Why a simple Reg 28 amendment could fuel the SA economy

Covid-19 and the ensuing national lockdown has had a dramatic effect on all spheres of South African society, but small and medium-sized enterprises (SMEs) - especially those in the service sector - have been particularly hard hit. These SMEs, however, are also the fastest creators of new jobs, and could underpin the country's much-needed economic recovery.

Tanya van Lill, CEO, Savca

This is according to Tanya van Lill, CEO of the Southern African Venture Capital and Private Equity Association (Savca), who points to a recent McKinsey report revealing that South African SMEs represent more than 98% of businesses, employ between 50% and 60% of the country's workforce across all sectors and are responsible for a quarter of private sector job growth. "Stimulus of SMEs is therefore the most effective mechanism to drive a recovery of the estimated two-million jobs that have been lost through the Covid-19 crisis thus far," she says.

More specifically, however, Van Lill believes that a simple amendment to Regulation 28 – a regulation in terms of the Pension Funds Act that specifies ceilings for exposures to different asset classes – could support this recovery by enabling considerably more investment to be directed towards SMEs. "Private equity and venture capital are major sources of funding for SMEs, but the sector is currently unable to mobilise the level of investment required and, as a result, 763 companies and close corporations were liquidated in the first six months of 2020.

"This is because the asset class is consolidated in the same bucket of alternative investments as hedge funds, which is capped at 15% of compliant funds' assets under management. Within that, private equity is capped at 10% and any one fund to a maximum of 2.5%," she explains.

As the private equity sector has grown over time, and investor awareness has increased, Van Lill argues that this consolidation no longer makes sense. “The ‘alternative investments’ category was introduced into Regulation 28 in 2011 after pressure from institutional investors for more diversification options. Subsequently, however, investors have built up capacity to engage with the asset class and today model the risk/return characteristics of hedge funds and private equity quite differently.”

While the Covid-19 crisis has highlighted the need to amend this regulation, Van Lill explains that it does not need to be overhauled. “This is a relatively simple measure that can be quick to implement. As we saw in 2011, Regulation 28 can be easily amended, and the quicker this is done, the sooner the economy will start feeling the benefits.”

Positioning paper

Savca has prepared a positioning paper which outlines two proposed amendments to Regulation 28:

1. Separate hedge funds and private equity into independent asset classes, each with their own caps. This would enable investment decision-makers to model the asset classes independently in their portfolio construction process, so as to properly accommodate the risk/return characteristics of each, thereby evaluating risk-adjusted real returns.
2. Gradually increase the private equity cap from 10% to 15%. This step can be phased, allowing the industry and investors to scale up capacity in tandem, possibly by one percentage point each year. A gradual approach is also low-risk as unintended consequences can come to light before full implementation.
   Increasing the private equity cap would effectively allow a pension fund to take a larger exposure to the entire asset class, enabling a higher degree of diversification. This offers positive public benefits by improving the overall financial security of pension fund savers in the long run.

   Van Lill says: “We believe that the private equity cap should be raised by expanding exposure at a gradual rate, as pension funds will need to develop the skills to analyse the asset class and the supply side may need to increase capacity.”

   She adds that such amendments to Regulation 28 would also allow for much-needed economic stimulus following the low rate of loan approvals from the government’s R500bn bank loan guarantee scheme. “While this initiative was aimed at providing relief to businesses affected by Covid-19, companies’ balance sheets are under immense pressure and businesses are therefore looking to de-risk rather than take on more debt.

   “This is where equity and smart capital can play a fundamental role in supporting economic recovery and growth. Amendments to Regulation 28 could see much-needed capital being invested to where it is needed,” Van Lill says.