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PENSION FUNDS EVOLUTION, REFORMS AND TRENDS IN SOUTH AFRICA

Nthabiseng Moleko
University of Stellenbosch, South Africa
nthabisengm@usb.ac.za

Sylvanus Ikhide
University of Stellenbosch, South Africa
Sylvanus.Ikhide@usb.ac.za

Abstract

This paper presents a graphical and descriptive analysis of the historical trends of the South African pension fund sector in order to provide insights and understanding of non-banking finance. Using a combination of secondary data and a desk review of existing literature, we provide in-depth analysis of the different types and number of pension funds, industry trends, policy reforms and legislative frameworks enacted by the South African government for the development of the sector. The study identified the evolution of the pension fund industry to be in four phases coinciding with different waves of industry policy reforms, namely: the infancy phase (1911-1958); institutionalisation phase (1959-1984); separation and continued separation phase (1985-1994); and corporatisation and amalgamation (1995-2015) The industry growth analysis indicated that a compounded annual growth rate of 14 percent is the highest annual growth over the past decade and this growth exceeds the global market average of 6.5 percent over the same period. The industry trend analysis is indicative of an upward trend in terms of funds' membership with the trendline showing a steep rise to over 15 million members from under 10 million memberships with the space of a decade. However, the number of pension funds operating in the industry has declined due to a steady move towards umbrella funds. Although the South African pension fund industry is not only moving in the right direction but also considered a beacon of success around the world, there remains huge potential for growth of the sector. Therefore, maintaining sound regulatory policies and government interventions will continue to ensure that pension funds are well managed and bad practices discouraged in the sector through the oversight functions of government regulatory institutions such as the Pension Fund Registrar and Financial Services Board.

Key Words: Pension Funds, Trends, Reforms, South Africa, PIC.
JEL Classification: G230 N270

1. INTRODUCTION

Pension funds in South Africa hold sizable bond and equity holdings. In the South African context, the growth of assets under management has increased the liquidity and depth of the local bond and equities markets. Globally, pension funds are critical drivers of the development of the stock or local securities market (Chan-Lau, 2004). It has been shown that stock market development has a positive and significant correlation with growth in pension funds (Caporale, Howells & Soliman, 2005; Beck & Levine, 2004; Levine & Zervos, 1998). The authors show that investment levels, productivity and growth of the funds are significantly correlated with stock markets.

Levine and Zervos (1998) argues countries with better developed banks and financial systems grow faster than those with weak financial systems. The ability to allocate capital, monitor and provide finance for investments, risk management, mobilization and pooling of savings are some of the benefits of well-developed financial systems (Levine, 1997; Levine, 2004). Pension funds contribute to financial systems through capital markets by impacting savings rates, productivity growth and capital accumulation. Many scholars argue pension funds also contribute to capital market development (Bijlsma, van Ewijk & Haaijen, 2014; Raisa, 2012; Hu, 2012; Niggermann & Rocholl, 2010; Davis, 2006; Walker & Lefort, 2002). The extent to which pension savings induce behaviour on capital markets are determined by the structure of pension systems and in many instances further enhanced by pension fund reforms undertaken. This paper seeks to analyse current trends in the South African pension fund system, its regulation and institutional framework as there is a paucity of work in the related field in African economies. South African pension funds have been rising substantially in the last decade and stand out as the fastest growing pension fund markets globally (Towers Watson, 2014). The focus of the paper is to outline the contribution of pension assets to financial markets as well as highlight the investment patterns and regulatory framework influencing the industry.

This paper is a response to a few studies that have attempted to outline the impact of development of non banking financial services sector in developing economies (Rateiwa & Aziakpono, 2017; Sibanda & Holden, 2014). Several studies have empirically tested the growth effects of financial market development (Beck and Levine, 2004; Levine & Zervos, 1998). Moreover, the empirical effects pension funds exhibit on growth, savings and capital markets

(Hu, 2012; Meng & Pfau, 2010; Irace, Ricca & Rezk, 2009). In this paper we seek to understand the changing patterns of institutional investors in financial markets and how reforms have contributed to a change in institutions, assets under management and employee pension contributions translates to investment distribution in the entire pension system. It is important to understand how regulatory amendments transformed capital markets, with South Africa's growing assets the underpinning reasons can be emulated by other developing economies who seek to improve regulation to address policy gaps identified in their pension system. The paper is structured as follows: Section 2 provides the evolution of pension funds in 4 distinct stages; Section 3 provides industry growth trends and Section 4 concludes.

2. THE EVOLUTION OF SOUTH AFRICAN PENSION FUNDS

The South African pension system has undergone reforms that can be categorized into 4 phases namely infancy, institutionalisation, separation and its continuation, and corporatisation and amalgamation. Each phase points to changes in the legislation, structure and systemic changes governing pension funds.

2.1 Infancy: At the beginning (1911-1958)

According to Van der Berg (2002), South Africa's first pension fund was introduced in the Transvaal Republic in 1882. The institutionalisation of South Africa's pension funds dates back to 1911 when the Public Debt Commissioners Act of 1911 was passed. The Public Debt Commissioners Act marked the beginning of the presently known Public Investment Corporation (PIC). The new Act made provision for holding state assets and using them to finance government budget deficits (Hendricks, 2008). Its functions over the next few decades expanded to the provision of loans to government and state entities such as South African Iron and Steel Industrial Corporation, South African Broadcasting Corporation and several Water Supply Corporations. It also provided funds to provincial administrations (Financial Services Board [FSB], 1959). This was a single government entity that was able to manage and control government funds. The pool of government money was a tool for government to also borrow from itself. Amongst these funds were industrial agreements that were entered into with Industry Councils binding employers to offer competitive benefit packages to its employees (Van der Berg, 2002). A total of 2771 funds existed with a total membership of 675 404 in 1958. This

comprised of eleven state controlled funds, 599 privately administered funds, with the majority 2147 underwritten funds (FSB, 1959).

2.2 Separation (1959-1984)

The second phase in the evolution of the pension fund sector was when the Pension fund registrar was appointed. The institutional and regulatory framework for the sector experienced further improvements. The first Annual Report (1959) published by the Registrar of South African pension funds states that the existence of such a body was to manage and play an oversight role for pension funds. The passing of the Pension Act of 1956 and establishment of a regulatory institution is deemed to be pioneering. The Registrar states in that era it was globally one of the most comprehensive and detailed regulatory tools managing pension funds (FSB Annual Report, 1959). It sets in place the classification of various types of pension funds that are still used to differentiate pension funds in the market. The annual reporting of all fund assets and liabilities, number of funds, members, amounts paid out as annuities and gratuities across privately administered, state controlled, foreign and exempt or underwritten funds was established. Official statistics and trends have been recorded from 1959 to date, and it provides fund trends in the South African context (FSB Annual Report, 1959; Public Investment Corporation [PIC] Annual Report, 2011).

The Pension Fund Act that was the first of its kind globally. It is for this reason it was said to be somewhat experimental in the first Annual report. Where the Act was found to be impractical the necessary adjustments would be made to the Act as it was implemented (FSB, 1959). Registration as a pension fund would be conditional upon complying to the Act’s definition and meeting the stringent requirements of being financially sound. Once the Office of the Registrar was satisfied that a pension fund met its requirements it was registered, failing which registration was halted whilst arrangements were made to the Office of the Registrar to enhance readiness to its satisfaction (FSB, 1959). The cancellation of funds for various reasons, amongst them fraudulent activities would be imposed as part of the Act. Pension funds would annually provide audited financial statements outlining their financial condition. These conditions contributed to the strengthened regulatory framework and development of funds into this next era.

The territory set aside for African inhabitants during the apartheid era was known as Transkei, Bophutatswana, Venda, and Ciskei (TBVC) whereby separate autonomous states were created for indigenous South African people. It is not clear whether the Pension Funds Act was applied consistently across South Africa and the TBVC homelands. These homelands were seen as separate administrations and were governed separately with separate development plans. It is likely though that pension reform was not as stringent and the Act was not applied to its full level of requirements, as these were a people deemed inferior by the apartheid government. Non-contributory pensions were racially fragmented prior to convergence to a means tested level until 1994. Prior to the equalization of state grants, whites earned more than ten times their African counterparts at R322 versus R31 (Van den Heever, 2007).

The Preservation of Pension Interest Bill was withdrawn by Parliament after facing fierce opposition from trade unions (Van der Berg, 2002). It was promulgated in 1981 by the government and it sought to preserve pension rights of funds upon member withdrawals. This meant that workers upon leaving employment with a specific firm would be unable to access their savings from retirement income. The issue was polarized by legislation inhibiting Africans from accessing unemployment insurance, this payout proved to be an important safety net in times of labour mobility. This Bill also propelled trade unions to start their own provident funds, which were the first non-contributory schemes for Africans (Van den Heever, 2007). Trade unions strongly influenced restructuring of regulations to the benefit of employees. A major shift experienced in the 1980s was the movement from defined benefit funds to defined contribution funds, mainly in private occupational schemes. In addition, a shift attributed to the improved benefits faced by employees resulted in the emergence of provident funds, supported by trade unions (Van der Berg, 2002; Standish & Boting, 2006). By the end of this period there were 11 929 registered pension funds covering a membership of 5 124 439. Total assets under management had grown to R21.1 billion by 1984.

2.3 Continued Separation (1985 - 1994)

Entry into this phase is the passing of Public Investment Commissioners Act of 1984. It strengthened the regulatory role of the sector. Public Investment Commissioners were appointed to control and play an investment management role over public funds. Public funds were invested only in the bonds and fixed interest market but by mid 1990's equity such as ordinary and preference shares

received an allocation of public funds. The total market value of shares held by funds as at year-end of this period of 1984 was only R6.1 million (FSB, 1984). During the period, up to the first held democratic elections, the Public Investment Commission maintained a close relationship with the apartheid government fulfilling its mandate as a debt provider to government (Hendricks, 2008). In this period Self-Administered, Underwritten and Foreign Funds were joined by Official Funds, which were administered by the Department of National Health and Population Development and by the South African Transport Services. In 1991 the establishment by the Department of Finance of the Transnet Pension Fund Act, no 62 of 1990 exempted these funds from certain provisions of the Pension Funds Act. Other such exempted funds include the Telkom and the Post Office Funds. Legislation was amended enabling this. Foreign funds dwindled towards the end of this era.

An amendment in the allocation of assets was passed; the abolishment of investing 53 percent of assets in prescribed assets was done away with (FSB, 1988). A new format had to be developed as new categories of assets came into operation in 1989, these changes had to be incorporated in the investment patterns of pension funds. Competitiveness was also introduced in 1994 with the PIC buying stocks on a competitive basis, which was a new development (PIC, 2011).

Government policy and legislation in the next phase would be influenced by reports and investigations commissioned by the Mouton Committee of 1992, jointly with the Katz Commission on Tax reform of 1995 (Van der Berg, 2002). The terms of reference for the Mouton Committee of inquiry was to investigate and make recommendations regarding principles that should apply for a retirement provisions system in the Republic. The report made 108 recommendations that would be the foundation for reform in the sector in the next phase (FSB, 1991). The majority of the population was not covered for retirement in their old age. Only an estimated 5.5 million people's retirement needs were covered versus 9 million people between the ages of 15-64 who weren't members of any retirement fund (Van der Berg, 2002). The state pre- and post 1994 had also commissioned various reports on the issue of social security and social protection as a means to combat poverty. The crucial linkage between pension funds and poverty is that social policy is crucial for combating poverty upon retirement in the form of old age pensions where private savings have not been possible. The South African pension fund sector was well developed entering into the post 1994 era, and the coverage for the

formally employed was noted as highly developed. The impoverished and those without employment were economically excluded and social security policy had to ensure the inclusion of pension benefits for the millions of South Africans whose retirement needs were not covered during this era.

2.4 Corporatisation and Amalgamation (1995 – 2016)

Several changes were seen in this next phase of the pension fund sector. Exempt Funds section 2(3)(a) were changed to Underwritten funds. Bargaining Council Funds were established, previously known as Industrial Agreements. The Government Employees Pension Fund (Government Employees Pension Fund [GEPF], n.d:1) was established with a merger of all state funds. Several reports commissioned during this period, these include Smith Report of 1995, Lund Committee report of 1996 and the Taylor report of 2002. The latter two were produced in the period leading up to the corporatisation of the biggest fund in South Africa. An important change is that state controlled funds were now formally managed by the PIC.

The PIC Bill was amended in 2004 giving a legal mandate to the previously known Public Investment Commissioners to act as asset managers. The PIC Act transferred all state assets to the PIC. The state assets would be derived from the GEPF and other state entities, such as the Unemployment Insurance Fund and Public Office Bearers Fund. The state remained in control of the fund as it attained its status as the sole shareholder, through the Minister of Finance to whom the Board of Trustees would be accountable. The PIC manages government funds, but is not accountable to government but to the Minister, an anomaly given the extent of assets under management. Hendrik (2008) argues that the PIC behaves no differently to a private asset management firm and it seeks returns and profits, rather than development or poverty alleviation. The PIC confirms this view with its centenary publication stating that it operates similarly to a typical asset management firm (PIC, 2011).

The Investment Policy of South Africa's GEPF managed by the PIC outlines that the strategic asset allocation must be spread across domestic and foreign equities and bonds. Contained in this policy is the mandate of the PIC which has been established to act as a manager for the GEPF' and its Isibaya Fund (GEPF, nd). Of all GEPF investments, a 5 percent allocation is made toward developmental investments, these investments contribute towards economic and social infrastructure, leading to job creation. The Isibaya and Pan African

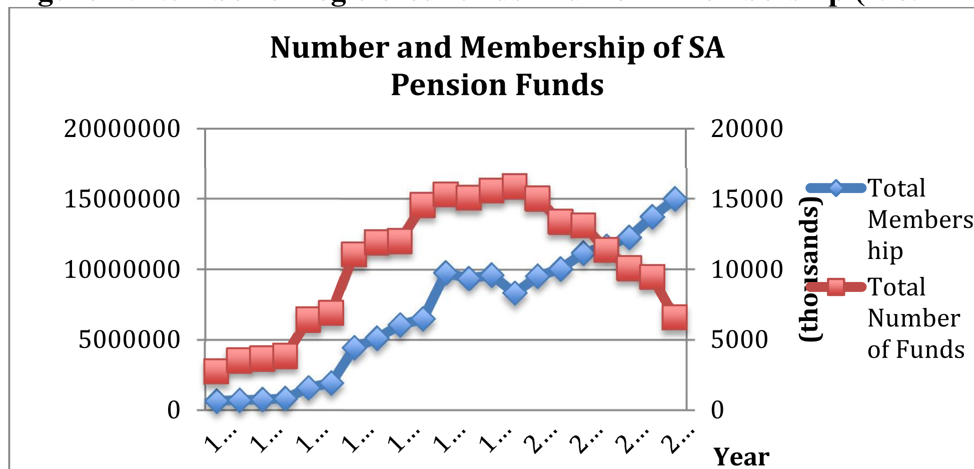
Infrastructure Development Fund target social impact projects and economic infrastructure, job creation, BBBEE and environmental sustainability.

Pension funds act as social safety nets in a structurally unbalanced economy. South Africa, similar to Latin American countries is characterized by high levels of income inequality, low growth and investment levels, per capita GDP levels better than most of Africa but inadequate to reduce unemployment and poverty levels. Using the World Bank model for pension funds the pension system consists of three pillars (Fox & Palmer, 2001). The first pillar is a distribution pillar financed by taxes managed by the public sector as a means to eradicate poverty. The second pillar is where retirement benefits are dependant on personal savings gained from ones account, these are usually mandatory, to encourage worker savings towards retirement. The third pillar is voluntary and can be privately or government managed on behalf of individuals also providing lump sum benefits and annuity purchases. It is important therefore to strengthen both regulatory framework in the management of the second and third pillar, but also the coverage of the non-contributory schemes.

3. PENSION FUND INDUSTRY GROWTH TRENDS

The Towers Watson Global Pension Asset Study (2014) is an international pension fund growth study that is published annually analyzing trends in the pension fund sector. It shows South Africa’s compounded annual growth rate of 14 percent is the highest annual growth over the past decade in the world followed by Australia (12%), Hong Kong (12%) and the United Kingdom (11%). The world average is 6.5% over the same period, showing that the South African growth far exceeds market average. This could be attributed partly to the growth in the total number of funds and total membership (Figure One).

Figure-1: Number of registered funds and Total Membership (1959 – 2012)



Source: (Authors own compilation using data from the Registrar of Pensions, 1959-2014)

The total number of members has risen from 675,404 to 15 million individuals between 1959 and 2012 (FSB, 2012). Standish and Boting (2006) argue that the number of active members has not moved substantially. South Africa's number of members remained under 10 million members until 2005. It has experienced a steady rise to the current 15 million members in the last decade. Van der Berg (2002) outlines that up to 69 percent of the South African labour force would be reliant on state old age social pensions in their old age. More than 75 percent of South African pensioners rely on the means tested social grants for income post retirement (Kaniki & Ntuli, 2011). The coverage of private and state controlled pensions remains severely limited despite a well regulated and highly developed pension system.

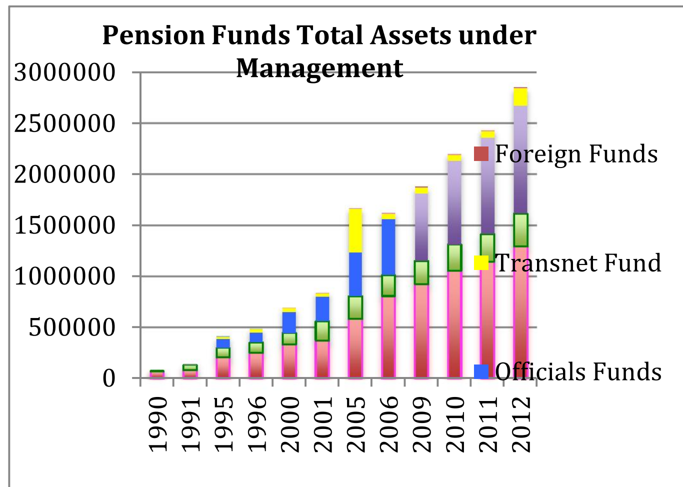
The National Development Plan records the labour force at 17.5million in 2010, with a labour force participation rate of 54% (National Planning Commission, 2013). The majority of South Africans are excluded from formal participation in the labour market and this would explain the numbers of total pension fund members not capturing the majority of South Africans. There is no existing data on the informal labour market and its contribution to the pension fund sector.

A decline in the number of pension funds has also been experienced as shown in Figure 1. This however is explained in more detail by the fluctuations in the

type of funds registered in the sector. The rankings according to the asset size are shown in detail in Figure 2. The governance of funds is the responsibility of trustees who oversee regulatory compliance of the fund. A large number of South African pension funds have less than 100 members at close to 80 percent, which has raised concerns about the availability of well-trained trustees to govern these funds (Stewart & Yermo, 2009).

Figures 2 shows the total assets under the management of the pension fund sector. The year on year growth flourished post-independence and can be attributed to both performance and growth in the contributions from the number of members. The South African pension fund sector is the largest in Africa.

Figure-2: Total Assets Under Management South Africa (R'billion)



Source: (Authors own compilation using data from the Financial Services Board 1990 - 2012)[1].

The Total assets under management grew in 1991 from R157.8 billion substantially to R2.7 trillion in two decades (Financial Services Board, 2012). The concentration of assets is mainly in privately self-administered, underwritten and GEPF funds. In 2012 privately administered pension funds contributed R1.29 trillion and the GEPF R1.05 trillion, together making up more than 85 percent of the total assets under management in the financial markets. Although underwritten funds are larger in number, by 2012 they only contributed 11.76 percent to total pension assets. The trends in the types of funds exhibit the same pattern. Table 1 shows that the total number of funds recorded in 2012 has risen over the 50-year period from 3075 funds to a more than double 6581 in 2012. The number of privately administered funds has seen a sharp increase of 372% rising from 662 to 3128 funds. The post

[1] Telkom, Post Office and Industrial Agreements Funds are calculated but no reflected in the graph due the scale which disables visibility because their contribution to the total is very small. Industrial Agreements from 1995 became Bargaining Council Funds and a variety of funds inception was 1995 such as Transnet, Telkom and the Post Office. The GEPF was also established in mid 2000s.

democratic era of 1994-2005 period sees a 66 percent rise in the number of privately administered funds, translating to 1393 funds being registered during this period. Underwritten Funds made up more than 75 percent of the number of registered funds, rising to levels of over 90 percent in the late 1980s and 1990s, this substantially decreased in the last decade post 2000. The sharp decline in the number of underwritten funds results in a low rise over the period of only 46 percent. Standish and Boting (2006) attribute the decline of the number of funds to the move towards umbrella funds[2].

There are several funds not supervised under the Pension Funds Act of 1958, namely Official Funds, the Government Employees Pension Fund (GEPF) and parastatals such as the Post Office Pension, Transnet and Telkom Funds. National Treasury supervises these funds.

Table 1: Types of Funds (No. of Registered Pension Funds)

	1959	1960	1970	1971	1980	1985	1990	1995	2000	2005	2010	2011	2012
Privately/Self Administered Funds	662	674	810	798	788	1032	1375	2094	3056	3487	3340	3292	3128
Underwritten Fund/Exempt Funds	2358	2768	5548	6046	10265	10953	13198	12970	12509	9888	6776	6204	3444
Industrial Agreements	16	17	28	25	35	30	19	16	13				
State Controlled Funds/GEPF	14	15	14	14	11	10	9				1	1	1
Official Funds							8	5	4	3	3	2	2
Transnet								1	1	3	3	3	3
Telkom								1	1	1	1	1	1
Post Office								1	1	1	1	1	1

[2] Umbrella funds can be defined as those funds that several employers join under one single fund, usually sponsored by a financial services company. The trustees comprise of the administration company owners and they are either pension or provident funds (Van den Heever, 2007:3).

Bargaining Council										5			
Foreign Funds	25	36	35	27	3	1	1	1	2	2	1	1	1
Total	3075	3510	6435	6910	11102	12026	14610	15089	15587	13390	10123	9505	6581

Source: (Author's own compilation data sourced from Financial Services Board, 1959-2012)

The information provided in Table 2 indicates that Insurance policies receive the largest percentage of total assets investments in the last 2 decades. During 1992-2005 an average rate of 23 percent was invested in the asset class, rising to an average 47 percent in the last five years. This is because all fund types were reported on by the Registrar post 2005, prior investment allocation up to the year 2005 reflects the allocation of only self-administered funds in their Annual Reports. The inclusion of underwritten, foreign and state controlled funds has strongly influenced the rise in allocation. Investment in shares in companies during the period 1992-2005 averaged 32 percent, however when additional fund allocation (inclusion of underwritten, foreign and state controlled funds) the average drops to 22 percent. Bills, bonds or securities issued over the 20-year period account for a 9 percent average and Krugerrands a meagre 5.2 percent average. There is no significant shift between privately administered funds and all other funds. This is consistent for all remaining asset types. It is post 2005 where foreign investments are shown reaching a high of 13 percent allocation of the total investment portfolio of pension funds. Debentures, loans and immovable property cumulatively receive less than 5 percent of the investment allocation over the period under review. Regulation 28 of the Pension Funds Act sets out parameters and limitation for investment in each asset type, the Pension fund registrar also assesses compliance by funds to this regulation.

Table 2: Investment Portfolio of Funds (% of Total Pension Fund Assets)

Source: (Author's own compilation data sourced from Financial Services

	1. Immovable property	2. Bills, bonds or securities	3. Debentures	4. Loans	5. Shares in companies/*Equities[3]	6. Collective Investment Schemes	7. Unit Trusts	8. Insurance policies	9. Deposits and Krugerrands	Foreign Investments	10. Other assets
1992	4.8	14.0	0.7	0.1	26.6	-	0.0	30.8	8.9	-	14.1
1993	4.9	19.2	0.7	0.1	26.5	-	1.1	29.6	8.2	-	9.5
1994	4.8	14.0	0.7	0.4	40.4	-	1.4	26.8	9.3	-	2.2
1995	4.3	12.6	0.7	0.3	47.7	-	1.5	24.6	7.5	-	0.8
1996	2.9	13.8	0.6	0.4	45.5	-	1.8	26.8	6.5	-	1.7
1997	4.1	14.8	0.5	0.5	43.0	-	2.9	26.2	5.4	-	2.6
1998	4.2	14.3	0.2	0.6	37.4	-	4.8	26.1	6.4	-	6.0
1999	3.6	12.0	0.2	0.6	34.3	-	4.8	28.2	7.0	-	8.3
2000	3.6	11.9	0.11	0.7	31.1	-	5.2	31.5	6.7	-	9.2
2001	2.7	11.2	0.0	0.8	31.1	-	5.1	32.6	6.3	-	10.2
2005*	0.6	8.6	0.1	0.1	23.3	5.5		47.6	4.3	7.8	2.1
2006	0.5	8.0	0.5	0.1	22.0	5.2		47.3	4.8	9.9	1.7
2009	0.7	7.4	1.1	0.1	18.0	7.3		48.0	6.2	9.5	1.7
2010	0.7	7.1	1.2	0.1	19.0	7.6		46.4	6.3	10	1.6
2011	0.7	7.5	1.1	0.0	18.8	7.9		45.9	5.1	11.8	1.2
2012	0.7	8.1	0.5		18.0	8.4		44.8	5.0	13.0	1.5

Board, 1959-2012)

[3] Investment in collective investment schemes started in 2005 and unit trusts were discontinued post 2005. Shares in companies also started in 2005. Investment in collective investment schemes started in 2005 and unit trusts were discontinued post 2005. Shares in companies also started in 2005. It is also important to note that the Financial Services Board reported Investment Portfolio of Self Administered Funds until 2004, after 2004 reporting reflects all Fund Types.

4. CONCLUSION

South Africa has a strong private occupational pension system, coupled with a state funded means tested public pension system. Historical inequalities led to a large dependence on state support for social protection in old age. The high unemployment rates, job insecurity and low-income levels for informal workers translate to constraints in contributions from large numbers of the labour force. These individuals remain economically inactive or in the informal sector, reducing contributions to nil, as there exist few products tailored to suit their needs. This is likely to continue to result in a significant portion of state funded pension assets utilized for social protection and redistribution to alleviate poverty in the first pillar, even for the current millennial generation who will retire in four decades. Making improvements in products tailored for skilled and unskilled labour requires regulatory incentives, this will improve access and contribution levels, reducing onerous state reliance of retirees.

A mandatory second pillar doesn't exist, and this points to opportunity for further development of the South African pension system in the private sector for mandatory contributions. Pension savings are mandatory only in the public sector producing sizeable allocations by state owned and managed pension assets into financial markets. The concentration of total assets is equally weighted between state owned and managed funds and privately self-administered, underwritten and state employee funds in the third pillar.

The study also shows significant changes occurred during the different phases of growth in the sector. From an early stage, the development of regulatory framework to manage the non-banking financial sector played a significant role in the development of the sector. There remains huge potential for growth of the South African pension fund sector but this study points to the importance of regulation and building strong, evolving financial institutions. Pension funds provide a crucial source of capital in financial markets that can be used to drive national priorities; however, the emphasis lies on the regulatory framework and management of institutions. These are enablers that can exhibit positive effects if they encourage increasing levels of capital allocation to productive investments in capital markets.

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