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Legal Insights

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Prescribed Assets – what do we know?

This is an update to a previous Legal Insights note entitled "Prescribed Assets Revisited", after the subject has received increased attention post Business for South Africa (B4SA) and the ruling ANC releasing their recommendations for rebuilding the economy on 10 July 2020.

Much has been written, and there are various sources to consider in arriving at a crisp analysis. Some of these are summarised hereunder, but the crux of the debate is whether Government or the private sector will take the lead in the much-needed infrastructure investments. If the Government takes a prominent role, experience shows that this invariably crowds out private sector investment and leads to suboptimal returns. This is possibly the seminal issue that will determine whether South Africa is embarking on a period of "impact investing" or "prescribed investments".

Regulation 28 of the Pension Funds Act details the extent to which retirement funds may invest in particular asset classes. This tries to ensure that fund members' savings are invested in a diversified way.

Only 15% of fund members' benefits may be invested in alternative investments such as private equity, hedge funds and unlisted property. Regulation 28 does not have an infrastructure investment category.

Private equity and property are categories that are often associated with infrastructure investments, which may be listed or unlisted instruments.

Both the ANC's and B4SA's economic recovery strategy papers emphasise the need for infrastructure investment to kick-start the economy, but B4SA also emphasises the need for the Government to embark on structural reform and to prioritise tackling the looming sovereign debt crisis. Both proposals have said that using retirement funds to finance infrastructure projects with the purpose of driving economic growth should be considered. These infrastructure investments need to have a sound investment case and be effectively executed because they are, in effect, paid for by future generations. Eskom's disastrous Kusile and Medupi power station projects provide a solid argument for why infrastructural projects should be put in the hands of the private sector.

IMPORTANT NOTE

For South Africa to improve economic growth, create jobs and lower inequality; there is consensus that infrastructure spend is required to narrow a demand deficit.

The positive growth resulting from effective infrastructure spend will be undone if the Government is unable to manage its ballooning debt.

The head of the ANC's Economic Transformation Committee, Enoch Godogwana, has said the party was in discussions with 20 pension funds, including the Public Investment Corporation which manages the Government Employees Pension Fund, regarding amendments to Regulation 28. He said the ANC is not proposing that the Government implement a policy of prescribed assets, but rather that the ANC is proposing a "relook" into Regulation 28. The subject of prescribed investments is a highly emotive one. Ultimately, whether an infrastructure investment will be considered a "prescribed investment" with an investment return drag, or an "impact investment" that has an acceptable return profile, may hinge around whether the Government pursues the ANC's ideology of playing a central role in directing the economy. With prescribed investments there is a party that gains something at the expense of another, whilst impact investing provides win-win outcomes.

On 24 June, the Finance Minister unveiled the supplementary budget's objectives to fulfil the Government's second stage in a three-pronged approach to reviving economic growth that started when Government began to attempt to mitigate the effect of the lockdown that began on 27 March 2020. The first was a R500bn fiscal package to save livelihoods. The next stage is to be a recovery package that will be coupled with a reorganisation of the drivers of economic growth, together with an increased focus on transformation. Much of the supplementary budget's adjustment beyond 2020 is driven by expected expenditure cuts rather than higher economic growth. Cutting spending, especially the Government wage bill, has implementation risks and will not in itself lift South Africa onto a recovery path. Government debt is expected to rise to 82% of GDP this fiscal year and to above 100% in 2024 if no action is taken to cut spending and grow the economy.

On 25 June 2020, in the Finance Minister's briefing to Parliament's financial and appropriations committees about the supplementary budget, the Finance Minister raised the following points. Mr Mboweni commented on amending Regulation 28 with specific reference to the investments in immovable property. He commented that investment managers used a narrow application of Regulation 28 and Government wanted the definition to include immovable property and infrastructure i.e. managers need to invest in infrastructure and immovable property. The Financial Sector Conduct Authority (FSCA) intends releasing a policy document on this in the next 6 months. The current limit for immovable property is 25% and Government apparently has no intention of amending this allocation.

The Southern African Venture Capital and Private Equity Association has also called for the amendments to Regulation 28 to support South Africa's economic recovery. The association has proposed two amendments. One suggestion is the separation of hedge funds and private equity into separate asset classes, each with their own maximum permitted investment, rather than them both falling within the 15% "alternate" asset class allowance. It also proposes gradually increasing the private equity cap from 10% to 15%. This would allow pension funds to take a larger exposure to the entire asset class, enabling a higher degree of diversification.

So, what is the expected return profile on infrastructure investments? The rate of return is not set for energy, water, roads, hospital or education infrastructure, but in most instances these are predetermined where there are upfront agreements on tolls, rentals, tariffs and concessions for the projects. Infrastructure projects, and in particular unlisted projects, pose liquidity questions for a retirement fund investor, but they mostly have a less volatile investment profile. Many of Seshego's clients are invested in portfolios that include the Future growth portfolio, which is included on merit. Future growth's Andrew Cantor is quoted on the subject of prescribed investments in our previous note.

So, where to from here?

Whether the impending infrastructure spend turns out to be "impact investing" or "prescribed investments", the current Regulation 28 does not allow for an optimal blend of asset classes in the portfolio construction whilst trying to enforce diversification. This is broached at the end of our previous note on prescribed investments. The basics have not changed for retirement fund trustees. The trustee board needs to seek portfolios with the optimal combination of asset classes for the objective, within the legislative framework, and with the lowest possible cost structure. This approach will continue to maximise the probability of achieving the desired objective.

A final thought on the current situation. Whilst a consultation process is underway, nothing has changed yet. There will be the usual fear-mongering for self-serving purposes, but as with any crisis, those that emerge from these challenging times in a relatively strong position will be those who distilled the issues and acted on facts.