth as mentioned above. The same report ranks South Africa, 97 out of 213 countries in the World Bank's Gross National Income Per Capita[128].

This growing inequality remains a significant threat to South Africa's socio-economic development.

According to the Department of Social Development (2008, 16):

"The fact that inequality has grown, in the face of positive short-term economic growth rates, requires that Government carefully re-consider its resource allocation priorities. Strategies need to be co-ordinated in such a manner that meaningful progress is made in advancing the well-being of the vast majority of the population. If this is not achieved, South Africa's long term growth potential will invariably remain constrained".

In line with global trends, South Africa realises the urgent need to integrate its social security system, and has therefore proposed a sweeping reform of the industry in the form of a 'National Social Security Fund' (NSSF), which aims to introduce a mandatory savings[129] for all working South Africans and a social security net for all.

The financial burden on the state to provide social welfare pension system is enormous. Social grants remain the most direct means of transferring resources to poor people. In 2010/11, the government intends to spend R89 billion on social grants[130]. Over 1.5 million individuals are paid about R5 billion in state old pensions every year, and even with all the progress made towards making social grants more inclusive and accessible, majority of households

[127] This is a measure of the differences in national income equality around the world.

[128] shows the gross domestic product at purchasing power parity of countries per capita, i.e., the value of all final goods and services produced within a country in a given year divided by the average (or mid-year) population for the same year.

[129] The challenge however remains the low national savings rate which of course stems largely from the low income of majority of households in the country.

[130] Total national budget for the same year period is R907billion

are still excluded. The social grant system does not cater for unemployed adults and thus half of poor households have no social assistance.

This figure is rising all the time and it is estimated that only 6% of the South African population is self-sufficient in retirement (Bailey 2010).

According to Coutts (2010, 1):

"Government acknowledges that the current retirement system has, by world standards, shown significant commercial success; however, it has failed to provide adequate and quality coverage to a significant portion of the population. The result is that majority of South Africans become dependent on social assistance".

In February of 2007, President Thabo Mbeki in his state of the nation address formally announced government's intention to implement an enhanced system of social security:

'In order to improve on the social programmes that we have implemented over the years, we aim this year to complete the work already started to reform our system of social security so that phased implementation can start as early as possible. A critical part of this reform will be the task of repairing a defect identified in the 2002 report of the committee of inquiry into a comprehensive system of social security in South Africa' (Department of Social Development 2008, 7).

The president went further in the same speech by highlighting the gaps and apparent failures of the existing arrangement.

'This is that the contributory earnings related pillar of our social security system is missing or unreliable for large numbers of working people. The principle guiding this approach is that, over and above social assistance provided through government budget, we need to explore the introduction of an earnings-related contributory social security system that is informed by the principle of social solidarity. This will mean that all South Africans will enjoy membership of a common administratively efficient social insurance system while those earning higher incomes will be able to continue contributing to private retirement and insurance schemes' (Ibid, 7).

As mentioned in earlier chapters, pension funds are integral to any nation's social-economic system, and thus the proposed reform seeks to re-align the retirement fund and social security industry with the larger developmental goal of government.

The proposed NSSF will have far reaching implication on existing structure, governance, management, the investment patterns of pension funds, and more importantly, the future role of pension funds in the country's economic development will be guided by the proposed reform.

It is therefore the aim of this chapter to investigate the NSSF proposal and its validity as a proposed solution to the endemic old - age poverty in South Africa.

This chapter is divided into three main sections: The first section explores the various developments leading to the current proposal and the rationale for the proposed reform. The second section looks at the reform in detail; aims and objectives; and the structure of the reform. And the last section will consider some international trends and retirement fund models as set by the World Bank.

7.2 Background to the proposed NSSF

As mentioned in the introductory section of this chapter, President Mbeki formalised government's plan to overhaul the retirement fund and social security arrangements in South Africa. However, the road leading to the 2007 president's speech was a long one[131].

It will be useful at this point to list some of the developments so far:

- 2002 - The Department of Social Development (DoSD) submitted a report which provided recommendations for broadening social insurance and implementing a 'comprehensive and integrated 'framework.
- 2004 - National Treasury (NT) issued a discussion paper on retirement reform in which the proposed concept of compulsory retirement provision was introduced. In the discussion paper, NT proposed changes to the retirement system in South Africa.

[131] It is interesting to note that it is perhaps even a longer road to the implementation of the proposed reform, as government continues to deliberate on the comments from the retirement fund industry and other stakeholders.

- 2005 - The DoSD furthermore issued a discussion document outlining their views on retirement reforms, their recommendations culminated in the 2007 budget speech.
- 2007 - A revised version of the discussion paper significantly extended the scope of the reform by proposing the inclusion of social security matters, taking into account South Africa's challenges with poverty, high unemployment and poor savings rate.
- 2007 - The budget speech of 28 February, by the Finance Minister (Trevor Manuel) announced the broad outlines of reform to South Africa's social security and retirement funding regimes.
- 2007 - Thereafter the National treasury issued its second discussion paper in February, which discussed the proposed national savings fund, private pension fund reform and a broad overview of retirement savings taxation.
- 2007 - Subsequently the DoSD released a feasibility study in September (DoSD 2007). This study advocated a combination of a defined benefit (DB) and defined contribution (DC) funding arrangements, and emphasised the importance of social security and mandatory contribution to a national retirement scheme.
- 2007 - And later that year, government established an inter-ministerial and inter-departmental forum to coordinate work relating to the reform and engage with private sector.
- 2010 - The industry awaits final proposal from government. Although there have not been any significant changes to the proposal since 2007 or any mention of a possible implementation date, the Chief Director of Social Insurance at the DoSD, in her speech at the 2010 Institute of Retirement Funds conference, (IRF 2010), provided some progress report. She confirmed that the Consolidated Government Document (CGD) is complete and that there is agreement within government on certain strategic aspects of the reform including: the benefit design; the NSSF as a statutory fund; the role of private retirement sector; and the institutional framework. She advised that the Inter-Ministerial

committee will table the proposal for approval as consultation document.

The current proposal is therefore an amalgamation of a series of reports and feedbacks provided to government by the various stakeholders

What is evident is that, there are still a lot of uncertainties pertaining to the roll out date of the proposed reform. Nevertheless there is a positive to this apparent delay and government and the retirement fund industry could perhaps take some lessons from the international experiences of France, UK and some Latin American countries as these countries embark on several radical changes to their pension and social benefit systems.

The following sections will focus on the rationale for the proposed reform, by looking at the current pension fund and social security arrangements, the challenges facing the industry and the private sector 'complementary-proposal' to the government's proposed reform.

7.3 Rationale for reforms

A thorough and critical understanding of the current social security and retirement fund arrangements is crucial in order to completely grasp the thinking behind the proposed social security and retirement fund reform. It is pertinent at this juncture to undertake an overview of the industry.

7.3.1 South Africa's social security landscape

South Africa's current system of social security has important non-contributory arrangements including social assistance, public and standardised schooling and public health services. The system is by nature redistributive and represents the most important pillar in achieving advances in human development and social integration. As rightly put by Pauw and Mncube (2007, 3) "It is aimed primarily to fill the void where households either failed to or were unable to manage their own risk through private or public contributory schemes".

Social security provision in South Africa comprises:

- "The Children's Protection Act of 1913 that provides maintenance grants to children

- The Old Age Pensions Act of 1928 which provides grants in the form of social pensions.
- The Disability Grants of 1937 which provided grants to all disabled South Africans" (Ibid 2007).

There are approximately 12.4 million beneficiaries of this system; the largest of which is the child support grant with around 8.2 million beneficiaries. The next most important is the provision for old age (the old persons grant) with 2.2 million beneficiaries, and lastly the disability grant with 1.4million beneficiaries (DoSD 2007).

Contributory social security in South Africa is almost nonexistent except perhaps for the Unemployment Insurance Fund.[132]

According to the DoSD (2008, 14):

"South Africa is characterized by a deep – rooted social and economic disparity, with over half the population poorly integrated into the modern economy. Income inequalities remain very high with only 10% of the population receiving over 50% of household income from work and social grants. The country's socio-economic conditions are largely structural with the majority of the population living in conditions that effectively exclude them from advancement and opportunities and poor human development limits the extent to which many can be integrated into a positive and well functioning society. High levels of unemployment co-existing with periods of big economic growth rates are evident of this problem. Structural weakness in private voluntary social security arrangements in areas such as health care, retirement and the death and disability of a breadwinner require a holistic approach consistent with well established international practice. An obligation is therefore placed on government and the country, to carefully re-evaluate the quality of existing programmes and institutions, both public and private, focus on meeting these needs"

The DoSD argues that the social harm caused by the existence of a wide spread poverty as a result of inadequate incomes need to be mitigated in the present as part of a long term development strategy, and if no action is taken to address the extent of social distress in existence today, it may take far longer for a virtuous cycle of improved economic growth and social protection to be achieved.

[132] The Unemployment Insurance fund is also linked to employment and is mostly inadequate considering the rate of unemployment, and average length of time spent in unemployment.

7.3.2 South Africa's retirement fund landscape

As discussed in Chapter Three of this research paper, the South Africa pension fund system is multi-layered in structure. It consists of a non – contributory means tested public benefit program, various pension and provident fund arrangements, and voluntary savings (known as retirement annuities).

There are currently over 13 500 private pension funds in South Africa, consisting of occupational pension funds, provident funds and retirement annuity funds. Four fifths of these funds have fewer than 100 members incurring huge administrative costs and regulatory challenges (National Treasury 2007, 15).

The pension fund coverage rate apparently competes with international standards; with about 60% of formal sector employees belonging to some form of a pension plan, however the reality of the socio-economic conditions in South Africa is such that a significant percentage of workers belong to the informal sector and majority of these workers have no pension plan whatsoever.

According to Hendricks (2008, 6):

"Membership of a pension fund is only obligatory in the occupations where such fund exists. Since a large proportion of the population is not covered by an occupational scheme fund for the simple reason that they are not in formal employment, they will be dependent upon a social, non contributory pension. Among those in formal employment, the coverage rate is quite high by international comparison and is estimated to be between 66% and 84 %".

There are about 9 million members[133] belonging to the various retirement funds (FSB 2007). And many more lack effective access to an affordable retirement funding plan due to the economic structure of the country. South Africa has a high rate of unemployment and a substantial part of the working – age population is informally employed.

The state pension provides a mean tested monthly minimum income of R1010 to men over the age of 65 and women over 60. The social old-age grant is

[133] This figure includes double counting. There are members belonging to more than one retirement funds.

financed from general revenues and aims to reduce poverty among the elderly.

Even though South Africa may be able to compete internationally in terms of the coverage rate, it is still faced with the problem of poor preservation of savings. Quite a large number of members do not preserve their funds when exiting a fund. And when members preserve their savings until retirement, the high administration costs and poor investment returns associated with certain pension funds often erode the value of these benefits, such that members are left with very little in retirement.

In order to contextualise the proposed reform, the next section will look at the various challenges facing the retirement fund industry.

7.3.3 Current challenges in the retirement fund industry

South Africa's retirement fund industry has come a long way since its formalisation in 1956. There have been significant changes and improvements both to the structure and management of the industry, which has enhanced its competitiveness globally. However, it remains fraught with a number of inadequacies, ranging from structural and institutional challenges to more complex socio-economic issues.

According to the National Treasury (2007, 5):

"The ratio of pension fund to Gross Domestic Product (GDP) in South Africa is about 63% which compares favourably with countries such as Australia, Chile, Malaysia, Singapore and the UK. However the aggregate figures mask several unsatisfactory features of retirement fund coverage. Limited access of lower income employees or self employed to cost effective retirement vehicles, combined with early withdrawals, contribute to inadequate savings accumulation over people's working lives. A recent industry survey suggest that preservation of funds among those under 40years old is less than 10% and may be as low as 1 percent amongst low income earners .this contributes to inadequate income replacement at retirement".

The overall socio-economic development of South Africa will to a large extent depend on its ability to identify these gaps, and put in measures that will ensure that pension funds metamorphose to agents of economic development. Some of these gaps and challenges are discussed below:

7.3.3.1 Insufficient coverage

One of the reasons for the relatively high rate of old-age poverty, and the consequent increasing social spend on the part of government, is the exclusion of many from the retirement savings industry. According to Coutts (2010,1), existing provision covers just about 5.8m workers if the previously mentioned figure of 9million are adjusted for an assumed double count.

To further put in perspective, Statistics SA (2010, 6) reported that as at January 2010, there were about 12 million employed workers, 9.3 million were formally employed and just above 2 million in the informal sector (excluding agriculture). If one compares these figures with the above figure of 5.8 million workers, it can be deduced that over 4 million gaps exists, these are people that could still be providing for retirement in the formal sector[134].

Coutts (2010, 1) stresses further that an indication of the scale of the gap in coverage can be shown when reference is made to the total employed population (rather than employees in the formal sector), which stands at 12million as mentioned above.

The low coverage can also be linked to the fact that the current arrangement is mainly for formal employees[135], and as it stands, coverage for retirement industry in South Africa is about 46%. The informal sector is about 15% of the employed which still accounts for a significant proportion of South African workers that are not provided for.

7.3.3.2 Leakages (Poor preservation)

Equally worrying is the observed savings leakages in the industry. Quite a number of people access their retirement fund provisions long before retirement, either through retrenchment, resignation or divorce, and worrying is that a large majority of these people opt for cash benefits. According to the Registrar of Pension Funds (FSB 2007), a total of over R85m was paid out in benefits in year 2005 compared to total contribution amount of just over R75m

[134] These gaps exist because contributions to retirement funds are voluntary, and as a result, only a few belong to the South African pension system.

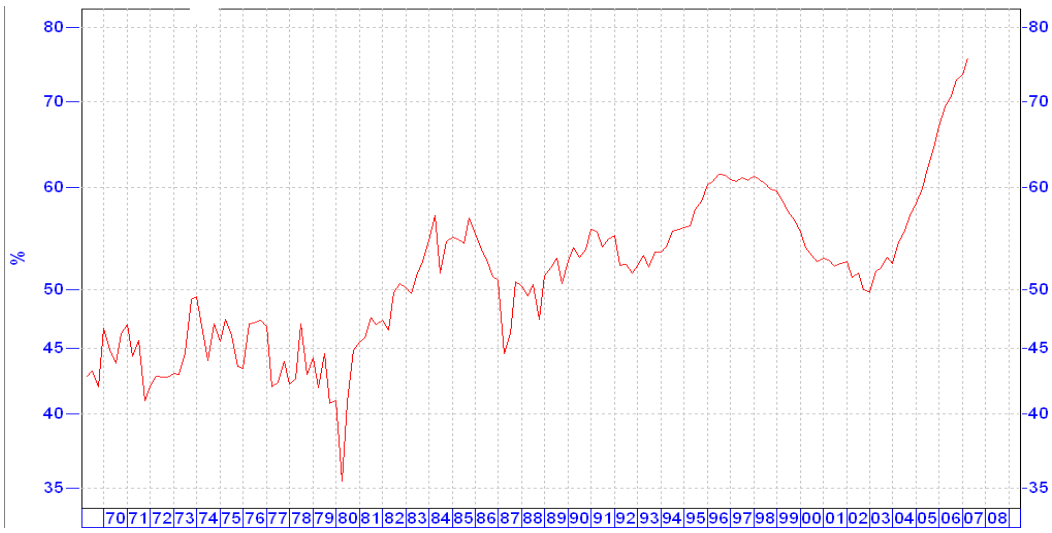
[135] It is hoped that the proposed reform will not further encourage migration to informal employment.

in same year, implying in general terms that there is more outflows than inflows into retirement funds.

A large majority of retirement fund members do not preserve their benefits until retirement. Over 80% of members who withdraw from retirement funds take their full benefits in cash (Sanlam 2010), and of the active members of retirement funds, only 19% had ever withdrawn from the fund, and 2/3 of this took their benefits in cash (Insight 2010).

Job loss and acute unemployment in the country creates a dire need for cash benefit by members already saddled with high debts. The graph below shows South Africa's household savings as a percentage of household debt.

Figure 7.1 Household saving (% of household debt)



(Source: Sanlam 2007, 9)

Over 70% of household income in recent years goes to servicing debts, leaving very little disposable income for basic needs, and thus very little or nothing for voluntary savings. Little wonder therefore that there is such a high trend of leakages in pension savings, leaving workers with little or nothing in their retirement savings bucket, thus more and more pensioners have to depend on government for survival.

7.3.3.3 Fragmented retirement and social security fund system

In section 6.2.2, reference was made to the proliferation of pension funds. The current retirement fund industry is highly fragmented and overtly complicated. As at end 2007, the FSB supervised over 13 500 funds, 4000 of which were dormant funds with 80% having less than 100 members[136] (National Treasury 2007).

In spite of the existence of so many pension funds, substantial gaps exist in the provision of retirement benefits, social grants, post retirement health/medical aid, unemployment insurance and death and disability benefits for all. Thus, many South Africans are unable to receive the support and benefits to which they are entitled.

7.3.3.4 Governance issues

This is perhaps one of the greatest challenges facing the industry. Current government structures do not provide sufficient protection for members of retirement funds against fraudulent activities and conflict of interest situation. Even though it must be acknowledged that the regulators have made considerable attempts to improve fund governance[137], however, some retirement funds remain inefficient, charging savers obnoxious upfront fees, which results in the members losing a significant amount of their income in the medium to the long term.

The sporadic evolution of private and public funds in South Africa has led to haphazard legislative landscape, where various funds fall under different acts and regulators. This compromises the goal of member protection and consistency in areas such as funding standards and dispute resolution.

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[136] The FSB the FSB continues to streamline the industry. It reported in its annual report of 2007 that there were only about 6000 funds remaining from over 13,000 few years ago. It is expected that smaller funds will move towards umbrella funds which are generally more cost – efficient.

[137] The PF 130, introduced by the FSB in June 2007. This circular requires that funds adopt various documents such as trustee code of conduct, investment policy statement etc; and further to this is the King 3 Code of Governance which came into effect on 1 March 2010, and serves as a general code of conduct for listed companies and all other entities, including retirement funds (Insight 2010).

According to the DoSD (2006, 14) "The adequacy of coverage provided through voluntary private provision is questionable. An analysis suggests that the industry wide replacement ration (for private retirement funds) must be around 23.4%. Consumers remain disempowered to a great degree by the current framework, transparency is poor, recourse in cases of abuse, although exists, is unlikely to prevent many retirement funds and intermediaries from skimming from large members of the public"

It is hoped that as part of the reform, a process will be put in place to improve governance regulation and consolidate the regulation and supervision of all retirement funds under one act. As a first step, all bargaining council funds not registered under the Pension Funds Act, were required to do so.

7.4 Summary

South Africa's social security and retirement fund system has evolved over the years in line with the country's socio-economic dynamics. Even though the current retirement fund system competes favourably with International standards, it struggles to achieve its overall social objectives, as majority of South Africans continue to suffer from old age poverty, and are increasingly more dependent on the state, and a significant percentage of the unemployed youth left with no social protection of any sort.

Achieving adequate income replacement in retirement is a function of many factors including years of contribution, rate of contribution and investment performance, combined with the avoidance of erosion of accumulated savings caused by early withdrawals and with proper oversight in place.

The next two main sections unpacks the details of the proposed reform: aims and objectives, structure, and the challenges facing the reform process

7.5 Retirement Fund Reform

As highlighted above, the various gaps and weaknesses in the existing social security and retirement fund arrangement has necessitated some intervention from government. A complete overhaul of the social security and retirement system has been proposed, and this is discussed below:

7.5.1 The proposed reform

"South Africa's socioeconomic indicators create a powerful case for a structured intervention within the area of social security. Despite at times fairly reasonable periods of economic growth, inequality and poverty have apparently deepened. Although there have been important redistributive interventions, these have not been sufficient to keep socioeconomic conditions from worsening .The long – term implications of failing to counter these trends will undermine the development potential of the country" (DoSD 2008,56).

The above statement from the DoSD encapsulates the realities of South Africa's social security and retirement fund arrangements. Improving the quality of private fund provision in South Africa[138]will require a comprehensive reform of the existing arrangements.

The proposed comprehensive reform therefore represents a major initiative on the part of government in addressing a number of the anomalies discussed above.

7.5.2 Aims and Objectives of the proposed reform

As mentioned above, the proposed reform seeks to provide a comprehensive and effective social security and retirement fund system. And thus, the focus of government is to ensure that the incomes of every worker is protected at retirement and a minimum level of support in the form of a poverty net created for those with low lifetime income levels and those unemployed.

In a key note address at the 2009 Institute of Retirement Fund (IRF) convention, Vusi Madonsela, the Director-General of Social Development re-emphasised that the reform cannot be restricted to the retirement provisions alone, but must also provide "a social security system that will protect people and their families in the event of catastrophic reversals, such as death, disability and unemployment" (IRF 2010).

According to the DoSD (2008, 7), the key objectives of the proposed reform are therefore:

- "To ensure that the social assistance framework and government funded basic services are functional adequate complete and efficient.

[138] In terms of lowering costs and improving equity and protecting against inadequate protection of member benefits.

- To introduce a contributory social security framework sufficient to ensure adequate levels of protection to income earners and
- To introduce appropriate redistributive measures aimed at income earners to: Mitigate any identifiable effects of social security provision on labour market participation within the formal sector, improve access to social security by removing access barriers, whether financial or institutional, and improve incentives to enter and remain within the formal labour market".

Essentially, the proposed reform seeks to achieve equity in contribution, mandatory participation and efficiency of the system, cross-subsidization, and compulsory preservation of funds[139].

7.5.3 Key areas of the proposed reform

The key areas of the proposed reform can be summarised as follows:

- Revise the 'means test' : The basic R1010 a month social old age grant to be extended to as many people as possible
- Improve governance
- A single state run and more comprehensive retirement fund that will provide retirement as well death and disability benefits
- Improve disclosure and restrict charges
- Some form of compulsory annuitisation
- Review the role of living annuities
- Privatise the asset management of national funds
- Compulsory preservation.
- Realignment of tax treatments for retirement funds.

7.5.4 Structure of the proposed NSSF

[139] The Department of Social Development favours a process where the current social grant system includes a basic income grant for the unemployed, and to introduce a single retirement fund for all citizens and perhaps a national health scheme.

One of the areas of the proposed reform that has generated a lot of debate has been the structure of the reform. However, both the DoSD and the NT have agreed on some structure.

The proposed social security and retirement reforms consists of four pillars as shown in the below table.

Table 7.1 Elements of the NSSF

Pillar 1	**Pillar 2**	**Pillar 3**	**Pillar 4**
Social grants system	**National scheme**	**Occupational or accredited funds**	**Individual retirement savings**
Pay- As- You- Go (PAYG)	**Mandatory**	**Mandatory**	**Voluntary**

- Pillar 1: This pillar represents the social assistance grants to all South Africans. It will include the removal of the means test currently applied to the disability and old age grants.

  The old age grant will become a universal non-contributory benefit available to all[140].

  It is intended to be a public grant system to deal with poverty and will be non-contributory. Everyone will have access to three basic social grants under this pillar: Income grant, child support grant and old age grant.

- Pillar 2: This pillar comprises a mandatory participation in the national social security system up to an agreed earnings threshold. It will provide basic retirement, unemployment, death and disability benefits. It is aimed at bridging the gap between the current social assistance grants and private sector provision.

[140] It is estimated that this grant will cost the government some R9billion and perhaps will be funded by removing the current tax subsidy on private retirement fund contributions

It will include a lower threshold and will likely exclude income earners earning less than R12000 per annum[141].

Within this pillar, there will be a two tiered system consisting of a defined contribution and a defined benefit element. Contributions to this second pillar will be set at about 15% of pre-tax income[142].

It has been suggested that the defined benefit tier be funded by government on a pay as you go basis to obviate the need for large reserves to be held within the government sponsored retirement fund.

- Pillar 3: This pillar consists of additional mandatory participation in private occupational or individual retirement funds for individuals earning above the threshold. It is to ensure that individuals at all earning levels make appropriate provision for insurance coverage and for retirement, and thus covers compulsory retirement savings together with mandatory risk cover. It will be sponsored by the government and every employed person will have to contribute a percentage of his/her salary to this fund.
- Pillar 4: This consists of supplementary voluntary savings, permitting individuals to choose how they allocate income over their lifetime. Similar to current RA world, where individuals may choose to contribute to and build upon retirement savings in addition to any occupational fund arrangements.

It is not clear how many members will be covered in each pillar. Limit for voluntary contribution or opt out is R150, 000[143] .

The above design is still to be finalised. It will most likely provide basic death and disability and unemployment benefits to a salary level proposed to be

[141] These categories of people are already catered for via the old age grant.

[142] Calculated to achieve a replacement ratio of about 40%. A term used to describe the percentage of a workers last salary that is paid as a pension.

[143] According to Alexander Forbes report on retirement funds in South Africa (2006), it was estimated that only about one million people in South Africa earn more than R150, 000 per annum.

R75, 000. Contributions for retirement benefits are likely to be in the region of 10% to 12%, with a further 2% to 4% meeting the cost of death, disability and administrative costs.

For workers earning less than R75, 000, all benefits will be provided by the NSSF, and are unlikely to continue on existing retirement funds i.e. make their existing contributions paid up. However, for those earning more than R75, 000, they may be able to continue on existing retirement fund for earnings above R75, 000. The workers in the latter category will therefore receive benefits from two funds.

The NT has confirmed to the industry that members will be able to transfer existing retirement savings to the proposed NSSF, all rights will be retained and all savings up to the implementation of the NSSF may be allowed to be taken in cash upon resignation from employment subject to applicable tax (Botha et al 2009).

Still on the tax issue, the next section briefly explores the proposed retirement fund tax reforms in alignment with the other proposed reforms.

7.6 The Retirement fund tax reform proposal

Government recognises that there are a number of complexities and inequalities in the current tax system, and thus there is a need to ensure that the tax treatment of retirement funds complement the newly proposed reforms.

The proposed tax reform will ensure that:

- The EET[144] system of retirement fund tax continues as this encourages savings and is the international norm.
- A uniform basis will apply to all retirement savings vehicles i.e. the distinction between pension, provident fund and retirement annuities and preservation funds will be phased out.

[144] Exemption on contribution to an approved retirement savings vehicle , exemption on investment roll-up, tax applied to end benefits

- The tax exemption on contribution will be limited to a pre-determined ceiling to prevent undue advantages to higher income earners.
- Low income earners, who pay little or no tax, may possibly receive the benefit of the wage subsidy in lieu of tax.
- The tax on end benefits will encourage individuals to opt for an annuity rather than a lump sum at retirement (Old Mutual 2010 , ABSA 2007)

It is evident from the above that the proposed reform seeks to tackle the structural deficiencies in the current system, while building on existing strengths in the private retirement fund sector, ensuring and maintaining a strong, cost effective and a well regulated private pension sector is thus a critical element of the retirement funding strategy.

Cameron (2010,1) summarises the overall intention of government when commented that “the government‘s retirement reform projects is rapidly developing into an investigation into establishing a comprehensive social security system that will aim to provide all South Africans with support from the cradle to the grave”.

The next section looks at the various issues and challenges facing the proposed reform.

7.7 Issues in the proposed NSSF

The National Treasury and the Department of Social Development agree on most of the areas of the reform, but also disagree on some of the details of the reform exercise. The below table summarises the major differences between the two departments.

Table 7.2

Differences between the views of the NT and the DoSD

	National Treasury	**Department of Social Development**
Contribution	The National treasury favours a defined contribution structure in which funds are accumulated in individual members name and the member purchases an annuity at retirement. The contributions of low income workers would be underpinned by a wage grant to employers	The Department of Social Development favours a defined benefit system, where the member is guaranteed a pension at retirement. The department proposes that the fund should be both compulsory and pay as you go[145].

[145] In other words to, to make the benefits affordable for everyone, part of future pensions will be funded by current contributions whilst working and part from the contributions of people employed after current workers may have retired.

Fund	The National treasury favours a single fund that will pay minimum benefits. The proposed NSSF, which would pay a pension equivalent to 40% replacement ration .The fund, will also pay minimum benefits on death and disability prior to retirement .You will be allowed to make additional contributions to the NSSF or to any other fund to increase your savings	Social Development also favours a single fund but one that will pay a pension you can survive on. It sees little or no place for any other funds. The department believes strongly that a balanced and delicate approach should be taken, in the establishment of a single national pension fund.

Opt -out[146]	The National Treasury favours allowing workers to opt out of the NSSF when it comes to saving for retirement. You can choose to save through any other approved fund, however you cannot opt out of the contribution for minimum risk benefits for death and disability	Social development proposes a single fund preferably with no opt outs

(Adapted from the DoSD, 2007)

[146] There is still no clarity on opt-out options even though both the Department of Social Development and National Treasury are now allowing for opt-out of the NSSF as a possibility despite the fact that the department of social development still favours a single national fund.

The main policy issues are therefore as follows:

7.7.1 Preservation

The National Treasury acknowledges that full preservation does not make sense in the face of the socio-economic needs of many South Africans, and that early access to benefits should be possible under certain circumstances, such as housing, unemployment etc.

7.7.2 Funded vs. Unfunded

While it remains likely that the NSSF will be a funded arrangement, one of the scenarios outlined by the DoSD was a pay-as-you-go fund. The DoSD and Labour supported this scenario as their first choice, while the National Treasury seems to continue pulling in favor of a funded system.

7.7.3 Administration

The South African Revenue Service (SARS) no longer seems to be seen as the entity to be fully responsible for the administration of the NSSF. While SARS would tackle the contribution collection, the administration and payment of benefits would be dealt with by some form of public-private partnership.

7.7.4 Low Income earners

Persons earning less than R12 000 annually cannot afford to pay contributions towards retirement. The proposal have considered a wage or contribution subsidies, or introducing a contribution floor, below which one does not contribute. Labour was strongly opposed to subsidies as a solution but favoured low income individuals being exempted from the system.

7.7.5 Investment Regulations

The proposal has been silent on the regulation of pension fund assets, particularly as it relates to Regulation 28, and calls from certain sector of the industry for an increase in the permissible investments in alternative investments (categorised as ‘other assets’ in the Regulation 28). As shown in Chapter three of this research work, Alternative Investments provide efficient portfolio diversification, and provide returns that are uncorrelated to traditional asset classes. This is particularly important during times of extreme market

volatilities where pension funds have lost a great deal of assets as stock markets took great knocks.

Government has however indicated that it intends to look at the ways pension assets are being invested, and perhaps prescribe certain percentage of pension fund assets to be directed towards developmental goals. It is hoped that the proposed amendment to Regulation 28 will incorporate some of this concerns without having to be forced to.

7.8 Unique Challenges to the Reform of the South Africa Retirement Industry:

The proposed reform undoubtedly represents a welcome shift in the manner in which retirement funds are managed in South Africa, it is nevertheless fraught with numerous challenges, and have been widely criticised within the industry, particularly bordering on the implementation and timing of the proposal.

According to Gluckman (2009, 3), government should be praised on its initiative and efforts at sanitising the social security and retirement fund industry; however, the questions to be asked about the soundness of the proposal include:

- Does the reform meet distributive concerns?
- Is the macro and fiscal policy accommodating the reform sound?
- Can the administrative structure operate the new multi tier pension scheme efficiently?
- Are the regulatory and supervisory arrangements and institutions in place to operate the new system with acceptable risks?
- Is there a long term credible commitment by the government?
- Is the political risk manageable?

The above becomes relevant especially when one considers the uniqueness of the socio-economic conditions of the average South African worker, one

that could make any sudden policy implementation impractical. Government is faced with the challenges of:

- Extending coverage through a compulsory fund in a diminishing labour market with age groups 18-24 having particularly acute income vulnerability[147] , and in a way that prevents informalisation of labour.[148]
- Ensuring compulsory preservation of retirement savings even in the face of increasing job losses and growing poverty, and portability of existing pension fund benefits to a new occupational fund or to an individual retirement account
- Justifying the practical need for retirement plans in the face of high mortality rates. Only about 30-40 percent of 20year old males are deemed likely to reach retirement age, the design of a long term retirement savings system is therefore not seen in some quarters as a pressing priority for South Africa relative to other social needs. There has to be a stronger risk component for those who will not reach retirement (Gluckman 2009, 8).

According to O'Brien (2009, 6):

> "South Africa ranks 121 in the UN Human development index with unemployment rate of over 25%. There is a high level of inequality and a low life expectancy rates. Prevalence of HIV/Aids means that many of the poor will not reach retirement age. The earnings patterns of the poor are very erratic and it is a fact that the poor have more pressing needs than retirement savings".

Notwithstanding the various challenges and criticisms against the proposed reform, there seems to be a general agreement amongst all stakeholders regarding the importance of some form of social corrections and poverty alleviation programmes that would ensure that every South African is protected in old age. And even though there are existing private and public

[147] Which is as a result of the high unemployment rate in the country.

[148] Low income workers could exit formal employment as a way of avoiding compulsory membership of the National Fund.

arrangements to provide some form of pensions, these have not been sufficient to keep the socio-economic conditions from worsening.

"South Africa's socioeconomic indicators create a powerful case for a structured intervention within the area of social security. Despite at times fairly reasonable periods of economic growth, inequality and poverty have apparently deepened. Although there have been important redistributive interventions, these have not been sufficient to keep socio-economic conditions from worsening .The long –term implications of failing to counter these trends will undermine the development potential of the country" (DoSD 2008, 56).

7.8.1 Summary

It is evident in this section that the process of reforming the social security and retirement fund system in South Africa requires a proper and effective management, one that will ensure that current realities are aligned with the state's future development goals.

Having discussed the proposed reforms in detail thus far, the next section will focus firstly, on some international trends vis-à-vis retirement fund reforms; and more importantly on the World Bank Models for social security and retirement fund provisions, particularly for developing nations.

7.9 Social Security Reform Case Study

Social security and retirement fund reforms are global phenomena. As countries grapple through different economic and social changes, international attention has shifted to how nations are able to cope with increasing social demands.

7.9.1 Global trends

In the past few years, there appears to be an international wave of social security and retirement fund reforms sweeping across most nations. Ageing population, socio-economic and developmental needs, and national fiscal deficits consequent to the global economic crisis, are some of the reasons for these reforms.

Current social security and retirement fund reforms across nations range from a subtle approach in most countries to more aggressive ones that includes nationalisation of pension funds such as seen in some Latin American countries[149].

Most developed countries faced with ageing population and huge fiscal deficits are forced to cut back on traditional social security provision, and have had to implement various reform measures such as:

- Increasing retirement ages
- Increasing contribution rates
- Reducing benefits
- Move towards private, defined contribution provision[150].

Even though it is beyond the scope of this research work to delve into social security and retirement fund reforms in detail, it will be beneficial in this chapter to give a snap shot of some international trends:

Asia –

The Chinese government recently approved a social insurance law which consolidates all hitherto fragmented legislations. The new legislation introduced a numerous provisions including old-age pension; basic medical; unemployment; maternity; and work injury insurance. The law introduced a one pillar system which also allows foreign nationals to participate.

In Malaysia, a new private pension plan was introduced to offer more options for retirement savings. The private pension plan will enjoy the same tax relief for contributions into the existing National Employees Provident Fund. This is to provide additional retirement savings for the dwindling benefits from the public fund.

Americas -

[149] As in the case in Argentina

[150] Majority of reforms have been from state unfunded defined benefit schemes to privately funded defined contribution system such as in Nigeria, or a combination of both as in the UK.

In the United States, further regulations were put in place to broaden the circumstances under which a person is considered to be a ‘fiduciary’. This is in line with overall changes in the financial industry.

Argentina in 2008 nationalised all private pension funds in a reaction to the financial and economic crisis of 2007/2008, which saw a great depletion in pension fund assets globally that rendered majority of the country’s pension funds unable to provide adequate retirement income for a large number of fund members and dependants.

Europe -

The UK recently published a report confirming the government’s plan to increase the state pension age to age 66. It also aims to simplify the pensions system by eliminating the means-tested and earnings-related top-ups. Eligibility will henceforth be based on residency rather than years of contributions. It also introduced the implementation of the auto-enrolment into the work place pension fund.

The Russian government increased total social contribution rate from 26% to 34%. And in Slovenia, the parliament intends to increase the retirement age from age 63 to 65 with 15 years of contributions. Eligibility for early retirements would be age 60 with 40 years of contributions.

In France, the recently (2011) passed Pension Reform Law has sparked off series of public protests. The French government announced in June 2010 that it intends to review the existing pension fund system in a bid to urgently address the financial costs of the rising number of older people relative to the younger ones in France.

This phenomenon puts pressure on the pension system which is based on a PAYG system, and with fewer people available for work, the government is faced with a growing pension liability, which could see the country’s public deficit increase by at least 5% of GDP over the next 30 years, and public debts could also double if nothing is done.

As tax burdens in France are already one of the highest in the European Community, and besides, raising taxes could have a negative impact on jobs

and growth, government is forced to take the option of keeping people longer in employment.

The Law provides for increase in minimum retirement from age 60 to age 62, and increase in the retirement for full pension from age 65 to age 67, regardless of number of years of contributions. It is claimed that this measure would save the government about $96billion in pension liabilities.

Africa -

Nigeria seems to have pre-empted the global economic crisis when the federal government passed the new Pension Fund Act in 2004, a product of a reform process that begun in 2003.

Prior to the reform, most pension schemes in the private and public sector were under funded or in most cases unfunded. The industry was plagued with an unsustainable outstanding pension liabilities and inefficient and corrupt pension fund administration system, particularly in the public sector, a situation that further aggravated the old age poverty rate in the country. There was also the issue of low coverage for workers in the formal sector, whilst that a large percentage of informal sector workers were left with no retirement plan or any social welfare plan.

The 2004 Pension Fund Act introduced a contributory system featuring Individual Retirement Accounts in line with the Chilean pension fund system. This system replaced the controversial pay-as-you-go public fund system. It is a defined contribution plan, membership is compulsory and all employers with more than five employees are obliged to set up retirement plans.

100 percent of pension fund assets can be invested in government securities, while a maximum of 20% can only be invested in listed equities. And more recently, government has indicated that pension funds will be required to invest a minimum of 20% in infrastructure development projects (Hewitt 2010, 2-4, OECD Observer 2010 and Barrow 2008, 18).

The impact of the above mentioned social security and retirement fund reform in these countries are far reaching, especially on the ability of the average worker to achieve adequate life - style sustainability in retirement[151].

Reduction in social and pension benefits threatens the very essence of the successes of many of these countries socio-economic development plans, and consequently there are widespread mass protests in some of these countries as the reforms are being rolled out.

Thus, social security is no longer taken for granted as it were, and now more than ever, the World Bank's 'prescription' for basic social security and retirement benefit arrangements has become quite relevant not only for developing nations but for the entire globe, and has renewed calls for countries to implement safety nets for its citizens in the face of a severe global poverty.

The next sub section therefore looks at the structure of the World Bank's global 'prescription' for social security arrangements, and how South Africa's current system compares with these models.

7.9.2 World Bank Models for old age provision

The World Bank prescribes a minimum social security and retirement provision framework particularly for developing countries. Two models have been developed so far[152] and are discussed below.

7.9.2.1 The 1990 Model

The 1990 World Bank model consists of three pillars:

[151] With reduced savings, longer time in unemployment and depleting pension assets, average replacement ratios are falling below livable rate of 40%.

[152] The World Bank developed two models in 1990 and 2000.

Table 7.3

1990 World Bank Model in South Africa's context

Pillar 1	**Pillar 2**	**Pillar 3**
Social Grants	Mandatory Savings	Voluntary Savings
Redistribution	Occupational funds/Individual accounts	Additional provisions
30% participation*	10% participation*	60% participation*

Source: Old Mutual (2009, 11)

South Africa's existing social security and retirement fund arrangement depends largely on voluntary savings as seen above. As discussed in sections 2.3 and 2.4, a significant portion of the working population are still not covered, and the low participation of the redistributive pillar as seen above presents a huge challenge as it is the most important pillar in achieving advances in human development and social integration.

7.9.2.2 World Bank 2000 Model

The 1990 Model was widely criticised as not fully representative of the unique social conditions and existence of certain developing countries especially the African Nations. These therefore led to the development of an additional Pillar which recognises the cultural peculiarities of these nations with regards to old age provision. The community pillar considers how the large majority of the elderly in Africa that do not benefit from other pillars survive. It is through community redistribution: the young taking care of the old in African culture.

The Four pillars of the 2000 model are described in the table below:

Table 7.4

2000 World Bank Model in South Africa's context

Pillar 0	**Pillar 1**	**Pillar 2**	**Pillar 3**	**Pillar 4**
Social Grants	Mandatory Savings	Mandatory Savings	Voluntary Savings	Community Provision
Non-contributory	Unfunded, Publicly managed defined benefit fund	Funded, Privately managed defined contribution fund	Individual Retirement accounts/ other additional provisions	Informal intra-family or inter-generational support

Source: Old Mutual (2009)

Current South Africa's social security and retirement fund model relies heavily on Pillars 0, 3 and 4. The proposed NSSF will include Pillars 1 & 2[153], and will increase participation in other pillars.

7.9.3 Summary

As highlighted in this section and also in previous chapters, changes in social demographics and increasing pension fund liabilities in conjunction with a widespread financial hardship puts social security arrangements across the globe under the spotlight.

It is no longer questionable that South Africa urgently requires sweeping social security reforms, what is in contention however is the manner and nature of the proposed reforms. It has to be implemented in a way that ensures efficient participation and sustainability.

[153] However it is not certain whether it will be a defined contribution or a defined benefit fund.

7.9.4 Conclusion

This chapter is quite pertinent to this research work as it examines the proposed future design and relevance of pension funds in South Africa. The growing poverty and widening income gap in South Africa remains one of the impediments to achieving a desirable human development target. The recent global financial and economic crisis presented a great opportunity for an overhaul of the country's social security system.

Section 2 of this chapter explored the background to the proposed social security and retirement reform. The section traced the various stages of the proposal, including numerous activities and responses from all stakeholders. It also made reference to the latest update from the DoSD, where the Chief Director of Social Insurance in her speech at the 2010 IRF Conference, reassured the retirement fund industry that government is fully committed to the implementation of the NSSF, and is at the last stage of the proposal being tabled to parliament for approval.

The section also explored the rationale for the proposed reform by highlighting various gaps and challenges facing the retirement fund industry.

The DoSD (2006, 14) buttressed the inherent gaps in its statement:

"The adequacy of coverage provided through voluntary private provision is questionable. An analysis suggests that the industry wide replacement ratio (for private retirement funds) must be around 23.4%. Consumers remain disempowered to a great degree by the current framework, transparency is poor, recourse in cases of abuse, although exists, is unlikely to prevent many retirement funds and intermediaries from skimming from large members of the public"

The structure, aims and objectives of the proposed reform were examined in detail in section 3. In this section, it was established that amongst other things, the reform seeks to achieve equity vis-à-vis contributions to retirement funds, efficiency of the retirement fund system, and cross-subsidisation of the poor by the rich and compulsory preservation of retirement savings.

The proposed reform seeks to tackle the structural deficiencies in the current system while, building on existing strengths in the private retirement fund

sector. Ensuring and maintaining a strong, cost effective and well regulated private pensions sector is thus a critical element of South Africa overall retirement funding strategy.

The section also looked at some of the major issues and challenges facing the proposal in terms of its relevance and also the implementation thereof. O' Brien(2009,6) questioned the relevance of a retirement fund overhaul at a time when South Africa is faced with more pressing needs than retirement. This point was supported by Gluckman (2009, 8). However, the section also presented the counter-argument from the DoSD's in support of the proposed the proposed reform.

Section 4 looked at some international retirement fund trends, especially in the face of the on-going global economic austerity measures. The first part of the section highlighted various measures taken by nations in reforming the pension fund industry. Most of these reforms revolve around cutting back on pension fund liabilities and transferring of retirement risks from the employer/state to the worker. The impact of the above mentioned social security and retirement fund reform in these countries are far reaching, especially on the ability of the average worker to achieve adequate life - style sustainability in retirement (replacement ratio).

Section 4.2 compared the World Bank's 1990 and 2000 models for retirement and social security plans, particularly for developing countries, with the existing social security and retirement arrangements in South Africa. The proposed NSSF intends to align South Africa's current social security framework with the World Bank's 2000 model by including additional pillars, to cover mandatory savings, and also increase participation in existing pillars.

Chapter Eight

Conclusion

8.1 Overview of the research

The recent financial and economic crisis has shown that pension fund investments in traditional asset classes, tend to overreact to extreme market volatilities, such as that seen in 2007/2008. During this period, global equities lost an average of over 40percent of their values and most developed nations were forced to slash interest rates drastically and in some cases to zero percent.

The subsequent loss of pension fund assets paved way for a widespread clamour for alternative investment strategies and more responsible investing by pension funds.

Against this background, this study as mentioned in the introductory chapter sought to:

- Examine the role of pension funds in national planning, fiscal planning and economic development by determining the pension systems' development options and a case for economically targeted or socially responsible investments (with the aim of establishing its economic viability).
- Critically analyse the role of government, labour and other public agencies in the investment and management of pension funds assets.
- Measure the extent of economically targeted investments (socially responsible Investments) by privately managed funds in South Africa

Chapter one explored the current economic climate, and the socio-economic malaise created by financial and economic crisis of 2007/8, which still continues to send aftershocks to the world markets. The current euro zone sovereign debt crisis and the American debt ceiling and unemployment figures continue to send jitters down global markets.

It also established the link between institutional funds and economic development, especially during times of public financial deficits and strong austerity. Developing countries, particularly during these times, are faced with severe fiscal imbalances that could thwart the economic growth achieved by many of these emerging economies in the late 90's and early 2000's.

Chapter two laid out the research method and methodology for the research work.

Chapter three conducted a literature review on the study. It stressed the fact that socially responsible investments (SRI's) and particularly economically targeted investments (ETI's) are highly controversial, and so is any study undertaken in this area. More so as it deals with issues for which there is not yet a body of research in South Africa.

It was also established that investments in hedge funds, mergers and acquisitions, venture capitals, private equity and socially responsible investments, popularly known as alternative investments (AI's) have created new opportunities for pension fund investments to achieve good returns adjusted for risks, whilst also ensuring that pension funds realign their objectives with that of the larger society.

The chapter also debated the issue of trustee's fiduciary duties, and asks that perhaps it is time that trustees of pension funds, particularly in developing nations begin to rethink their fiduciary duties, and consider incorporating ESG issues into their investment patterns, if any long term and real benefits is to be achieved for its fund members in an environment where a meaningful and sustainable economic development can be guaranteed. Particularly, when one considers the growing resentment of larger society to the manner in which businesses have conducted its activities in the past. This growing anger was recently depicted in the widespread mass protests ('occupy wall street'), which started in the United States but soon spread to the rest of the world.

Many ETIs are designed to create or keep jobs for the local economy and there are numerous examples of developing countries particularly in Africa where governments have had to direct pension fund investments towards certain identified infrastructural projects. Critics of ETIs wonder if such

targeted investments are indeed beneficial to the fund members, for whom the fund exists in the first place.

The recent Draft Code for Responsible Investing by Institutional Investors and The King Report on Corporate Governance South Africa (King III) in South Africa further lends credence to the ever increasing demands on companies, asset managers, trustees and all stake holders, for more responsible investment patterns.

Chapter Four provided a contextual framework for the research work .It described the entire nature and structure of South Africa's retirement fund industry. It is evident that the industry is constantly evolving and is quite multi-faceted, with many layers comprising non – contributory, means- tested public benefit program, various pension and provident fund arrangements, and voluntary savings (known as retirement annuities).

The issue of governance and investment of pension fund assets as shown in the chapter remains the focal point in the industry. Supervision of the funds varies according to the legislation or Act establishing the funds. With over 13 500 private pension funds in South Africa and consisting of occupational pension funds, provident funds and retirement annuity funds, it is indeed a great task managing the affairs of these funds, thus the diverse nature of the legislative landscape.

The investments of pension fund assets have also come under intense scrutiny. The Regulation 28, which governs the way pension fund assets are invested has been criticised for being too restrictive and not dynamic enough to offer alternative investment patterns especially during times of extreme financial and economic crisis such as seen in 2007/8. The recent amendment to the regulation increased pension assets allocation to 'other' assets from 2.5% to 22.5%[154], representing a significant improvement from previous years and perhaps a sign that the pension fund regulators are beginning to shift towards a more developmental approach to pension fund investments.

[154] See appendix 13.

The Chapter also looked at retirement fund benefits: withdrawal; retirement; and death benefits and the taxation thereof. Government has built in various measures to streamline the way in which withdrawal and retirement benefits are taxed, replacing the hitherto complex tax tables with a much simpler one.

The deductibility of contributions to pension funds by employers and employees have also been streamlined, employer contributions on behalf of the employee to retirement annuity funds are now deductible for tax purposes. Recent draft amendments (effective March 2012) propose a uniform tax deduction rates for all retirement funds, to be set at 22.5%.

Coutts (2010, 2) mentioned in this chapter that the overall state subsidy on retirement contributions and investment income thereof is estimated to be about R28.5bn in 2005 only. It was also established that the manner in which pension fund benefits are taxed remains critical to the achievement of government's goal of ensuring that a large majority of South African workers preserve their benefits to retirement.

Chapter five examined the development of SRI's and AI's in relation to pension fund investment behaviour. It showed that pension funds across the globe have begun to embrace the concept of SRIs in their investment behaviours, by showing the shift from volatile and traditional investment vehicles to a mix of alternative investment vehicles that promises more efficient portfolio diversification and superior returns.

The chapter delved into the measurement and classification of the impact of pension fund investments. Bearing in mind that measuring pension fund investment impact can be as onerous as the management of pension funds itself and for simplicity purposes, pension fund investment impacts were categorised as direct and indirect impacts.

Funds that invests directly in dedicated SRI funds or in publicly listed companies which take SRI or ESG issues into consideration in their investment decisions will have a more direct impact on the economy, while funds that do not have specific SRI policies but invest in publicly listed companies could have indirect impact on the economy, through the deepening of the capital market and overall financial system.

The chapter showed case studies of some of the SRI funds in South Africa, highlighting their impacts on the socio-economic development of the country. It also looked at some of the sustainable development goals and achievements of some the Top 10 JSE listed companies, as a means of establishing pension funds indirect impact on the economy via the equity investments of pension funds in listed companies.

SRI funds contributed immensely to the socio economic development of the country through job creation and infrastructure development. It helped in alleviating poverty and helped develop entrepreneurship through credit extension to undeserved and unbanked sector of the economy. Similarly, pension funds own a sizeable share of the JSE by virtue of its asset-size. Its equity investments also contribute indirectly in sustainable economic development and capital market / financial system development. Pension fund investment in some of the Top 10 JSE listed companies assisted in job creation and sustenance, and more importantly in community development and revenue generation for government (in form of taxes).

Chapter six examined the concept and growth of Alternative Investments particularly on the back of the recent financial and economic crisis. Investments in SRI's and AI's continue to gain momentum as pension funds seek for better yields and less volatility on one hand, and more responsible and sustainable investments on the other hand.

AI's have not only provided pension funds with more efficient portfolio diversification and better returns with less volatility, but have also contributed greatly to overall economic development. Private equity investments have contributed materially to social and economic transformation in the country through its numerous BEE backed transactions. It has also provided seed capital to numerous start-up businesses and helped sustain a lot more small and medium-sized companies.

Recent amendment to the Regulation 28 of the Pension Fund Act has further given impetus to the growth of SRI in the country, and provides a welcome opportunity for Institutional investors to significantly increase their allocation to 'other' asset category which includes PE, Hedge Funds etc, perhaps to the

maximum percentage of 20%. It is reflective of Governments intention to encourage pension funds and other institutional investors alike to invest in development projects.

The chapter further investigated trade unions and their role in pension fund investments. The section created a link between the purpose of labour unions and the ultimate objective of pension funds. It created a link between workers interest and pension fund benefits in the ultimate pursuit of socio-economic development of a nation.

It was established that there is an increasing recognition by the trade unions globally that the investment of workers capital should reflect the fundamental interest of workers, not only by bringing competitive financial returns, but also by contributing to the long term viability of the economy, social standards and the environment. Alternative investments can do that, and that's where the worlds of workers capital and ETI's meet.

The size of union sponsored funds and the unique prevailing inequalities and challenges facing the majority of South African workers (whose funds constitute a significant portion of total pension fund assets) are a natural attraction for union's involvement in the management of pension fund assets.

Chapter seven was quite pertinent to this research work as it examined the proposed future design of pension funds in South Africa. It explored the background to the proposed social security and retirement reform, traced the various stages of the proposal, including numerous activities and responses from all stakeholders and also provided a status report by making reference to the latest update from the DoSD, where the Chief Director of Social Insurance, in her speech at the 2010 Institute of Retirement Fund (IRF) Conference, reassured the retirement fund industry that government is fully committed to the implementation of the National Social Security Fund, and is at the last stage of the proposal being tabled to parliament for approval.

The core of the chapter centred on the rationale for the proposed reform, and the structure, aims and objectives of the reform.

Ensuring and maintaining a strong, cost effective and well regulated private pension sector is thus a critical element of South Africa overall retirement funding strategy.

The Chapter also looked at some of the major issues and challenges facing the proposal in terms of its relevance, and also the implementation thereof.

O' Brien questioned the relevance of a retirement fund overhaul at a time when South Africa is faced with more pressing needs than retirement. This point was supported by Gluckman (2009, 8). However, the section also presented the counter-argument from the DoSD's in support of the proposed the proposed reform.

For some international reference, the chapter looked at some global retirement fund trends, especially in the face of the on-going global economic austerity measures.

It highlighted various measures taken by nations in reforming the pension fund industry, most of which revolves around cutting back on pension fund liabilities and transferring of retirement risks from the employer/state to the worker.

It also compared the World Bank's 1990 and 2000 models for retirement and social security plans, particularly for developing countries, with the existing social security and retirement arrangements in South Africa. According to the Treasury, the proposed NSSF intends to align South Africa's current social security framework with the World Bank's 2000 model by including additional pillars, to cover mandatory savings, and also increase participation in existing pillars.

8.2 Future research

Impact investing or socially responsible investments, are by no means an exhaustive debate particularly in a developing country such as South Africa where the risk of political interference and corruption needs to be balanced against the dire need for development financing, poverty alleviation and wealth redistribution.

Pension funds will continue to play a significant role in the economic development of the country, and what has come through from this research work is the clamour for increased pension funds asset allocation towards more direct impact investments over and above the recently increased investment limit of 20% for pension funds exposure to AI's.

What will be important for future study is a critical review of AI's and the investment risks that pension funds will be exposed to, considering the legislative purpose of pension fund establishments and the fiduciary duties of its trustees vis-a-vis ensuring that pension funds are able to meet their primary liabilities to the fund members whilst incorporating economic, social and governance issues into their investment decisions.

South Africa and similarly other developing countries are faced with numerous and varying institutional and political instabilities that may expose pension fund assets to political and economic risks. What are the unique challenges facing private equity investments and other forms of responsible investments in South Africa? What are the underlying factors behind every socially responsible investment decision by pension funds? How equipped are pension fund trustees in taking these decisions and what are the criteria for selecting a particular SRI fund?

All kinds of investments involve some level of risk, it will therefore be important for all stakeholders to recognise these risks and develop appropriate measures to mitigate against these risks. Recent riots on the streets call for a redefinition of the objectives of companies from 'maximising shareholder value' to socially responsible investments.

8.3 Research findings

Pension funds are an integral part of a nation's economy. This research work established the various dimensions in which pension fund investments can impact the socio economic development of a country, especially in developing countries, where there exists a huge infrastructural and economic gap among different sectors of the economy.

The research work was able to establish the relevance of SRI and AI's in the pension fund investment decision making process, and identified the various

commitments by the different stakeholders towards a more responsible and sustainable investment behaviour.

The research was restricted by the limited amount of data available in the industry and particularly on the investment patterns of pension funds (The 2006 FSB report is the most recent report available on pension funds by the FSB). Also very limited data is available of PE's and Hedge funds due to the unregulated nature of these investments. However, there is evidence that shows that AI's are becoming popular and are increasingly being more regulated subsequent to the 2007 financial and economic crisis.

The recent amendment to the regulation 28 of the Pension Fund Act in South Africa, which increased pension funds permissible allocation to AI's to 22.5% from 2.5%[155] will create an avenue for additional allocation by pension funds to more impact investments, and a greater contribution to the country's economic development.

Pension funds are workers capital, and therefore should be invested in a manner that will benefit workers, and these benefits cannot be restricted to mere financial benefits, it should be able to generate social, financial and environmental benefits, and in a sustainable way.

The research work established a link between labour and pension fund investments, by looking at the role of labour union as custodians of workers interest. It also highlighted governments interest in ensuring that pension funds contribute to economic development by increasing permissible allocation to AI's and encouraging that pension funds invests responsibly.

It is therefore important; especially in developing nations that pension funds begin to act as development finance institutions (DFI), by broadening its traditional objective of providing retirement benefits, to include ESG considerations.

[155] Prior to the 2011 amendment, pension funds were only allowed a maximum investment of 2.5% of total assets in the 'other assets' category, which included private equities and hedge funds. The new amendment created separate investment category for private equities (10%), hedge funds (10%), and other assets excluding the two mentioned (2.5%). See appendix 13.

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Appendix 1

Number of All Retirement Funds in South Africa

Fund Type	2005	Additions	Cancellations	Conversions	2006
Privately administered funds	3 487	68	(52)	112	3 615
Underwritten funds	9 888	28	(300)	(99)	9 517
Official funds	3	-	-	-	3
Transnet Pension Fund	3	-	-	-	3
Telkom Pension Fund	1	-	-	-	1
Post Office Fund	1	-	-	-	1
Bargaining Council Funds	5	-	(2)	-	3
Foreign Funds	2	-	(2)	-	0
TOTAL	13 390	96	(356)	13	13 143

(FSB 2006, 10)

Appendix 2

Number of Members of All Retirement funds in South Africa

Fund Type	2006	2005
Privately Administered Funds	6 152 543	4 403 620
Underwritten Funds	3 420 416	4 036 480
Official Funds	1 375 397	1 376 000
Transnet Fund	159 943	164 627
Telkom Fund	261	283
Post office Fund	22 715	23 034
Bargaining-council Funds	60 602	73 923
Foreign Funds	-	25
Total	11 191 877	10 077 992

Telkom Retirement Fund is however registered under the Pension Fund Act and therefore categorized (40 534 members) under the privately administered funds.

(FSB 2006, 11)

Appendix 3

Aggregate Assets of All Retirement Funds in South Africa

Fund Type	**2006 (R'm)**	**2005(R'm)**
Privately administered Funds	805 927	580 695
Underwritten Funds	206 754	224 198
Official Funds	545 600	426 611
Transnet Fund	53 591	42 649
Telkom Fund	283	215
Post office Fund	7 180	6 846
Bargaining-council Funds	1 588	2 707
Foreign Funds	-	-
Total	1 620 923	1 283 921

Foreign Funds furnish guarantees to cover their liabilities to South African residents.

(FSB 2006, 11)

Appendix 4

Investment Patterns of Pension Funds Registered With the Financial Services Board in Terms of the Pension Funds Act

ASSETS	2006		2005	
	R'm	% of Total Assets	R'm	% of Total Assets
Immovable properties	4 628	0.5	4 683	0.6
Bills and bonds	78 540	8.0	67 724	8.6
Participating mortgage bonds	37	0.0	4	0.0
Debentures	5 378	O.5	530	0.1
Loans	1 107	0.1	662	0.1
Equities	218 962	22.0	184 143	23.3
Collective investment Schemes	51 635	5.2	43 470	5.5
Insurance policies	470 310	47.3	375 683	47.6
Deposits& krugerrands	48 012	4.8	34 052	4.3
Foreign investments	98 126	9.9	61 702	7.8
Other assets	17 077	1.7	16 918	2.1
TOTAL	993 812	100	789 571	100

(FSB 2007, 13)

Property plant and equipment, housing loan facilities, surplus improperly utilized receivable, transfers receivable, accounts receivable, contributions receivable and cash at bank are not included

Equities comprise of local equities, equity index-linked instruments preference shares and unlisted equities

Foreign investments includes listed foreign equities and unlisted equities

Other assets represent a combination of derivatives and investments not listed on the table".

Appendix 5

Assets Held in Compliance With Regulation 28 as at end 2006.

Categories of assets	%(Total investments)	Fair Value R'000	% of Fair Value R'000
Deposits in banks, mutual banks, Post bank and SAFEX.	100	57 428 953	5.72
Krugerrands	100	29 992	0.00
Bills, bonds and securities issued or guaranteed loans.	100	15 777 050	1.57
Bills, bonds and securities issued by, and loans to an institution in the Republic in terms of section 19(1)(h) of the Act	100	10 389 446	1.04
Bills, bonds and securities issued by, and loans to an institution in the Republic in terms of section 19(1)(i) of the Act	100	3 015 530	0.30
Immovable property and claims secured by mortgage bonds thereon. Units in Collective Investment Schemes in property shares, loans	25%	8 729 864	0.87

and debentures, both convertible and non-convertible.			
Preference and ordinary shares in companies, excluding shares in property companies. Convertible debentures, whether voluntary or compulsorily convertible, and units in equity unit trust schemes of which the objective is to invest their assets mainly in shares	75%	300 523 022	29.95
Listed and un listed debentures, units in collective investment schemes with the objective to invest in income-generating securities, and any secured claim against individuals and companies	25	25 639 638	2.56
Investments in the business of a participating employer inside the Republic	15	13 806 036	1.38
Any other assets not	2.5	2 549 602	0.25

referred to in this annexure			
Fair value of units in a collective investment scheme included in total assets to be excluded in terms of sub regulation (2)a)(i) of Regulation 28		30 206 414	3.0
Fair value of insurance policies included in total assets to be excluded in terms of sub regulations 2(a)ii) and (3) of regulation 28.		480 002 630	47.84
TOTAL		1 003 452 825	100
Investments outside the Republic	%(**Total investments)**	%of Fair Value	Fair value of assets
Deposits with banks outside the Republic	15%	0.29	2 913 650
Bills ,bonds and securities issued by government outside the Republic	15%	0.32	3 206 148
Immovable property ,units in collective investment schemes in property shares, shares in, loans to and debentures of	10%	0.00	42 338

property			
Preference and ordinary shares in companies, convertible debentures outside the Republic	15%	3.52	35 334 509
Units in equity collective investment schemes outside the Republic	15%	2.54	25 505 481
Debentures and other secured claims against individuals and companies and units in income collective investment schemes outside the Republic	15%	0.50	5 039 012
Other	2.5%	0.04	353 221
Total (Limited to 15% of fair value of assets above)		7.21	72 394 359

(FSB 2006, 43)

Appendix 6

The following therefore represent the broad base of the draft amendment to Regulation 28:

1. "Individual Member Choice

Currently the limits of Regulation 28 apply to a fund as a whole. This has meant that if a fund is complaint overall, certain individual members may have had investments that are outside of the allowable investment limits. The re-draft proposes that investments must be compliant at member level and a fund level.

2. Scope of Regulation 28

Current law allows policies that offer a guarantee to be excluded from the investment limits imposed by Regulation 28.The draft amendment will remove the exemption and all policies (pension and retirement annuity) will have to comply with the requirements of Regulation 28, irrespective of any guarantee which may be offered.

3. Investment Requirements for Asset Categories

Under current law it has been perceived that the definitions of investment categories are inconsistent with the definitions of funds and fund managers in other legislation. It is believed that the levels of limits imposed by Regulation 28 are outdated and need review. In addition it is felt that investment assets must be rated and that only once a rating has been granted can an assessment be made on the percentage of investment in a particular asset class. The risk profiling has become of importance following events in Europe and America and the regulator is seeking to protect funds by ensuring the soundness of assets. It is also propose that:

4.

- Recognition in definition must be given to the Security Services Act, The Collective Investment Scheme Control Act and provision for Islamic-complaint instruments.
- Investment categories may be split along categories of liquid assets (bank deposits and certain liquid money market instruments) and listed securities (equities, corporate bonds and government bonds). Attention must still be paid to the categorization of directly held immovable property, other tangible assets and Krugerrands.
- The Registrar will prescribe which credit rating agencies may issue credit ratings.
- Property investments will have to differentiate between direct holdings and investment in property instruments. It is felt that current limit of 25% for investments in property instruments is too high.

- The current Regulation 28 does not allow modern investment products. The draft amendment looks to allow for a more effective management of assets and the proper disclosure of investment vehicles. The following are proposed:

  - Borrowing- the conditions contained in Regulation 21 are to be incorporated into Regulation 28 to protect funds against irresponsible borrowing.
  - Foreign Investments- In line with exchange control regulations, funds will be able to invest 20% of their assets offshore
  - Foreign investments into Africa- Funds will be allowed to invest 25% of their assets in African assets.
  - Securities Lending- To protect the solvency and liquidity of funds and within limits to be set by the Regulator, funds will be able to engage in securities lending. A draft notice on the condition s under which this is to allow is till to be issued.
  - The Look-Through-Principle - Regulation 28 does not currently provide for the 'look –through" principle which meant that investment managers can potentially circumvent the requirements of Regulation 28 by investing in layers of investments vehicles to mask the underlying investment exposure. The amendment seeks to dispel this practice and will look closely at derivatives and foreign investment exposures as well as investments in an underlying asset through another fund.
  - Housing Bonds- Although not covered in the draft explanatory notes, an element is contained in the draft of Regulation 28 that will allow funds to grant housing loans in accordance with Section 19(1) of the Act of up to 95% of the funds assets" (PENDUKA, National Treasury 2010).

Appendix 7

Pension Fund Investment Return

"Return made by pension a fund on the value of investments shown below is calculated by using the following formula:

R= 2 / A + B- I

Where R = Return on investments

A= Initial value of investments

B= End value of investments

I= Interest, dividends, rent, policy income, net profit or losses on realization on investments and the amount by which investments were written up or down to fair value.

Funds are required to disclose in their financial returns the method used for determining accrued, vested or provisional income from insurance policies".

Appendix 8

Prudent Investment Requirements

Asset category	**% Maximum (Total investments)**
Ordinary and preference shares	75% (of which no more than 5% in any unlisted company or Development Capital Market Stock and no more than 10% in any listed company with a market capitalisation. Of less than R2bn and no more than 15% in any listed company with a market capitalisation. Of more than R2bn)
Property, property shares and property trusts	25% (of which no more than 5% in any one property)
Shares and property as above combined	90%
Claims secured by mortgage bonds on immovable property	25% (of which no more 0.25% for any one individual)
Krugerrands	10%
Cash, fixed deposits, gilts and semi-gilts	No limitations except that no more than 20% of the fund may be invested in any one institution
Assets outside South Africa	20%

(Botha et al 2010, 909)

Appendix 9

South Africa SRI FUNDS

Fund Type	Fund Name	(Rm)Assets Under Management	(%)Domestic Assets
Equity	Element Earth Equity Fund	476m	100%
	Element Islamic Equity Fund	103m	NA
	Future growth Albaraka Equity Fund	801.5m	NA
	Futuregrowth Infrastructure and Development Equity Fund	490.2m	NA
	Futuregrowth SRI Equity Fund	4.2m	NA
	Investec Africa Equity Freestyle Fund	90m	70%

	Investec RI Equity Fund	390m	NA
	Oasis Crescent	3,127m	83%
	Oasis crescent international fund of funds	374m	0%
	Old Mutual community growth equity fund	2,4bn	NA
	Sanlam SRI Equity Fund	50m	NA
	Sasfin TwentyTen Fund	97.04m	NA
	Stanlib Shariah Equity Fund	123,4m	NA
Balanced	Advantage Shariah Fund	4.6m	85%

	Advantage /Momentum Super Nation Fund	72m	NA
	Cadiz Money Market Fund	112m	NA
	Futuregrowth SRI Balanced Fund	6m	NA
	Investec TDI Balanced Fund	96m	NA
	Metropolitan African Wealth Creator	1,1bn	92%
	Sanlam Infrastructure Fund	250m	85%
	Stanlib corporate wealth development	250m	NA
	27 Four Shariah Fund	30m	NA
Fixed Interest	Cadiz Infrastructure Bond Fund	53,9m	NA

	Cadiz SRI Bond Fund	105,7m	NA
	Coronation Siyakha Bond Fund	27m	NA
	Futuregrowth Infrastructure and Development Bond Fund	4.6bn	NA
	Old Mutual Community Growth Gilt Fund	900m	NA
	Old Mutual Community Growth Money MARKET FUND	17.7M	85%
	Sanlam SRI Bond Fund	150m	NA
Private Equity Alternative	EMF Kagiso Infrastructure Empowerment Fund	649m	NA

	Investment solutions Sakhiswe fund	80m	NA
	Investment solutions Shariah Fund	1bn	85%
	Macquarie and Old Mutual AIIF (African Infrastructure Investment Fund	721m	NA
	Macquarie and Old Mutual SAIF (South African Infrastructure Fund	1,32bn	80%
	OMIGSA Ideas Fund	2,25bn	85%
Property	Futuregrowth Community Property Fund	2,6bn	NA

Source: (Giamporcaro, 2010, 12-13).

Appendix 11

JSE LISTED SRI FUNDS

FUND NAME	DESCRIPTION OF SRI FUND	TOP COMPANIES
Community Growth Fund	Invests in companies focused on job creation, training and skills development, employment equity, BEE, good labour practices, sound environmental practices and good corporate governance.	BHP Billiton, Sasol, MTN, Impala Holdings, FirstRand, Standard Bank, Imperial Holdings, Delta. AECI.
Fraters Earth Equity Fund	Focuses on corporate governance, and good labour practices. uses shareholder activism	Remgro, Gold Fields, Anglo gold, Sasol,Venfin, Altech, Tongaat, Tiger brands, SAB Miller.
Futuregrowth Albaraka Equity Fund	Focuses on shari'ah compliant investments. Does not invest in alcohol, gambling, non –halaal, or interest bearing instruments.	Sasol, Iscor, Tongaat, Anglo, Nampak, Barloworld.

Oasis Crescent Equity Fund	Excludes companies involved in gambling, insurance or other financial services companies, as well as companies that are highly geared.	Afrox, Sasol, Anglo, Nampak, Nuclicks, Barloworld, Venfin, Medclinic.
Community Gilt Fund	Focuses on longer term fixed interests instruments with emphasis on institutions and projects that fosters economic development in south Africa.	R157Bond,R153 Bond, R194Bond, DV07 Bond.

Source: (NALEDI 2003, 15)

Appendix 12

Performance of Targeted Development Investment (TDI) Funds (or SRI Funds) for period ended December 31 2010.

Fund Name	Fund Size (Rm)	One year	Three year	Five year
Balanced				
Dibansa AlphaWatch Balanced	63.2	24.59	7.77	-
Metropolitan African Wealth Creator	1 147.4	-2.43	1.92	10.62
Momentum/Advantage Supernation	95.5	20.59	7.46	16.21
OMIGSA Community Growth Fund of Funds	62.2	20.24	-	-
Stanlib Wealth Development	211.3	11.32	8.98	17.86
Equity				
Element Earth Equity	515,7	26.48	5.94	17.69
Futuregrowth Albaraka Equity	885.8	18.93	-1.73	12.08
Futuregrowth Infrastructure and Development Equity Fund	525.9	13.14	-	-
OMIGSA Quants SRI	47.3	27.6	5.90	-
OMIGSA Community Growth Fund	2,634.9	30.85	7.41	17.37
Oasis Crescent Equity	3 923.4	19.63	4.80	16.96

Oasis Crescent International Feeder	444.1	4.15	-2.48	9.36
Absolute Returns				
Invested TDI	101.5	22.31	11.92	-
Alternative				
OMIGSA AI Ideas	2 399.2	9.47	13.73	16.86
Fixed Interests				
Cadiz Infrastructure Bond	556.5	-0.87	6.63	-
OMIGSA Community Growth Gilt	1 128.7	-0.65	7.11	7.43
Coronation Siyakha Bond	27.2	-0.45	6.68	-
Futuregrowth Infrastructure and Development Bond	3 916,7	1.57	8.83	9.13
Property				
Futuregrowth Community Property	3 331.1	8.22	14.97	17.10

(Source: Alexander Forbes, Manager Watch. 2010).

Appendix 13

MONTHLY REPORT ON LEGAL DEVELOPMENTS IN THE EMPLOYEE BENEFITS INDUSTRY

1. New regulation 28 (Asset spreading requirements)

The final draft of the new regulation 28 was published on the website of National Treasury (www.treasury.gov.za) on 23 February 2011. The effective date is 1 July 2011.

Preamble

The preamble to the new regulation 28 provides as follows:

"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. Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assts, including factors of an environmental, social and governance character. This concept applies across all assets and categories of assets and should promote the interests of a fund in a stable and transparent environment."

Policy statement and principles

A fund must have an investment policy statement that must be reviewed at least annually. The fund must comply with the following principles which must also be addressed in the investment policy statement:

- Promote the education of trustees with respect to pension fund investment, governance and other related matters;
- Monitor compliance with regulation 28 by its advisors and service providers;
- In contracting services to the fund or its trustees, consider the need to promote broad-based black economic empowerment of those providing services;
- Ensure that the fund's assets are appropriate for its liabilities;
- Before making an investment in an asset perform reasonable due diligence taking into account risks relevant to the investment including but not limited to credit, market and liquidity risks, as well as operational risk for assets not listed on an exchange;

- Before making investment in a foreign asset, perform reasonable due diligence taking into account risks relevant to a foreign asset including but not limited to currency and country risks.

- In performing its due diligence a fund may take credit ratings into account, but such ratings should not be relied on in isolation for risk assessment or analysis of an asset;

- Understand the changing risk profile of assets of the fund over time;

- Before making an investment in and while invested in an asset consider any factor which may materially affect the sustainable long term performance of the asset, including but not limited to those of an environmental, social and governance character.

Asset limits

A fund may only hold assets and categories of assets referred to in Table 1 and must comply with the limits set out in regulation 28.

The following aggregate limits apply in addition to the limits in Table 1:

Other unlisted debt instruments, unlisted shares (excluding property companies), unlisted immovable property and hedge funds, private equity funds and any other assets – 35%

Unlisted shares (excluding property companies) and private equity funds – 15%

RSA cash (item 1.1) and debt instruments of RSA bank – 25% per issuer/entity

A copy of Table 1 is attached hereto as Annexure 1.

Some of the main features include:

- Listed shares – the overall limit of 75% is retained, but the per-issuer limits are divided into three categories, depending on market capitalisation.

- Fixed property – the overall limit of 25% is retained but the per-issuer limits are divided into three categories depending on market capitalisation.

- The previous overall limit of 90% in listed shares and fixed property no longer applies.

- The Kruger rand category has been expanded to include exchange-traded commodities, but the overall limit remains 10%.

- Debt instruments – the overall limit for bank-issued listed debt was raised to 75% and for public entity-issued listed debt to 50%.

- Before the 2011 change to regulation 28 the limit for other/alternative assets was 2,5%. More flexibility is now afforded to funds in that specific

reference is made to hedge funds and private equity funds. The limit for each of these type of funds is 10% and for other assets not mentioned elsewhere 2,5% - the overall limit for investments in hedge funds, private equity funds and assets not mentioned elsewhere is 15%.

Member level compliance

Where a fund provides individual member choice with regard to investment, regulation 28 compliance on member level is required. However, an exception is made for certain existing individual contractual arrangements, in retirement annuity, pension preservation and provident preservation funds, that are in place before 1 April 2011 – these arrangements will be allowed to remain outside of regulation 28 limits until such time that any material contractual provision related to that arrangement or the category of underlying assets is changed.

Foreign exposure

The maximum foreign exposure will in future be determined by the SA Reserve Bank – currently the maximum exposure is 25% of assets.

Market movements

Subject to certain conditions, the limits of regulation 28 may be exceeded where the excess is due to a change in the fair value or characteristic of an asset.

Look-through

A fund may not use an asset structure to circumvent the regulation 28 limits – look-through must be applied to disclose the underlying asset. However where a fund invests in a hedge fund or private equity fund no look-through into that fund is required.

To alleviate extensive disclosure requirements, a *de minimis* rule is applied – if an asset comprises less than 5 percent of the value of the assets of the fund, then the fund need only disclose the categories of underlying assets making up the investment, and not each underlying asset.

Borrowing

A fund may not borrow money other than for bridging purposes. Loans for bridging purposes may not exceed 50% of the gross annual fund income during the preceding financial year.

Scrip lending and derivative instruments

A fund may engage in scrip lending and may invest in derivative instruments subject to conditions to be prescribed by the Registrar.

Assets excluded

The following assets are excluded in applying the regulation 28 limits –

- an investment in a collective investment scheme which scheme complies with the regulation 28 limits;

- a linked policy if the underlying assets comply with the regulation 28 limits;

- a non-linked policy that guarantees or partially guarantees policy benefits, if the statutory actuary of the insurer certified that the guarantee is consistent with guidance issued by the Registrar of Long-term Insurance; and

- an asset issued by an entity regulated by the FSB if the underlying assets comply with the regulation 28 limits.

Implementation date

The new regulation 28 will be effective from 1 July 2011. According to the explanatory memorandum to the regulation, while certain funds may not be able to comply fully with the regulation at that time, earlier implementation is intended to give funds the space to begin re-equilibrating to the new, more flexible limits. Those funds that do not expect to meet the compliance deadline should apply to the Registrar before 31 May 2011. Exemption may be granted on the basis that the fund can prove its path towards compliance.

2. Directive PF No 5: Appointment of Principal Officer

The register provided clarity on the procedure with regard to the appointment of a principal officer of a fund. It is stated that boards of funds and principal officers have an ongoing duty to inform the register of anything that might adversely affect the status of the principal officer. The directive contains the following annexures (prescribed formats):

A Notification to the registrar by the board of the appointment of the principal officer
B Declaration by the appointed principal officer requiring various details and confirmations
C Notification to the registrar of the termination of or resignation of the principal officer's appointment

3. Draft replacement of regulation 2: Valuation exemption requirements

The draft Notice proposes that, subject to certain conditions, defined contribution (DC) funds will in future be able to obtain valuation exemption and such exemption will not expire as long as the conditions are complied with. This proposal is welcomed as it will dispose of the current requirement of having to re-apply for exemption every three years.

4. Taxation of severance and retirement fund lump sum benefits

In a letter dated 28 February 2011 to ASISA, SARS confirmed that the merger of retirement fund lump sum benefits and severance benefits as well as the revised retirement tax table announced in the 2011 Budget are effective from 1 March 2011, but this will only be implemented on SARS' system from 7 March 2011. Application

for tax directives may be delayed until 7 March 2011 to ensure that the revised tax tables are accurately reflected in the tax directive.

Source :(Anton Swanepoel ,Legal Advisor Sanlam Employee Benefits. 2011).

Appendix 14

Item	Column 1	Column 2	
	Categories of assets	Limits being the maximum percentage of aggregate fair value o total assets of fund	
		Per issuer/entity, as applicable	For all issuers/ entities
1.	CASH		100%
1.1	Notes and coins; any balance or deposit in an account held with a South African bank; A money market instrument issued by a South African bank including an Islamic liquidity management financial instrument; Any positive net balance in a margin account with an exchange; and Any positive net balance in a settlement account with an exchange, operated for the buying and selling of assets.	25%	100%
1.2	Any balance or deposit held with a foreign bank; A money market instrument issued by a foreign bank including an Islamic liquidity management financial instrument;	5%	
2.	DEBT INSTRUMENTS INCLUDING ISLAMIC DEBT INSTRUMENTS		100% for debt instruments issue by or guaranteed by the Republic, otherwise 75%
2.1	Inside the Republic and foreign assets		
	(a) Debt instruments issued by, and loans to, the government of the Republic, and any debt or loan guaranteed by the Republic		100%

	(b) Debt instruments issued or guaranteed by the government of a foreign country	10%	
	(c) Debt instruments issued or guaranteed by a South African bank against its balance sheet:		75%
	(i) listed on an exchange with an issuer market capitalisation of R20 billion or more, or an amount or conditions as prescribed	25%	
	(ii) listed on an exchange with an issuer market capitalisation of between R2 billion and R20 billion, or an amount or conditions as prescribed	15%	
	(iii) listed on an exchange with an issuer market capitalisation of less than R2 billion, or an amount or conditions as prescribed	10%	
	(iv) not listed on an exchange	5%	25%
	(d) Debt instruments issued or guaranteed by an entity that has equity listed on an exchange, or debt instruments issued or guaranteed by a public entity under the Public Finance Management Act, 1999 (Act No. 1 of 1999) as prescribed:	10%	50%
	(i) listed on an exchange	10%	50%
	(ii) not listed on an exchange	5%	25%
	(e) Other debt instruments:	5%	25%
	(i) listed on an exchange	5%	25%
	(ii) not listed on an exchange	5%	15%

3.	EQUITIES		75%
3.1	Inside the Republic and foreign assets		
	(a) Preference and ordinary shares in companies, excluding shares in property companies, listed on an exchange:		75%
	(i) issuer market capitalisation of R20 billion or more, or an amount or conditions as prescribed	15%	
	(ii) issuer market capitalisation of between R2 billion and R20 billion, or an amount or conditions as prescribed	10%	
	(iii) issuer market capitalisation of less than R2 billion, or an amount or conditions as prescribed	5%	
	(b) Preference and ordinary shares in companies, excluding shares in property companies, not listed on an exchange	2,5%	10%
4.	IMMOVABLE PROPERTY		25%
4.1	Inside the Republic and foreign assets		
	(a) Preference shares, ordinary shares and linked units comprising shares linked to debentures in property companies, or units in a Collective Investment Scheme in Property, listed on an exchange:		25%
	(i) issuer market capitalisation of R10 billion or more, or an amount or conditions as prescribed	15%	
	(ii) issuer market capitalisation of between R3 billion and R10 billion, or an amount or conditions as prescribed	10%	
	(iii) issuer market capitalisation of less than R3 billion,	5%	

	or an amount or conditions as prescribed		
	(b) Immovable property, preference and ordinary shares in property companies, and linked units comprising shares linked to debentures in property companies, not listed on an exchange:	5%	15%
5.	COMMODITIES		10%
5.1	Inside the Republic and foreign assets		
	(a) Kruger Rands and other commodities listed on an exchange, including exchange traded commodities:		25%
	(i) gold	10%	
	(ii) each other commodity	5%	
6.	INVESTMENTS IN THE BUSINESS OF A PARTICIPATING EMPLOYER INSIDE THE REPUBLIC IN TERMS OF:		
	(a) section 19(4) of the Pension Funds Act		5%
	(b) To the extent it has been allowed by an exemption in terms of section 19(4A) of the Pension Funds Act		10%
7.	HOUSING LOANS GRANTED TO MEMBERS IN ACCORDANCE WITH THE PROVISIONS OF SECTION 19(5)		95%
8.	HEDGE FUNDS, PRIVATE EQUITY FUNDS AND ANY OTHER ASSETS NOT REFERRED TO IN THIS SCHEDULE		15%
8.1	Inside the Republic and foreign assets		
	(a) Hedge funds		10%
	(i) Funds of hedge funds	5% per fund of hedge funds	
	(ii) Hedge funds	2,5% per	

		hedge fund	

	(b) Private equity funds		10%
	(i) Funds of private equity funds	5% per fund of private equity funds	
	(ii) Private equity funds	2,5% per private equity fund	
	(c) Other assets not referred to in this schedule and excluding a hedge fund or private equity fund		2,5%

Effective date

This regulation comes into effect on 1 July 2011, provided that transitional arrangements may be prescribed.