Regulation 28

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Time to rethink the Reg 28 offshore allowance.

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Controversial changes to Regulation 28 came into effect in February 2022, allowing SA retirement savings funds to increase their offshore allocation from 30% to 45%.

This has led to a range of negative outcomes, which were likely unintended and unanticipated at the time.

Domestic funds had around R1.6 trillion of offshore assets, representing around 30% of their total assets according to SARB data.

A 50% increase in offshore limit from 30% to 45% suggests the potential for up to R800bn of outflows from the local savings industry. Relative performance between offshore markets and the JSE, along with resulting weakness in the Rand, would reduce the ultimate quantum of outflows.

With SA nominal GDP estimated at around R6.9 trillion, an outflow of up to R800bn would equate to potentially up to 11% of SA GDP, which is massive.

Estimates suggest local funds are currently around 40% offshore, and thus two thirds through the reallocation process.

So, what has been the negative consequences of the new 45% offshore limit?

For South Africans: The outflows have weakened the Rand, boosted import inflation via more expensive dollar priced food, petrol, and diesel, and causing the SARB to hike interest rates more than otherwise required. Higher food and energy inflation hurts all South Africans, while higher interest rates hurt consumers with mortgages and vehicle loans. The hurdle rate for new job creating projects rise, reducing the quantum of potential new projects. Less capital is available for public-private partnerships to fund improved infrastructure, that could improve the lives of South Africans.

For SA retirement savers: As a subset of the SA population, retirement savers suffer the same consequences as other South Africans, along with a reduction in the value of their 55% SA allocation, due to large supply, then followed by permanently lower SA asset liquidity.
Savers are being diversified into more expensive offshore equities, and bonds with much lower yields.

To illustrate the point: the US represents 62% of global equity market capitalisation, against its 26% GDP share, while US equities are trading in the 95th percentile most expensive versus Rest of world equities (Source JPMorgan Asset Management). The FTSE World Government Bond Index has a significantly lower yield at 3.80% than SA government bonds, albeit a much better credit rating than SA government bonds.

To diversify further offshore is functionally a ZAR hedge call as most bond yields are lower, and most equity valuations are higher. The offshore universe is large and has high quality companies, but we don't believe more than 30% allocation is required to capture the global winners.

The reduction in demand for SA government bonds has been evidenced through lower demand at subsequent government bond auctions. Lower government bond demand raises the interest cost on government debt. All South Africans are losers when government interest costs rise, as it crowds out other necessary spending and budget deficits are more expensive to fund for taxpayers. Retirement savers are generally taxpayers. More bond supply and lower SA bond values, lower the value of the bond allocation within the 55% SA allocation.

What's the value of having more money offshore if the process of getting it there reduces the value of the remainder of one's savings, as well as the quality of your everyday life in SA?
While pension funds should be well diversified, they do receive favourable tax treatment from National Treasury, and their regulation should be neutral to positive towards the rest of the country, not net negative.

For SA exchanges & the asset management industry: The sizeable export of capital offshore permanently reduces demand for SA equities and government bonds. This has been to the detriment of the JSE and A2X exchanges, asset consultants, asset managers, stockbrokers, and retail savers, as discussed below. JSE central order book liquidity has fallen, pushing more trade into the end of day auction, asset consultants have lower assets under advice, asset managers have lower assets under management, and stockbrokers experience reduced trading volumes. All of the above are South African taxpayers, and employers.

For Foreign investors: A combination of a weaker Rand and lower JSE share values reduce the Dollar value of SA equities, which lowers SA's country weight in the (dollar) emerging market benchmarks. This means less active and passive emerging market inflows will reach SA going forward, resulting in lower offshore demand for SA equities, and for Rand.

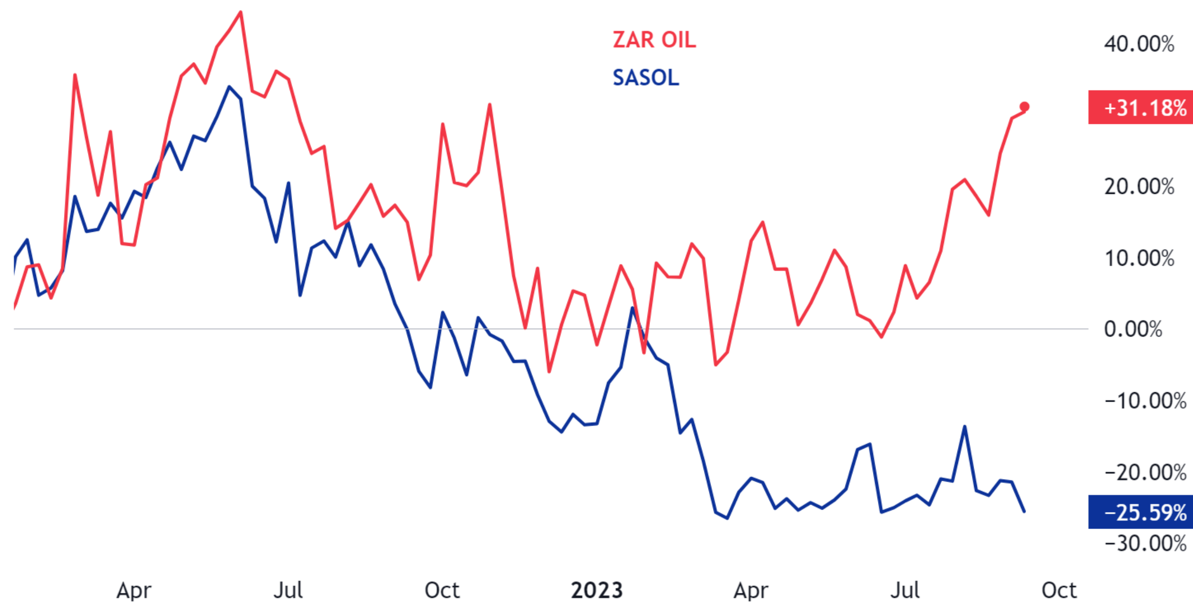
For the SA government: Less demand for South African government bonds raises the interest cost to government, and thus taxpayers. It also reduces demand for desperately needed infrastructure investment via public-private-partnerships.

For SARS: Offshore asset consultants, asset managers, stockbrokers and exchanges do not pay tax in SA, while SA managers do.

For diesel users like Eskom, logistics companies, farmers, and those with generators: Higher diesel prices hurts all users and increase the cost of all transported goods, while increasing diesel imports, and thus weakening the Rand at the margin.

For smaller companies & new listings: As managers focus more attention on very large offshore companies, they reduce analysis of small SA companies. These become cheaper by the day, thus raising their cost of capital, and making new listings unattractive. It's worth noting that over the last 30-years, the universe of JSE listed companies has shrunk from around 700 to 300.

For SA valuations: While it's difficult to specifically quantify the effect of the massive exodus on SA equity valuations, we can get a sense via a stock like Sasol. Sasol has significantly underperformed the Rand oil price, partly as a result of SA Reg 28 related selling. Using the performance gap to Rand oil below, Sasol alone accounts for at least a –0.75% hit to the SA Capped Swix index value, and thus a reduced 55% domestic allocation value.



For transformation: Money invested offshore does not have any imperative to facilitate transformation in South Africa. On the other hand, money invested with an SA manager, or in SA companies, has an obligation to follow transformation guidelines. Foreign managers contribute nothing to our efforts to train or employ previously disadvantaged South Africans and don't have an SA office or SA employees. There is no sense in increasing transformation requirements if you are shrinking the pool of assets that need to follow a transformation path.

In summary

As a country we need our bond investment base to grow, our exchanges to be more liquid, and larger, our global index weights to be greater, and our infrastructure to improve via the private sector, or public-private partnerships.

The original 30% allocation was adequate, especially considering that the JSE has a large offshore component via companies like AB Inbev, Anglo American, BHP, Bidcorp, BTI Glencore, Naspers, Prosus, Richemont and our resource companies, who collectively account for 57% of JSE market capitalisation.

If investors want more offshore exposure, and greater diversification than the original 30% allocation, they can do so via their personal offshore allowances.

As South Africans we need to recognize what's not working, and change things for the better, It's the policy of the government to accelerate transformation, support localization, and for the Finance Ministry to borrow responsibly at the lowest interest rate possible.

The increased offshore limit to Reg 28 has had the exact opposite effect. Surely a rethink is required now that the negative consequences are evident.

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At the core of our identity is a profound sense of optimism, a can-do attitude, and the firm conviction that informed and prepared choices

For more information regarding the latest quarterly review, don't hesitate to get in touch with us:

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