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NATIONAL
TREASURY

GOVERNMENT GAZETTE NOTICE FOR PUBLIC COMMENT (formal gazetting shortly after tabling of Budget)

REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

DRAFT REGULATION 28 THAT GIVES EFFECT TO SECTION 36(1)(BB) OF THE PENSION FUNDS ACT 1956, 2010

[W.P. –- ‘10]

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DRAFT REGULATION 28 THAT GIVES EFFECT TO SECTION 36(1)(BB) OF THE PENSION FUNDS ACT 1956, 2010

INTRODUCTION

The draft Regulation 28 gives effect to Section 36(1)(bB) of the Pension Funds Act 1956, which provides that the Minister of Finance may make regulations limiting the amount and the extent to which a pension fund may invest in particular assets or in particular kinds or categories of assets, prescribing the basis on which the limit shall be determined and defining the kinds or categories of assets to which the limit applies.

This draft Regulation is gazetted for public consideration.

Comments on the proposed amendment may be submitted in writing on or before Friday 16 April 2010 to:

The Chief Director of Financial Services, c/o Linda van Zyl, Private Bag X115, Pretoria, 0001; or per facsimile to (012) 315 5206; or per email to reg28@treasury.gov.za.

The draft regulations are also available on the National Treasury and Financial Services Board websites - www.treasury.gov.za and www.fsb.co.za.

The National Treasury and the Financial Services Board will continue to engage stakeholders over the comment period to ensure broad stakeholder participation in the Regulation 28 review process. Specific issues to be consulted upon include the proposed definitions, investment categories and investment category limits.

All comments submitted will be taken into account when finalising the regulations.

BACKGROUND

Regulation 28 that gives effect to section 36(1)(bB) was promulgated in 1962 and was last amended in 1998. Innovation and other developments since 1998, and the recent financial crisis, necessitates the urgent amendment of Regulation 28, pending a future holistic review of the Regulations made under section 36 of the Pension Funds Act and published under GNR. 98, Government gazette No. 162 of 26 January 1962.

The key reasons for the amendments to Regulation 28 are:

Regulation 28 references other Acts and regulations that have been amended or substantially altered since 1998 (reference is made to the Acts directly as well as provisions contained therein).

Definitions, asset categories and the structure of limits applied in Regulation 28 conflict with such definitions, categories and limits applied by relevant regulation across other investment funds. Alignment is therefore required for consistency.

Over recent years the investment channels available to pension funds have significantly changed with the incorporation of derivatives, structured products and foreign investments. These more complicated investments and innovations are not explicitly accommodated within Regulation 28, which exposes the current framework to abuse as certain conduct is not expressly prohibited or undermine potential risk–reward benefits if under-utilised.

The exclusion of insurance policies which incorporate a guarantee from the present Regulation 28 allows insurers to offer retirement savings products enabling trustees to exceed the limits prescribed in Regulation 28. In effect these products allow for the by-passing of prudential limits with impunity.

Existing provisions do not facilitate or comply with an Islamic-compliant pension fund's scope to diversify risk as current regulatory design encourages investment in interest bearing products (that are prohibited under Islam).

The global financial crisis has exposed pension funds to greater risk, and hence the need to update the investment channels that prudent pension funds can invest in.

THE CURRENT REGULATION

Regulation 28 prescribes maxima for various types of investment that may be made by a retirement fund. They are intended to guide funds which invest in their own name. The maxima relate to the fair value of the assets of the fund under the direct control of the trustees, and exclude from consideration insurance policies that provide any form of guarantee, or where performance is linked to the performance of underlying assets and the investment of the underlying assets conforms to the requirements of regulation, and unit trusts which conform to the requirements of Regulation 28.

The maxima are broadly:

- No more than 75% may be invested in equities
- No more than 25% may be invested in property
- No more than 90% may be invested in a combination of equities and property
- No more than 5% may be invested in the sponsoring employer
- No more than 15% may be invested in a large capitalisation listed equity, and 10% in any single other equity
- No more than 20% may be invested with any single bank
- No more than 15% may be invested off-shore (recent exchange control limit changes upwards have been provided for to portfolios upon their application to the Retirement Fund Registrar i.e. the imposed limit is actually 20%)
- No more than 2,5% may be invested in “other assets”.

There are no restrictions on investments into money-market or RSA Government issued fixed-income instruments.

Derivative instruments are not defined, leaving them to fall within the category of “other assets”. No guidance is given as to how derivatives may be employed.

No look-through principle is entrenched in Regulation.

There is provision for the Registrar to exempt funds from some or all of these maxima on prior written application. It was on this basis that the Registrar adjusted foreign exposure limits for pension funds in line with revised exchange control limits.

EXPLANATION OF MAIN AMENDMENTS

DEFINITIONS

Current Law

Definitions are outdated and incomplete. This is on account of the proliferation of new products like derivatives, changes to the market that have taken place since 1998, and changes to governing legislation across the financial services sector that impact pension funds and pension fund management.

Proposed amendment

Definitions are added and amended to clearly specify the meaning of terms used in the Regulation. These terms pertain to changes in the exchange control environment, the enacted Collective Investment Schemes Control Act of 2002, the Securities Services Act of 2004 and the accommodation of Islamic-compliant financial products. Definitions are aligned across the investment management regulatory regime to ensure consistency for investment managers that manage different funds subject to different (and often conflicting) governing regulation.

INDIVIDUAL MEMBER CHOICE

Current Law

Regulation 28 applies only to the fund as a whole and therefore may expose an individual member wholly to a high risk asset category.

Proposed Amendment

Where a fund provides an individual member with an option to elect his or her underlying investments and that member is directly exposed to the return on the elected underlying investments, the underlying investments must now comply with Regulation 28 and its spreading requirements.

SCOPE OF REGULATION 28

Current Law

Retirement annuity policies (that provide a guarantee) are excluded from Regulation 28 limits, and may be excluded from the Long-term Insurance regulation if its value is linked to underlying assets.

Proposed Amendment

This exemption has been removed, hence ensuring all retirement annuity policies invest within Regulation 28 limits.

INVESTMENT REQUIREMENTS FOR ASSET CATEGORIES

Current Law

As indicated, definitions applied in Regulation 28 are inconsistent with definitions of the same terms in other legislation governing investment fund managers. Prescribed asset limits are in categories inconsistent with categories applied for other investment vehicles managed by investment managers, and the level of the limits are outdated and require review.

There is no oversight of credit rating agencies and the application of credit ratings for investment decisions by a pension fund. Within individual categories of assets there is no sensitivity given by the Registrar of Retirement Funds to assets with a different credit risk profile. Not all assets within a given asset category necessarily reflect the same credit risk and therefore warrant the same regulatory treatment or restriction.

Islamic-compliant financial services prohibits the use of interest generating investment instruments. While an Islamic pension fund can still comply with Regulation 28 by spreading investments across the categories of non-interest generating investments, the principle of spreading is undermined as the fund is limited to investing in listed and unlisted equities and fixed property. The pension fund members may as a result be prejudiced in terms of poor risk management and returns.

The regulatory treatment of property as an asset class does not distinguish among direct investment in an underlying property, indirect investment through a listed property investment instrument, or exposures to mortgages, although these may have significantly different risk management applications and risk profiles.

Proposed Amendment

Definitions in Regulation 28 are aligned to definitions in the Security Services Act 2004 and Collective Investment Scheme Control Act 2002, and provision for Islamic-compliant instruments are built into the these respective definitions. Categories and limits are, to the extent possible, aligned with categories under the Collective Investment Schemes Control Act 2002, but consultation is required to assess whether the proposed categories and limits are appropriate for pension funds as prudential entities (in contrast to collective investment schemes which are not). Specifically, consideration must be given to whether spreading requirements should be split along broad categories of liquid assets (to include bank deposits and certain liquid money market instruments) and listed securities (to include listed equities, corporate bonds and government bonds), with the anomaly asset categories like Kruger Rands and directly held immovable property to follow. This is in contrast to the existing categories of bank deposits, equities, government bonds and fixed-income (also with anomaly categories like Kruger Rands and immovable property).

The Registrar of Retirement Funds may prescribe which credit rating agencies may issue credit ratings for pension fund investment decisions. For asset categories exposed to credit risk, credit rating bands are created. This is consistent with the approach taken for collective investment schemes and therefore harmonises regulatory treatment across these investment fund vehicles. A draft Notice determining the basis for and restrictions regarding credit rating agencies and their credit ratings, and indicating the rating bands applicable, will be released for public comment and stakeholder consultation.

A money market and a bond “equivalent” Islamic investment instrument are defined to create Islamic-compliant long- and short-term fixed-income type investments, to accommodate their use in the pension fund framework and promote improved risk management for Islamic-compliant pension products.

Regulatory treatment will distinguish direct holding of an underlying property and mortgages/loans from indirect exposure to property through a listed property investment instrument (which it is proposed fits within the listed securities asset category). Consultation is required on the appropriate categories and limits for direct and indirect property investment exposure, in particular to consider whether indirect property investment is appropriately housed as a security or is seen as a distinct asset class along with direct property holdings. Further, if indirectly held property as an asset category is absorbed into listed securities, comments are welcome on whether the current limit of 25% for directly held property is appropriate or should be lowered.

ADDITIONAL INVESTMENT REQUIREMENTS

Current Law

Regulation 28 does not accommodate modern investment products, like derivatives, and does not take into account market development over the past decade, particularly with respect to a significantly altered exchange control regime.

Proposed Amendment

Amendments are not intended to relax restrictions and allow more risky investments but rather to allow for more efficient and effective portfolio management and proper disclosure of investment vehicles in the prudential regulation, and guard against abusive practices like using derivatives to gear the portfolio. Amongst others, some of the proposed amendments are:

Borrowing: For regulatory clarity and certainty, provisions previously contained in Pension Fund Circular 21 are inserted to protect the fund against irresponsible borrowing, in particular to ensure that the fund is not exposed to liquidity risk or inappropriate loan covenants.

Foreign investments: This is to align with exchange control regulations that allow pension funds to invest up to 20% of their assets in investments outside of the Republic.

Foreign Investments into Africa: This is to align with exchange control regulations that allow pension funds to invest an additional 5% to their foreign exposure limit of 20% for investment into African assets.

Securities lending: To generate income for the fund and promote capital market liquidity, funds are permitted to engage in securities lending subject to limits and conditions, to be prescribed by the Registrar of Retirement Funds, to protect the solvency and liquidity of the fund and enhance member returns. While securities lending has been in principle allowed by the Registrar, compliance officers may have prevented activity not expressly allowed for by Regulation 28, and securities lending that did take place was not governed by appropriate regulation. A draft Notice governing securities lending by pension funds will be released for public comment and form basis for stakeholder consultation.

Derivative instruments: Having been defined, the investment into derivatives is permitted subject to provisions and conditions to be prescribed by the Registrar. It is intended that investment into derivative instruments be permitted for purposes of efficient portfolio management and hedging against an investment held by the fund. Derivatives will not be allowed for gearing or leverage. These provisions have to date been applied by the Registrar of Retirement Funds but were not set out in formal regulation and are therefore exposed to abuse. A draft Notice governing investment by pension funds into derivatives will be released for public comment and form basis for stakeholder consultation.

APPLICATION OF THE "LOOK-THROUGH" PRINCIPLE

Current Law

Regulation 28 does not provide for the look-through principle, meaning that pension fund investment managers can potentially circumvent prudential limits by investing through layers of investment vehicles to mask the underlying investment exposure.

Proposed Amendment

The look-through principle will apply for calculating exposures. This speaks specifically to derivative and foreign asset exposures, as well as investments in an underlying asset class through another fund.