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Submission to the Commission of Inquiry into allegations of impropriety regarding Public Investment Corporation

To:

Honourable Justice Lex Mpati, Gill Marcus and Emmanuel Lediga

A vision for a capable PIC serving the public interest

30 July 2019

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Submission purpose

This written submission is made to address the following terms of reference of the Commission of Inquiry into allegations of impropriety regarding Public Investment Corporation as gazetted in Presidential Proclamation No. 30 of 2018:

- 1.15 - *Whether the current governance and operating model of the PIC, including the composition of the Board, is the most effective and efficient model and, if not, to make recommendations on the most suitable governance and operational model for the PIC for the future*; and
- 1.16 - *Whether, considering its findings, it is necessary to make changes to the PIC Act, the PIC Memorandum of Incorporation in terms of the Companies Act, 2008, and the investment decision -making framework of the PIC, as well as the delegation of authority for the framework (if any) and, if so, to advise on the possible*.

We are pleased to be able to contribute our views to assist the Commission in its deliberations on the Public Investment Corporation (PIC). It is an important institution for the country and reports of its mismanagement should concern all South Africans.

A well-run PIC has the potential to support the development of the country while also protecting the pensions of civil servants. Our contribution in this report is to consider the ideal scenario for the future of the PIC, and in particular its investment decision-making framework.

We have not concerned ourselves with the details of the practices that are alleged to have occurred at the PIC historically (i.e. other terms of reference 1.1 – 1.14), suffice to say that to our minds some investments made by the PIC cannot possibly reflect good investment decision-making practices. We treat this, however, as a background fact.

We are available to answer any questions on this written submission and for further interactions with the Commission.

Recommendations

- Radical transparency regarding the PIC's investment portfolios and returns
- A board that is mandated to pursue investment and social returns in the public interest, but to do so independently
- A separate and independent investment decision making process
- Policies should be formulated and made explicit for ESG and impact investing and evaluated by external professionals
- Full disclosure must be made on internal costs too

Executive summary

Our view is that the PIC should be professionally managed and apply exemplary investment processes. This is not controversial. Investment processes involved in managing pension funds are well-established worldwide and there are several examples of best practice that can be emulated, including in public sectors elsewhere.

More controversial is the question of the ends that such investment management should be put to. There are two categories of concerns in this regard:

1. The institutional arrangements for the funds that the PIC manages and the PIC itself. The largest is the Government Employees Pension Fund (GEPF), an advance-funded scheme to which both civil servants and the government, as employer, contribute to. It is not obvious that the GEPF should function as an advance-funded pension scheme rather than a pay-as-you-go (PAYG) scheme. We argue that, while an advance-funded scheme is the correct approach, it implies that tax payers have an interest in seeing positive social returns from the PIC's fund management that can be odds with the interests of pension fund members.

2. The second category of concerns regards the policies that should apply to the investment decisions that are made about the assets the PIC manages. Fund management need not be only a matter of generating financial returns and managing risk. Specifically, certain environmental, social and governance issues can come to bear on investment decision-making. These concerns become more important when there is a long time horizon, as is the case for pension funds. A pool of savings can be used as an instrument to drive an economy to address pressing concerns such as climate change, dealing with persistent poverty and inequality in the country, and influencing the way companies are led. Generally these concerns align with investor interests and ultimately lead to better long run returns. However, a further consideration is social impact investing, an investing concept according to which financial returns are sacrificed in exchange for increased social outcomes. These are not directly in the interests of pension fund members but are in the interests of the public at large. We argue that while this objective has contributed to some of the failures of the PIC, it is nevertheless a necessary objective that must be managed correctly.

Our note is structured as follows. First we consider the general features of different types of pension funding arrangements. We classify the GEPF according to these and assess the suitability of the GEPF's structure. Second we consider the historic roots of the GEPF and the implications this history has for its outlook. Third, we develop a proposal for the investment policy strategy of the PIC that we believe would be appropriate for the institution.

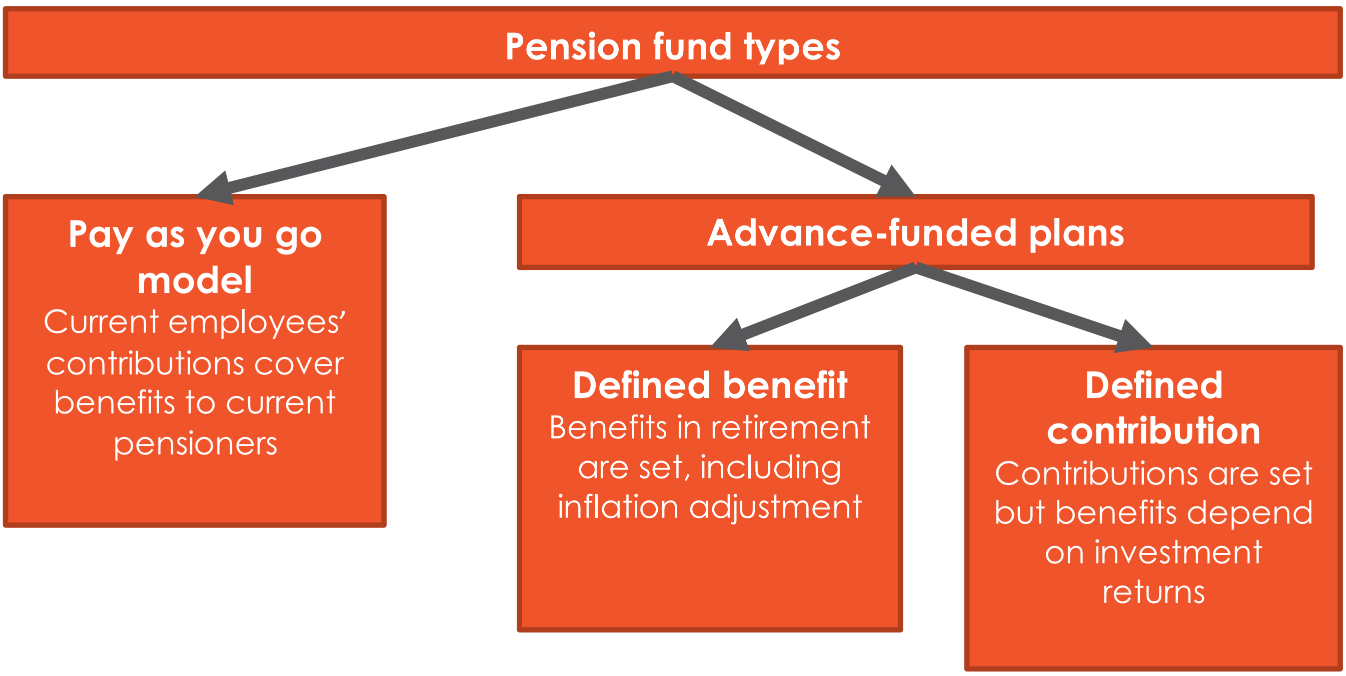
Our views here are based on our experience with the South African investment markets, as well as those further afield, over the last 20 years, advising clients and studying its institutions. We have no interest in the PIC or the outcomes of the Commission, save those of any South African citizen who benefits from good public policy and high quality public institutions.

Fundamentals of state pension provision

Worldwide, it is generally recognised that private sector firms should provide for future pension obligations to their employees at the time they accrue. In practice that means firms and employees contribute funds to a third party entity that holds those funds until such time as pension obligations must be met. This is because private sector entities are generally seen as having a finite lifetime and credit risk. It is possible that companies will cease to exist. In such an eventuality, employees' pensions should not be compromised and sufficient assets should be held in the fund to meet pension obligations.

Such arrangements are known as an advance-funded pension plans. Advance-funded plans can be divided into two further categories: defined benefit, in which benefits to pensioners are set amounts that are known in advance, perhaps with inflationary adjustments, irrespective of the performance of assets invested in the fund; and defined contribution, in which only the quantum of contribution is defined upfront and benefits vary in line with the investment performance of the invested assets. In defined contribution funds, the investment risk sits entirely with the member of the fund whose lifestyle in retirement will depend on the performance of their portfolio. For such investors, the suitability and practices of the fund manager are directly consequential to their future quality of life. In contrast, in defined benefit schemes the sponsoring company carries all of the investment risk in that it will have to make up any shortfall in funds available to meet liabilities (though it also will benefit in the event of outperformance of the portfolio). It is a matter of some debate which approach supports higher investment returns. The academic literature tends to suggest that defined benefit schemes, in which the employer carries the investment risk, outperform defined benefit schemes, though this is mostly attributed to the higher fees that members face in defined contribution schemes (see for example, Munnell et al, 2015).

Figure 1: Overview of pension fund types



In contrast to advance-funded schemes, pension obligations can be met out of the cash flows of the pension scheme when they become due. In such a scenario, no provision is made for pension obligations in advance. Such an arrangement is known as an unfunded pension plan or a pay-as-you-go (PAYG) pension plan. Typically, current employees and the employer make contributions to the unfunded plan which are then used to pay benefits to current pensioners. Current workers earn a right to future benefits by making contributions now, though these are used to meet the current benefits of retirees and other members. The fund does not accumulate any reserves. Such funds are commonly found in the public sector around the world.

The Government Employees Pension Fund is advance-funded, which means the government and employees contribute to a fund that will meet future benefit obligations to pensioners. The fund is managed by the Public Investment Corporation. It is the PIC's largest client, though not the only one.

As a defined benefit scheme, both members and the employer, being the government, make contributions. The employer is the guarantor of the scheme so if there is any shortfall in meeting obligations to pensioners, the employer has to make good that shortfall. To manage this liability, actuarial estimates are made of future obligations to determine a present value of those liabilities. The pension fund is considered "fully funded" if its assets are sufficient to cover the present value of future obligations. If there is a shortfall, it is underfunded and the employer will be expected to make up this short fall. In the case of the GEPF, the Government Employees Pension Law (1996) requires that the fund's financial position be investigated and reported every three years, though this has in fact been undertaken ever two years.

There are pros and cons to both types of pension fund arrangement, as we will discuss below.

Establishment of the GEPF

The GEPF was established in 1996. Several previous schemes including homeland and central government pension funds, and pension obligations to the armed wings of liberation movements, were combined and the GEPF was established a fund to meet these obligations. Collectively the legacy schemes had functioned largely as a pay-as-you-go schemes in which obligations were met out of government cash flows (Hendricks, 2008). In the closing years of the Apartheid government, several advance-funded schemes were established to serve civil servants with defined benefits. While we are not aware of literature that details the motives at the time, it is clear that the establishment of advance-funded schemes provided Apartheid-era civil servants a secure retirement with little credit risk to the new democratic government. This was accepted by the new government which could also use the scheme to meet commitments to many decommissioned members of armed wings and other members of the resistance movements. The scheme benefits were based on final salary levels making it straightforward to provide for the retirement for many aging members of anti-Apartheid institutions.

The creation of an advance-funded plan had significant financial consequences for the government. Large amounts had to be contributed to the fund in order to meet the future obligations at the time. In practice the government did this by issuing debt and the creation of the GEPF was a key contributor to a significant increase in government debt (Hendricks, ibid.). The effect was that the creation of the GEPF did not have a significant impact on overall savings levels – the assets of the GEPF were to a large extent met by the debt issued by the government, so net savings were minimal.

Both workers and the government contribute to the fund, with workers facing a deduction from their monthly salary to provide contributions. Given that the state has largely run a budget deficit since the creation of the GEPF, its contributions are effectively funded out of debt.

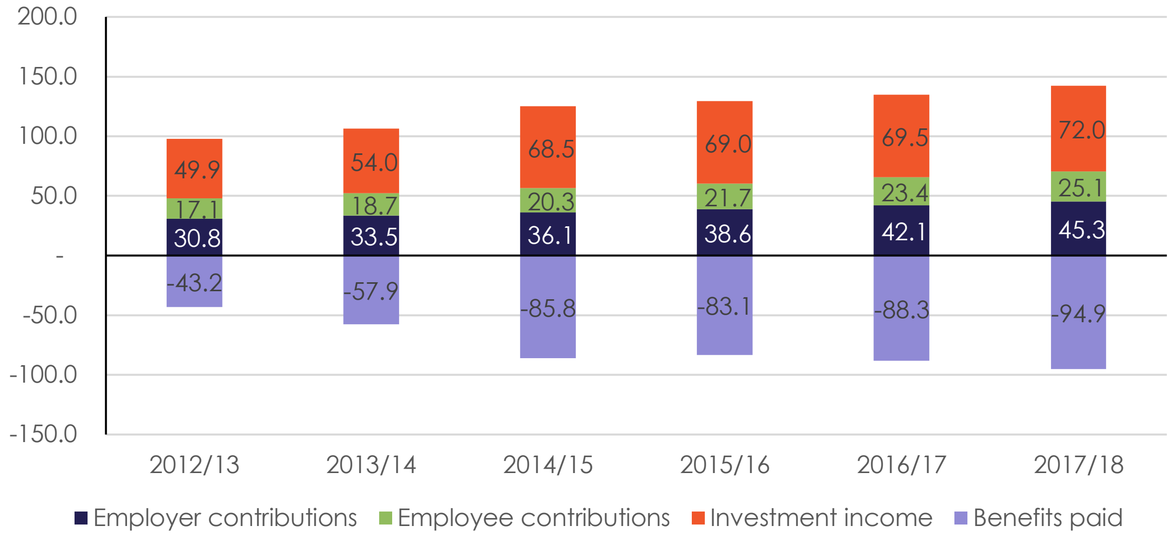
The GEPF was substantially managed by the Public Investment Commissioners, which was later rebranded as the Public Investment Corporation following the corporatisation of the PIC as government's fund manager. The PIC now manages the GEPF along with several other funds such as the Unemployment Insurance Fund, Compensation Fund, and others, though the GEPF accounts for 87% of the assets under management, which are now in excess of R2-trillion (PIC, 2018).

Assessment of the advance-funded structure GEPF

We consider the pros and cons of funded and pay as you go options for pension schemes as a first step to assessing the role the GEPF and PIC may want to play in future. There are several large public sector pension funds around the world that work on PAYG principle, such as the Canada Pension Plan and several European government schemes. Indeed South Africa's old age grant is a form of pay-as-you-go pension. The difference between funded and pay-as-you go schemes is ostensibly about which generation should carry the burden of funding retirees. By making contributions now, which are used to fund current retirees, the current generation is buying the right to having a future generation pay their benefits (a right which can have various degrees of enforceability, depending on the country). In countries with declining fertility and lengthening life expectancy there are growing concerns about the increasing ratio of retired to currently working members, known as the old age dependency ratio. When the OAD grows, pressure mounts to increase the contributions made by currently working members, reduce benefits to retirees, or extend the working age. Intergenerational injustice is a clear risk as current workers may be required to make greater contributions, but then face longer working lives or lower benefits by the time they reach retirement.

A PAYG is not the only way such intergenerational injustices can arise. Over the last six years, the government has contributed an average of R37.7-billion per year to the GEPF as the employer contribution, which amounted to 64% of contributions while employees made 36% of the contributions.

Figure 2: Annual inflows and outflows of GEPF



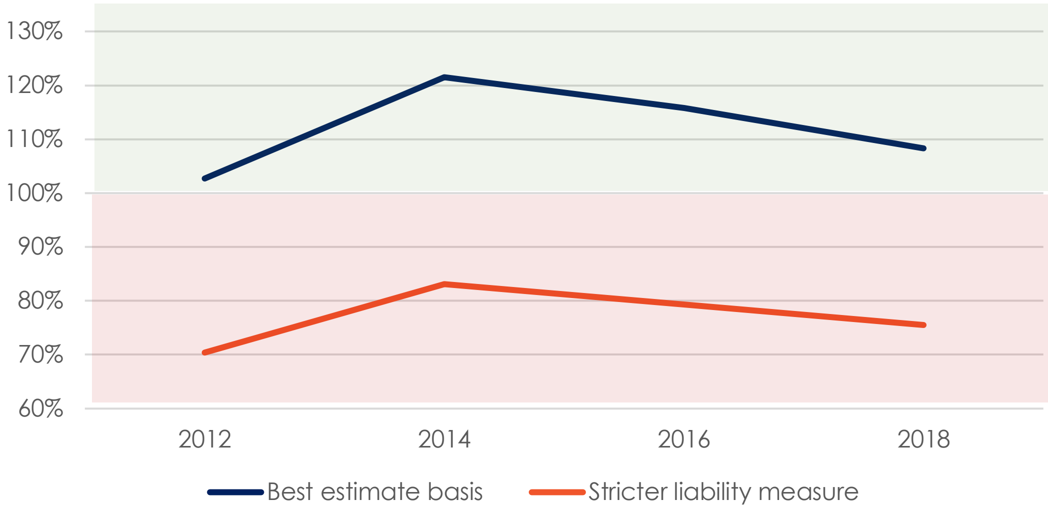
Sources: National Treasury Budget Review 2019

At the same time, government has increased its borrowing to fund total expenditure, which includes contributions to the GEPF.

As an advance funded scheme, the GEPF should hold sufficient assets to cover the estimated liabilities it will have to meet to future retirees as well as current ones. These liabilities are estimated by actuaries based on various assumptions including mortality rates, quantum of final salary, size of the work force and so on. Currently, the estimated present value of future liabilities are covered by the assets held by the fund on a range from 108.3% to 75.5%, which is the range of the "best estimate basis" through to the "stricter liability measure" (National Treasury, 2019).

On the strict measure, this means the GEPF's R1.8-trillion rand of assets is about R583bn short of its liabilities (which for the sake of comparison is more than the total debt of Eskom and in that arena threatens to undermine the solvency of government as a whole). The funded position of the GEPF has deteriorated in recent years because of the growth of benefits and lower than expected investment returns (see Figure 3 below).

Figure 3: Funded status of the GEPF



Sources: Towers Watson, Alexander Forbes, PIC

The low investment returns means there is a dead weight economic loss from funding the GEPF. The GEPF's portfolio earned a return of 8.5% in the 2017/18 financial year and 4.3% in the 2016/17 financial year. The cost of government debt is higher. For example, between April 2018 and January 2019 the yield paid on new bonds issued by government was 9.3% (Treasury, 2019). While short term volatility is to be expected, the GEPF should not be earning lower returns than government debt on average. The GEPF's ability to take on higher risk than risk-free government debt, for example by investing in listed equities and private equity, should enable it to earn risk premiums. Its failure to do so means government would be better off borrowing to pay retirees directly in a PAYG scheme than borrowing and investing it to pay them at some time in future. It also makes it economically rational for the government to demand that the PIC acquire government bonds as it does not in fact harm returns.

In the 2018/19 national budget, the total deficit is expected to be R224.5-billion. The contribution paid by government to the GEPF therefore represents 20% of the amount of new debt the government will have to raise for the year. National debt is a claim on future generations too, in the sense that it finances expenditure now that will have to be paid for on a date in future when the debt must be settled. That will fall on the tax base broadly and not just civil servants. Combined with the potential R583bn shortfall in the fund, future generations, including those who will never claim a civil service pension, are being committed to the substantial funding of civil servant retirees. The situation is therefore not dissimilar to a PAYG scheme and implies the same risks that current contributors might, on retirement, find their benefits being forced down, longer working lives being required or future generations being required to expand contributions dramatically. This would be different if the fund was being funded out of surpluses.

The real difference between PAYG and advance-funded schemes is not the allocation of burdens between generations, but the optics and disciplinary effects of them. A PAYG scheme feels like a tax is being paid while an advance-funded scheme feels like saving is taking place. South Africa's means tested old age pension, for instance, is paid out of general taxes collected, though many PAYG schemes around the world it is only the members of the scheme that pay the deductions. More importantly, however, in an advance funded scheme the present value of future liabilities are known up front and a financial decision has to be made there and then about how to meet them. This has a strong disciplinary political effect – promising greater benefits has to be matched by an immediate cost to both employers and employees (or the funded status of the scheme deteriorates, which is a warning light visible to all). In PAYG schemes the long run costs of benefit increases are not explicitly determined or funded and it is easier to kick the can down the road. Politicians can promise higher benefits to workers or special groups of workers but the costs will only hit once they are out of office (Schwarz, undated).

Another important feature of advance funded schemes is the large investment portfolio that is generated. This can have positive effects on the financial system of the country and be used to invest in many different areas of the economy. Pension savings are usually essential to kick-start the development of capital markets in developing countries. The PIC's assets represent a significant portion of both equity and debt in issue in South Africa (approximately 12% of the JSE's listed companies is managed by the PIC).

When it comes to pools of government funded assets, there are two main types that are found internationally: sovereign wealth funds (SWFs) such as those of Dubai and Norway mentioned above, and public pension reserve funds (PPRFs) (see, for instance, OECD 2008). Within the PPRFs, there are commonly two different types: social security reserve funds (SSRFs) and sovereign pension reserve funds (SPRFs). In South Africa, the UIF and Workers Compensation Fund are SSRFs, though of a relatively small scale. PPRFs are generally considered a form of sovereign wealth fund, but one with the specific mandate of financing future public pension liabilities. Some SSRFs are not considered sovereign wealth funds, however, when they are legally independent of government and their balance sheets are not integrated into government accounts.

This discussion leads us to several conclusions regarding the GEPF.

1. **An advance funded scheme** is preferable largely for the fiscal discipline it imposes. The cost of benefit increases are known upfront and must be costed, even if they are met via debt or underfunding of pension savings. For developing countries like South Africa, this political discipline is important.

2. To **eliminate inter-generational injustices**, the GEPF should stimulate economic growth and sustainability, as well as support investments with highly impactful social outcomes, so as to provide a benefit to those future generations who will be settling the debt that is accumulating to fund it.

3. That the GEPF is effectively a **sovereign wealth fund,** of the SPRF form, that is designed to protect the tax payer from the future liability of pension obligations. This broad tax payer contribution can in part be justified if the GEPF is used to further national interests beyond the interests of pension beneficiaries only. This implies that the GEPF's mandate should include broad social returns and not only financial returns.

An investment policy for a PIC acting in the public interest

Pension funds have long term liabilities of decades or even centuries. They therefore need to consider issues beyond the immediate future. For this reason, internationally, there has been a global movement among institutional investors, often driven by demands of clients, to consider sustainability as part of investment decision-making. This is often seen in terms of fighting climate change, either through negative screening such as excluding coal investments or positive screens such as directing investment to renewable energy.

Sustainability includes social issues. For example, extreme inequality, such as that experienced in South Africa, fosters social instability. This can lead to damaging social unrest that has harmful economic consequences. Investors with a long term horizon, therefore, should act to manage down this risk by funding investments that lessen inequality.

Furthermore, long run investors should be concerned with the sustainability of companies themselves. This should lead them to discourage companies from taking excessive short term risks that might lead to large immediate payoffs but at the expense of long run returns, which is exacerbated by problems around executive pay which seem to encourage short term thinking. Institutions should therefore act to ensure proper governance at companies, ensuring appropriate behaviour by executives to protect the sustainability of companies.

These three concerns – environment, society and governance – are often grouped together as "ESG investing", a concept that has grown in importance with significant research now directed to helping investors to implement it. The assumption behind ESG is that it is in the self-interest of savers to support it because it results in sustainable, long run returns.

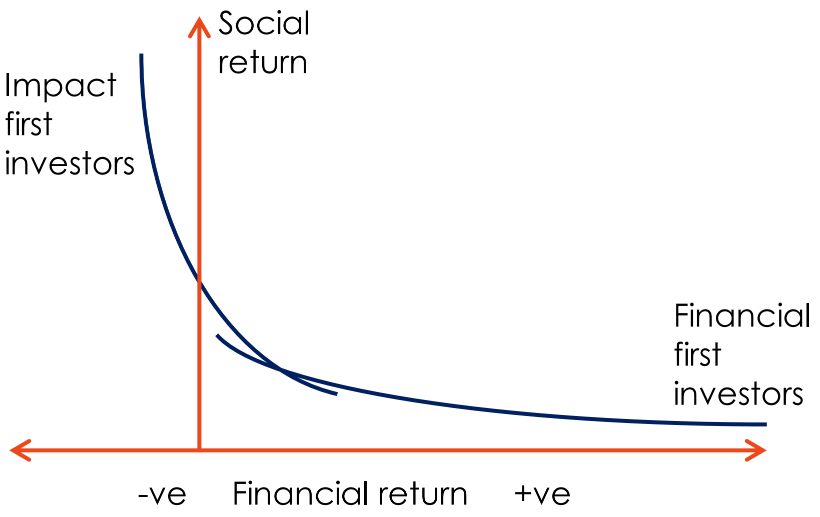
In the case of the PIC, however, there are further considerations that emerge not just from the sustainability of its investments, but from certain national priorities. The consideration of national priorities reflects the fact that the GEPF and other social security funds managed by the PIC are partly funded out of government debt and thereby the tax payer at large. The tax payer has a right to expect some return from that investment, if it is possible, that is apart from the returns to pension fund members.

This implies an inherent tension between two masters that the PIC should be serving: the beneficiaries of its funds and the South African public at large. Their interests do not always coincide. Beneficiaries want maximum benefits at low risk. The public wants social goods that are not necessarily financial.

The South African economy is still dealing with the legacy of Apartheid and colonialism, requiring transformation of many industries and the funding of the growth of black business. This is in part a social concern that should fit in an ESG mandate, but it requires further deliberate interventions that may actually be at the expense of sustainability when it means returns are being sacrificed for the sake of social objectives. The question is whether it is acceptable to sacrifice returns, even long run returns, if it means we are able to deliver desirable social outcomes?

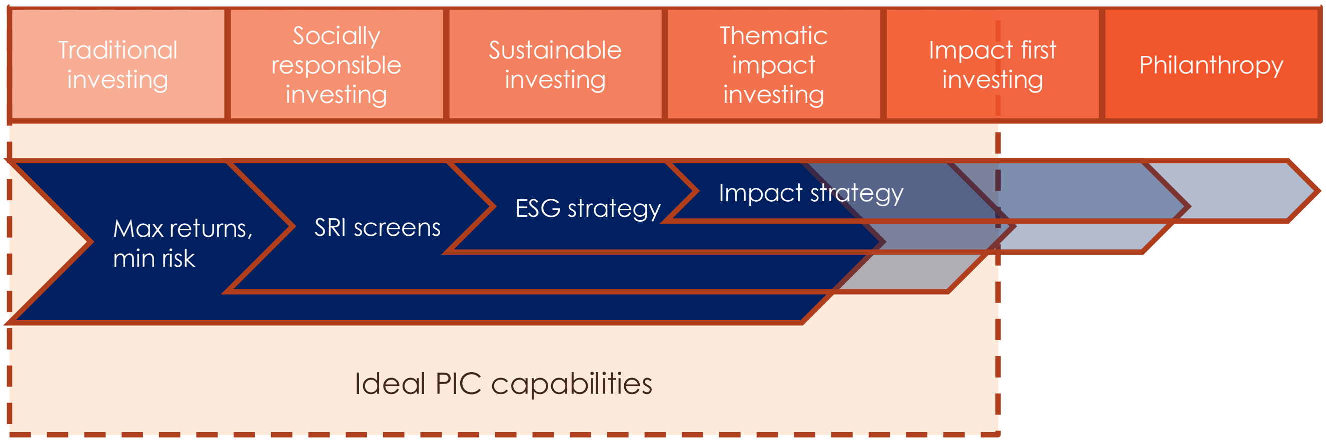
Such questions are frequently asked in the academic literature on institutional investing. One growing area of research is known as "impact investing". This is defined as "…the intention to generate social and environmental impact alongside a financial return" (GIIN, 2019). Impact investors function along a continuum that ranges from "social first" investors who prioritise social returns to "finance first" investors who prioritise financial returns (see Figure 4). In the context of the PIC, where there are potentially significant positive social outcomes, it may be reasonable to sacrifice financial returns.

Figure 4: Tradeoffs in social return vs financial return in impact investing



Given our discussion so far, we believe that there is a legitimate expectation from the public, which carries the risk and long run cost of the performance of the GEPF, that it should make investments for the public good even at the expense of financial returns. In Figure 5 we depict the continuum of different approaches in fund management from traditional through to philanthropic social investing. The PIC should be capable of providing world class fund management in the first four styles – traditional, SRI, sustainable investing, thematic impact investing (such as BEE) and in some circumstances, impact first investing.

Figure 5: Gradations of socially-oriented investing



There is a big "but", however. The problem with ESG, and much more so with impact investing, is that it is difficult to assess non-financial returns. In the case of ESG, financial returns should be clear over the long-run. Investment decisions can demonstrate the investment case by estimating future financial consequences of ESG-guided decisions. To be sure, there is significant work required to determine just what effects on the environment, social effects and governance will in fact lead to sustainability, let alone which particular investments to choose. Developing policies on what governance standards to demand from investments is difficult and contested terrain. Some index tracking funds that claim to only hold sustainable investments end up holding, for example, fossil fuel companies that have managed to find a way through the screens that are developed. However, while not quite the same as the short run signals of asset prices and yields, at least in theory those decisions will eventually be judged against long run returns. The PIC can indeed, as the biggest single investor on the JSE, have a dramatic and positive effect by using its influence to improve the governance and sustainability of South African companies, which would have spill over public benefits for all.

In the case of impact investing, however, the problems are much more significant. Social returns are fundamentally non-financial and never will translate into a financially measurable parameter. Instead, less quantifiable considerations like justice, human flourishing, health, and so on, are the targeted upsides. These are difficult to measure and many academics and professionals are now working on developing approaches. What is clear is that rigorous monitoring and evaluation, by independent third parties, is essential to any impact investing approach. This means it comes with an additional layer of costs to cover monitoring and evaluation that further worsen financial return. Impact investing is difficult, but when done properly can have positive social outcomes at a reasonable cost.

In the case of the PIC, the Isibaya Fund was established in 1999, as debates over the developmental role of the PIC were raging. According to its website, it "provides finance for projects that generate financial returns while also supporting positive, long-term economic, social, and environmental outcomes for South Africa." This wording positions it within the ESG terrain as does its membership of the United Nations Principles of Responsible Investment, though it can feasibly be given an impact investing interpretation too. Indeed, in practice, the Isibaya fund focuses extensively on black economic empowerment, which it funds through private equity and "developmental investments". It applies this mandate through a set of earmarked funds for infrastructure, environmental sustainability, priority sectors (that drive job creation, skills, poverty alleviation), private equity and small/medium enterprises. Within this mix, particularly "priority sectors" can be seen as impact investing strategies and not just ESG.

The measurement problems identified in the literature certainly seem to be relevant to the Isibaya Fund. As soon as, in principle, financial return is not the only measure of success, a weaker financial return can be explained away by reference to social outcomes. Because these are hard to measure, it is difficult to hold the investment managers accountable on whether they have really delivered. But, although it is hard, we believe the PIC could become a world leader in ESG and impact investing. Though it requires a robust institutional design to achieve in which independent monitoring and evaluation is paramount. We sketch this in the final section.

Conclusion: what would the PIC need to look like

Examining international examples of excellent public sector fund management leads us to identify several important features that the PIC should adopt. We believe that these would help improve the value the PIC delivers which, as one of the 10 biggest pension fund managers in the world, would make it a global leader.

1. Radical transparency. The PIC's entire portfolio should be available in near real time on its website. It should post closing values and holdings of all listed assets as well as all unlisted assets as at the latest valuation date. Given our view that the PIC should be delivering a social good and not just a financial good, such a level of transparency would allow the public to monitor whether those public goods are being delivered. There are precedents to follow from elsewhere – the California Public Empoloyees' Retirement System (Calpers), for example, provides daily closing values and entire portfolio on its website. It broadcasts its board meetings (though some sessions are closed) for the public. There is no legal barrier to such radical transparency provided all contracts the PIC signs allows for such disclosure of positions.

2. An effective relationship with government. Confusion can easily arise over the notion of "independence". Independence refers to the decision making capability of board members and key executives. It is a quality of individuals, not of institutions. In saying that board members should be independent, we mean that they should not be influenced by concerns outside of their core mandate, such as friendships with managers they oversee, or the influence of investment beneficiaries or pressure from politicians. Independence, however, should not be taken to mean that the PIC should operate without consideration of the interests of government. Indeed, supporting government's developmental objectives should be part of the mandate of the PIC, in addition to the fact that the PIC serves a critical government function of managing its savings. The notion of independence is not that the PIC should serve interests other than the government's, but that its key decision makers should be able to do so without influence. The mandate should be drawn up carefully to set out exactly what government's developmental objectives are, but board members should then be able to apply independence in implementing those objectives. The board should be selected for its expertise in asset management and the development objectives of the country. The chairman should be appointed by the minister of finance in consultation with the president, but be required to meet the criteria of independent non-executive capacity stipulated in governance codes (which would forbid the chairman from also being in the employ of government).

3. A separate investment decision-making process. Investment decision making should be about implementing investment policies, decisions that should be made without any other influence. Those who are tasked with investment decisions should be independent of the operational management of the company. The Chief Investment Officer should report to the board and not the CEO and he or she should be evaluated against investment and social return objectives. The CIO and CEO roles should never be conflated. This prevents conflicts of interest arising between the operational needs of the PIC and the investment strategy. Beneath the CIO, specialist decision makers should oversee asset classes and teams of analysts should work on developing investment cases and monitoring post investment. Investment ideas should be pitched to an investment committee comprised of the CIO and other senior investment professionals (such as the asset class heads). Further mandating of private sector fund managers can be done to pursue specific mandates where the PIC lacks sufficient internal skills, for example in international investment.

4. Policies should be formulated and made explicit for ESG and impact investing. Impact investing should include bailing out government institutions where the public benefit can be clearly demonstrated. This benefit should be measured and the sacrifice of financial return (or increased risks) should be calculated and justified in terms of the public benefits and reported in disclosures. This can include supporting government in managing crisis situations, but such decisions should always be made by the PIC independently with the case independently developed for the public good by the PIC's investment committee. Such investing should never be directed to political ends that happen to fit short term political interests. The public benefits should be measured by independent third parties who report directly to the board and not to the investment decision makers themselves. Their findings should be made publicly available in real time. The measurement of impact should be based on scientific principles, with outcomes compared to baselines and control groups.

5. Disclosure must be made on internal costs too. The PIC should provide detailed disclosure of its own costs and efficiency levels. The financial returns to investments should be shown as well as the costs of managing those investments.

It is clear that most of our recommendations are about transparency. This is not coincidence – in all investing matters, transparency is a critical driver of performance. It is only when those who stand to benefit have access to information that appropriate monitoring of investment decisions can take place. The PIC's role as a custodian of savings for the whole country means that the public should be equipped to play its monitoring role. That is a fundamental institutional characteristic to ensure that the PIC becomes a world class public sector asset manager.

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