NATIONAL
TREASURY

EXPLANATORY MEMORANDUM

ON THE

2nd DRAFT REGULATION 28 THAT GIVES EFFECT TO SECTION 36(1)(bB) OF THE PENSION FUNDS ACT 1956, 2010

2 DECEMBER 2010

[W.P. –- '10]

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.

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

Comments invited on the proposed amendments to Regulation 28 are requested to be of a technical nature only, and should be submitted in writing on or before Friday 28 January 2011 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 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.

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

BACKGROUND

The aim of pension fund investment regulation is to ensure that the savings South Africans contribute towards their retirement is invested in a prudent manner that not only protects the pension fund member, but is channelled in ways that achieve economic development and growth. Regulation 28 of the Pension Funds Act empowers the Minister to define asset spreading requirements for pension funds. Of the R5.2 trillion total household savings in

South Africa, Regulation 28 applies to all private pension funds which constitute about R1.1 trillion.

Regulation 28 was promulgated in 1962 and last amended in 1998. Accordingly concerns have been raised about the continued relevance and appropriateness of the existing limits and provisions in the regulation.

In February 2010 National Treasury released a draft regulation which attempted to remedy shortcomings identified in the existing Regulation 28. Considerable coordinated engagement between the National Treasury, the FSB and industry stakeholders has informed the revised draft of Regulation 28, to be released for a further round of comment and engagement.

The asset spreading requirements provided for through Regulation 28 are intended to diversify pension fund assets across asset categories and investments. It does not then of itself protect such investments – this is ultimately a matter for trustees, who make investment decisions on the advice of their investment advisors.

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; for example, foreign exposure is limited in regulation to excon limits that applied in 1998 (although in this instance higher limits have been accommodated on an application basis).

There is inconsistency in the application of definitions, asset categories and the structure of limits between pension funds & other investment funds.

The limits are intended to achieve diversification across assets and asset classes. In its current form the imposed limits try to prevent a “worst case” scenario of a pension fund eroding its asset base to the extent that retirement savings are significantly compromised. But this approach neglects to guide retirement fund trustees as to what investment strategy would be appropriate for the specific nature and obligations of the fund. Given that retirement savings need to at least match inflationary pressures, no recognition is given to the fact that an overly conservative investment strategy (dominated for example by cash and non inflation-linked bonds) can be as damaging to long-term savings as one that is overly exposed to perceived risky assets.

While a rules-based approach to regulation may seem like an unambiguous way to control pension fund investment behaviour, many pension funds have been able to circumvent the rules. As no “look-through” principle is provided for pension fund investment managers have circumvented prudential limits by investing through layers of investment vehicles to mask the underlying investment exposure (especially with respect to hedge fund and private equity fund exposure, and derivatives).

Investment channels available to pension funds have significantly changed with the incorporation of derivatives, structured products and new types of investment funds like private equity and hedge funds. These are not explicitly accommodated in Regulation 28 which may expose the pension funds to overly risky investment as certain conduct, like gearing, is not expressly prevented. More complicated and at times more opaque products are also more difficult for Trustees to fully contemplate in terms of the potential risks and returns they may bring to the fund.

Increased foreign exposure to pension funds brought about through the relaxation of exchange controls, while good for investment diversification, requires a specialised knowledge by Trustees and fund advisors.

The exclusion from Regulation 28 of insurance policies with any form of a guarantee, irrespective how minimal, has allowed insurers to offer products to retirement funds that systematically exceed the asset limits and yet give minimal underwriting protection.

The limits may encourage a “herd” mentality amongst asset managers and prevent funds from making what may be appropriate investments into, for example, alternative investments or structured products.

Regulation 28 applies only to the fund as a whole and therefore may overly expose an individual member to a high risk asset category, or alternatively mean that a member cannot invest in an asset suited to his or her portfolio because the aggregate limit for the pension fund is already reached.

Credit risk may be an issue as assets within an asset category attract the same limits irrespective of their credit-risk profile.

There is no provision for Islamic-compliant pension funds to diversify risk through debt (and therefore interest earning) equivalent instruments

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:

- Not more than 75% may be invested in equities.
- Not more than 25% may be invested in property.
- Not more than 90% may be invested in a combination of equities and property.
- Not more than 5% may be invested in the sponsoring employer.
- Not more than 15% may be invested in a listed equity with a defined large market capitalisation, and not more than 10% in any single other equity stock.
- Not more than 20% may be invested with any single bank.
- Not 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% plus 5% for Africa).
- Not more than 2,5% may be invested in "other assets," which are not specified.

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

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.

Regulation 28 does not entrench a "look-through" principle to report on underlying assets backing an investment.

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

PRINCIPLES TO STRENGTHEN THE RULES-BASED APPROACH TO REGULATION

Current Law

Regulation 28 is intended to achieve diversification across assets and asset classes. In its current form the imposed limits try to prevent a “worst case” scenario of a pension fund eroding its asset base to the extent that retirement savings are significantly compromised. But this approach neglects to guide retirement fund trustees as to what investment strategy would be appropriate for the specific nature and obligations of the fund. Given that retirement savings need to at least match inflationary pressures, no recognition is given to the fact that an overly conservative investment strategy (dominated for example by cash and non inflation-linked bonds) can be as damaging to long-term savings as one that is overly exposed to perceived risky assets.

Further, the current regulation does not adequately guide a fund, its advisors, and its trustees as to their respective roles with regards to investment decisions as envisioned by the Act, and promotes tick-box compliance, rather than encourage compliance with the spirit of the law.

February 2010 Proposed Amendments

Regulation 28 remains entirely rules-based.

Revised Proposal

In the context of more than 7 000 retirement funds (recently consolidated down from 13 000 funds), Regulation 28 should remain primarily rules-based until broader retirement reform, with an overlay of principles relating to asset-liability matching; improved trustee education; investment decisions taking consideration of the spirit of the regulation; sustainable investing; BEE; and managing foreign exposure risks.

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 circumvent prudential limits by investing through layers of investment vehicles that may mask the underlying asset exposure (especially with respect to hedge fund and private equity fund exposure, and derivatives).

February 2010 Proposed Amendments

Look-through principle introduced.

Revised Proposal

The look-through principle will apply for calculating exposures. A pension fund should report on the underlying assets backing its investments and not just the linked structure (although the structure itself may also be relevant). In other words, if investing into a hedge fund through a debenture or long-term insurance policy, the hedge fund asset must be reported and comply with stated limits, as well as limited liability and gearing restrictions. If accessing unlisted equity through a private equity vehicle, both the unlisted equity investments and the "rights" of the pension fund awarded through the linking structure, e.g. into a partnership, must be understood and reported.

A 5% *de minimis* rule is proposed to mitigate undue regulatory burden, applicable to an investment made up of assets across asset classes. Anti-avoidance wording aims to discourage the use of insurance product wrappers and other structures (like debentures) employed to misrepresent the nature of an underlying asset.

INDIVIDUAL MEMBER CHOICE

Current Law

Regulation 28 applies only to the fund as a whole and therefore may overly expose an individual member to a high risk asset category, or alternatively mean that a member cannot invest in an asset suited to his or her portfolio because the aggregate limit for the pension fund is already reached.

February 2010 Proposed Amendments

Retirement products should be compliant at member level, on grounds that policy priority is member protection in addition to overall sustainability of the pension fund.

Revised Proposal

The February proposal is retained. In recognising the difficulty in requiring compliance of an existing contracted policy, grandfathering provisions may be considered in limited instances.

THE EXEMPTION OF LONG-TERM INSURANCE POLICIES WITH A GUARANTEE

Current Law

Any long-term insurance policy with a guarantee, including retirement annuities, is exempt from Regulation 28.

February 2010 Proposed Amendments

Only an insurance policy which is not a linked policy (where a linked policy means that the value of the policy is derived from the performance of underlying assets) is exempt from the regulation.

Revised Proposal

Only long-term policies with a full guarantee remain exempt from Regulation 28. The exemption for retirement annuities is removed, ensuring all linked policies invest within Regulation 28 limits. Part guaranteed policies may be automatically exempt by the Registrar if designed in a way that adequately protects and fairly benefits a pension fund and its members.

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.

February 2010 Proposed Amendments

Definitions are added and amended to clearly specify the meaning of terms used in the regulation. These terms pertain to, for example, 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.

Derivatives are also defined, and their use subject to strict requirements, in particular to prevent gearing by the fund.

Definitions for “money-market instruments” and “Islamic debt instruments” are introduced.

Revised Proposal

The definitions identified above are retained. In addition, “hedge fund” and “private equity fund” are expressly provided for (see the section on alternative investments to follow). The concept of a “recognised foreign exchange” falls away, being incorporated into the definition of “exchange,” which is defined to include only those foreign exchanges that are full members of the World Federation of Exchanges (WFE). Foreign exchanges that are not WFE members will be treated as unlisted under the new regulation.

ASSET CLASSES AND INVESTMENT LIMITS

GENERAL
Current Law

As indicated, definitions applied in Regulation 28 are inconsistent with definitions of the same terms in other legislation governing investment fund managers. The scope of asset categories, as well as limits applied therein, are in some instances outdated and require review.

In the main structured along traditional asset classes, with listed/unlisted sub categories but inconsistency in terms of limits applied across listed and unlisted assets. For example, 25% unlisted debt is permitted but only 5% into unlisted equity.

February 2010 Proposed Amendments

Regulation 28 is structured along listed/unlisted categories, with asset class sub-categories.

Revised Proposal

The categories of assets will remain delineated across the recognised asset classes of cash; equity; debt; property; commodities; and alternative investments, with significantly lower limits set for unlisted and unregulated instruments or vehicles, although how these categories are defined is updated. Limits imposed in some instances are likewise reconsidered and updated.

To avoid market disruption, transition arrangements will be considered to facilitate a smooth portfolio adjustment process.

CASH
Current Law

This category is intended to meet the liquidity needs of a pension fund, and includes bank deposits, cash held in a margin account and bank issued money-market instruments. Other bank debt treated as any other corporate debt.

February 2010 Proposed Amendments

Define "assets in liquid form" to align with collective investment scheme regulatory environment, for which besides cash, deposits and margin accounts only very short-dated (less than 7-day maturity) bank debt qualifies.

Revised Proposal

The revised category excludes bank money-market instruments, which as short-dated debt is moved to the debt category. The 5% limit for cash held in a margin account is removed.

DEBT INSTRUMENTS
Current Law

There is no limit on SA Government issued bonds. Foreign government bonds are subject only to the exchange control limits (of 20% plus an additional 5% for Africa). Other debt is limited to 25% of total assets, with no distinction made between listed/unlisted or rated/unrated instruments.

No credit ratings requirements are applied in the regulation. Similarly there is no requirement for ratings used to be issued by an approved rating agency.

February 2010 Proposed Amendments

The debt categories are retained; the existing limits are likewise mostly retained, although a significantly lower limit for unlisted and unrated debt is imposed of 5%.

In addition the concept of credit ratings bands is introduced into the regulation. Credit rating agencies must be approved by the Registrar.

Revised Proposal

This asset category is significantly expanded, to incorporate short- and long-dated date, and raises certain limits. Pension funds can hold up to 75% of their assets in debt issued and backed by South African banks (to include money-market instruments), up to 25% in quasi-government entities, and up to 25% in other corporate debt. A tighter limit of 15% is applied for unlisted debt in the corporate debt category, and this category is subject to strict investment diversification and valuation requirements.

On the issue of credit ratings, the revised draft retains the requirement that rating agencies must be approved but removes rating bands on the basis that such promotes herd behaviour and tick-box regulatory compliance.

EQUITIES
Current Law

The regulation distinguishes between listed and unlisted equity assets, and for listed equities further delineates between those with large and small market capitalisation. Unlisted equities are subject to a 5% limit. Private equity investments have enjoyed a higher than intended limit (from the Registrar's perspective) of 7.5%, achieved through the 5% unlisted share allowance plus 2.5% in "other assets".

February 2010 Proposed Amendments

The existing listed equity provisions are retained, although the delineation between large and small stocks is upwardly revised for inflation. Unlisted equities are significantly more constrained to be included in the 2.5% "other assets" category

Revised Proposal

The per-issuer limits for equities are divided into three categories – small (5%), medium (10%) and large (15%). The limits will be checked for inflationary pressures over time and the FSB is enabled to update these accordingly. The limit for unlisted equities, whether held directly or through a private equity vehicle, is increased to 10%, subject to strict investment diversification and valuation requirements.

IMMOVABLE PROPERTY

Current Law

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 implications and risk profiles.

February 2010 Proposed Amendments

Contemplates distinction between directly held and managed property from property exposure obtained through a listed property investment fund on the basis that directly-held property investments are only suitable for appropriately-resourced pension funds.

Revised Proposal

Regulatory treatment distinguishes between listed and unlisted property exposure, and unlisted property is given a lower aggregate limit than listed property. Similar to equities, listed property is divided into three sub-categories – small (5%), medium (10%) and large (15%). The limits will be checked and tested on a continuous basis, and the FSB will from time to time update the prescribed limits accordingly.

COMMODITIES

Current Law

Only Kruger rands are accommodated and subject to a 10% limit.

February 2010 Proposed Amendments

Proposes a lower limit for Kruger rands but there remains no accommodation of commodities more broadly.

Revised Proposal

The Kruger rand category is expanded to also include listed exchange-traded commodities, but remains subject to the 10% limit.

OTHER ASSETS, TO INCLUDE ALTERNATIVE INVESTMENTS

Current Law

The current regulation limits investment into assets that are not expressly identified in the regulation, such as investments into fine art or livestock, to 2.5%.

Alternative investments like private equity and hedge funds are not explicitly defined in the regulation or specified in the applied limits.

February 2010 Proposed Amendments

The 2.5% limit is retained. Alternative investments are intended to be reported under this category, but are not defined in the regulation.

Revised Proposal

Significantly more flexibility is afforded to pension funds with this limit raised to 15%. For greater certainty, certain alternative investments like private equity funds and hedge funds are explicitly defined and included in the Table of limits.

Rather than entirely prohibit alternative and unregulated assets (like unlisted equity, unlisted/unrated debt, private equity, investments into Africa and hedge funds), Regulation 28 is proposed to enable contained and monitored investment into these products, supported by strict asset and investment diversification limits and appropriate valuation procedures (for which the Pension Fund Registrar should give guidance).

The Registrar may impose additional requirements to investments made through a partnership or trust structure.

FOREIGN ASSETS

Current Law

Foreign exposure limits are specified in Regulation 28 and are outdated. There is no other consideration granted of micro-prudential requirements related to foreign exposure.

February 2010 Proposed Amendments

Foreign limits remain specified in the regulation but are updated to current foreign exposure limits. There remains no consideration of micro-prudential requirements related to foreign exposure, although investments into foreign unlisted equity is prohibited.

Revised Proposal

For greater flexibility, foreign limits are to be prescribed by the Registrar of Pension Funds (as informed by circular by the Financial Surveillance Department of the South African Reserve Bank, in terms of the Currency and Exchanges Act). Foreign exposure risks are required to be considered before making an investment decision. Unlisted foreign equity is enabled but subject to strict diversification and valuation requirements.

OTHER MATTERS

HOUSING LOANS

Current Law

Housing loans may be issued by a pension fund to a member against that member's pension savings (to the value of 95% of those savings).

February 2010 Proposed Amendments

The existing allowance is retained.

Revised Proposal

Housing loans are still permitted, but only to the 95% level if issued through a bank against the retirement savings as surety. Housing loans issued directly by a pension fund is curtailed to 5% of a member's savings.

BORROWING

Current Law

There are no provisions concerning fund borrowing in the regulation.

February 2010 Proposed Amendments

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.

Revised Proposal

These provisions are retained.

DERIVATIVES

Current Law

Derivatives activity not explicitly accommodated for.

February 2010 Proposed Amendments

Provides for derivatives use by pension funds to be subject to requirements prescribed by the Pension Fund Registrar (no draft Notice released).

Revised Proposal

Same as February draft (draft Notice to be released with the revised draft Regulation 28).

SECURITIES LENDING
Current Law

Securities lending not explicitly catered for.

February 2010 Proposed Amendments

Provides for securities lending by pension funds to be subject to requirements prescribed by the Pension Fund Registrar (no draft Notice released).

Revised Proposal
Same as February draft (draft Notice to be released with the revised draft Regulation 28).