REGULATION 28 PUBLIC FORUMS

2nd DRAFT REGULATION 28

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REPUBLIC OF SOUTH AFRICA

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INTRODUCTION

ON THE LEGISLATIVE AGENDA FOR SOME TIME, PROCESS ACCELERATED IN 2009

2009	Jul – Dec 2009: Discussions between FSB and National Treasury
2010	Feb: Draft proposal released for public comment
	Apr: 31 sets of formal comments received
	Jul - Nov: Steering and Technical Committee deliberations
	Dec: 2nd draft proposal released for public comment
2011	28 Jan: Comments on 2nd draft due

EXISTING REGULATION 28

The current limits are:

- Maximum 75% may be invested in listed equities (5% unlisted)
- Maximum 25% may be invested in debentures
- Maximum 25% may be invested in property
- Maximum 90% may be invested in a combination of equities and property + maximum 95% in non-government instruments
- Maximum 5% may be invested in the sponsoring employer
- Maximum 15% may be invested in a large capitalisation listed equity, and 10% in any single other equity
- Maximum 20% may be invested with any single bank
- Maximum 15% may be invested off-shore (recent excon limit changes upwards provided for upon application to Registrar i.e. imposed limit is 20%)
- Maximum 2,5% may be invested in “other assets”

=> Exemption for CIS & linked policy (with certificate) + non-linked policy

AMENDMENT OVERDUE – WHAT'S AT ISSUE?

- Rules vs. Principles
- New investment channels – for better or worse…
  - Private pools of capital, unregulated
  - Derivative instruments: how are these used?
  - Raised exchange control limits
- Regulatory arbitrage between LTIA and PFA
- Alignment between pensions/LTI/CIS requirements?
- Islamic compliant products – better risk management
- References other Acts, regulations and products that have been amended or substantially altered since 1998

BROAD POLICY OBJECTIVES

- Member Protection.
- Leverage the crucial link between retirement savings and economic growth as influenced by the level of savings and its allocation towards productive assets.
- Reduce the fiscal pressure on the state to provide for citizens through social security programmes.

CONSISTENCY VS. FLEXIBILITY

Concerted effort to build in more consistency across asset classes on the one hand, with flexibility to accommodate the fullest range of member needs and choice on the other, in particular relying on the following principles:

- Regulatory response to be proportionate to specific risks identified;
- Structure of rules should to be consistent with typical risk management view (to extent possible);
- Asset categories with similar / equivalent risks to have similar / equivalent limits;
- Rather than “ban” high risk classes of assets, mitigate risks through proper valuation, diversification, transparency to the supervisor, disclosure to the member, and a tighter overall limit; and
- True nature of asset to be reported, not linked structure

HOW TO APPLY THE REGULATION

PRINCIPLES TO STRENGTHEN REGULATION

Current Reg 28: Entirely rules-based.

Feb proposal: Rules retained.

Comments: Outdated, impractical; Implicit state endorsement; does not encourage prudential investing or protect against inflation risk or interest rate risk.

Now: Mainly rules-based but overlay of principles relating to:

- **Asset-liability matching**
- **Due diligence**
- **Improved trustee education**
- **Spirit of the regulation**
- **Sustainable investing - ESG matters count**
- **BBBEE; and**
- **Foreign exposure risks**

LOOK-THROUGH

Current Reg 28: No look-through principle.

Feb proposal: Look-through principle introduced.

Comments: Time consuming, expensive, impractical, could distort market, cause anti-competitive behaviour.

Now: Look-through principle maintained, subject to 5% *de minimis* rule, part-guaranteed policies need the "OK" to be exempt, HF is the final "asset".

INDIVIDUAL MEMBER CHOICE

Current Reg 28: Asset requirements apply only at the fund level.

Feb proposal: Member level compliance, including for RA funds.

Comments: Cost prohibitive, unnecessary. Implementation unclear.

Now: Member level compliance retained, grandfathering provisions may be considered in limited instances.

EXEMPTIONS FOR LONG TERM INSURANCE POLICIES

Current Reg 28: Any LTI policy with any guarantee exempt.

Feb proposal: LTI policies with full guarantee exempt on grounds that such policies are subject to LTI regulation.

Comments: At odds with the look-through principle, introduces competitive bias, practical difficulties.

Now: Only long-term insurance policies with a full guarantee remain automatically exempt, part-guaranteed policies may be exempt subject to certificate issued by the LTI Registrar.

ASSET CLASSES AND INVESTMENT LIMITS

GENERAL

Current Reg 28: Structured along traditional asset classes, with listed / unlisted sub categories in each asset class (but little nuance for these and poorly defined).

Feb proposal: Split across degree of regulation.

Comments: Align categorisation more with industry practice i.e. by asset class, limits outdated and inconsistent with risk management principles.

Now: Categories delineated across recognised asset classes, provide for transition arrangements to facilitate a smooth portfolio adjustment process (limits considered in slides to follow…).

Consider: Transition arrangements, “liquid assets” as a category, unlisted / unregulated assets, dedicated categories for private pools, CRAs (over-relying on one opinion, biased valuations, moral hazard, conflicts of interest).

“CASH”

Current Reg 28: 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.

Feb proposal: 100% of assets can be in cash. Money market instrument with less than 7-day maturity bank debt qualifies.

Comments: Don’t allow 100% cash, have lower aggregate limit. Increase limit for margin accounts.

Now:

1.	CASH		
1.1	Inside the Republic	25%	100%
1.2	Foreign assets	5%	An amount as prescribed

Consider: What is cash? Liquidity vs. investment characteristics of cash, banks prudentially regulated, maturity threshold, safety of margin accounts.

DEBT

Current Reg 28: No limit on SA gov bonds. Foreign government bonds subject only to exchange control limits (of 20% plus an additional 5% for Africa). Other debt limited to 25% of total assets, with no distinction made between listed/unlisted or rated/unrated instruments.

Feb Proposal: Existing 25% limit subject to credit bands (by recognised CRAs). Limit on **unlisted / rated** debt lowered to 5%. Unlisted / unrated into "Other Assets" at 2.5%.

Comments: Provide explicitly for unlisted bonds with low or no credit ratings. Current limits limit economic and infrastructure development as well as asset matching. Ratings are not appropriate for all debt instruments or issuers.

Consider: SOE's over-reliant on state, banks need flexible funding, debt listing requirements inadequate, debt ranks higher than equity, category "crowding", role of valuation & diversification.

DEBT (CONT)

2.	DEBT INSTRUMENTS, INCLUDING MONEY MARKET INSTRUMENTS AND ISLAMIC DEBT INSTRUMENTS				100% for debt instrument issued by or guaranteed by the Republic, otherwise 75%
2.1	Inside the Republic and foreign assets				
	(a)		Debt instruments issued by, and loans to, the government of the Republic, or any bond or loan guaranteed by the Republic		100%
	(b)		Debt instruments issued or guaranteed by the government of a foreign country	10%	An amount as prescribed
	(c)		Debt instruments issued or guaranteed by a South African bank against its balance sheet:-		75%
		(i)	with a market capitalisation of R20 billion or more, or an amount or conditions as prescribed	25%	
		(ii)	with a market cap of between R2 billion and R20 billion, or an amount or conditions as prescribed	15%	
		(iii)	with a market capitalisation of less than R2 billion, or an amount or conditions as prescribed	10%	
	(d)		Debt instruments issued or guaranteed by a wholly owned state owned entity, provincial government or local government in the Republic	5%	25%
	(e)		Other debt instruments		25%
		(i)	Listed on an exchange	5%	25%
		(ii)	Not listed on an exchange	5%	15%

EQUITIES

Current Reg 28: Distinguishes listed from unlisted equity assets, and has 2 per issuer limit categories according to market cap. Unlisted equities subject to 5% limit. Private equity investments have effective 7.5% limit (5% unlisted shares + 2.5% in “Other Assets” category).

Feb Proposal: Listed equities stays at 75%. Delineation between large / small stocks revised for inflation. Unlisted equities significantly constrained to be included in the 2.5% “Other Assets” category.

Comments: Increase listed equities limit, increase unlisted equities limit, remove delineation by market cap measure.

EQUITIES (CONT)

Now:

3.	**EQUITIES**				**75%**
3.1	**Inside the Republic and foreign assets**				
	(a)		**Preference and ordinary shares in companies, excluding shares in property companies, listed on an exchange: -**		**75%**
		(i)	**with a market capitalisation of R20 billion or more, or an amount or conditions as prescribed**	**15%**	
		(ii)	**with a market capitalisation of between R2 billion and R20 billion, or an amount or conditions as prescribed**	**10%**	
		(iii)	**With a market capitalisation of less than R2 billion, or an amount or conditions as prescribed**	**5%**	
	(b)		**Preference and ordinary shares in companies, excluding shares in property companies, not listed on an exchange**		**10%**
		(i)	**Incorporated in the Republic**	**2.5%**	**10%**
		(ii)	**Not incorporated in the Republic**	**2.5%**	**5%**

Consider: Economic development, younger members, diversification, dividing line between debt and equity, market cap trap, flexible segmentation into 3 size categories.

IMMOVABLE PROPERTY

Current Reg 28: No distinction between direct investment in an underlying property, indirect investment through a listed property investment instrument, or exposures to mortgages.

Feb proposal: 25% limit for physical property. Distinguishes directly held from listed property (listed PLS companies & PUTs under securities).

Comments: All property-related assets under “property” with subdivisions. Different limits for direct (physical) and indirect property. Disallow DC funds from holding property directly.

4.	**IMMOVABLE PROPERTY**				**25%**
4.1	**Inside the Republic and foreign assets**				
	(a)	**Preference and ordinary shares in property companies, or units in a Collective Investment Scheme in Property, listed on an exchange:-**			**25%**
		(i)	**with a market capitalisation of R10 billion or more, or an amount or conditions as prescribed**	**15%**	
		(ii)	**with a market capitalisation of between R3 billion and R10 billion, or an amount or conditions as prescribed**	**10%**	
		(iii)	**with a market capitalisation of less than R3 billion, or an amount or conditions as prescribed**	**5%**	
	(b)	**Immovable property and claims secured by mortgage bonds thereon, preference and ordinary shares in property companies not listed on the exchange, secured loans and debentures**		**5%**	**15%**

Consider: Directly vs. indirectly held, listed property vs. other asset classes, listed vs. unlisted property, number of segments, flexible limits, property debt vs. other debt.

COMMODITIES

Current Reg 28: Only Kruger Rands are accommodated and subject to a 10% limit.

Feb proposal: Kruger Rand limit lowered from 10% to 5%. No accommodation of commodities more broadly.

Comment: Rename category “Commodities” with 10% limit and allow for other types of commodity instruments including physical commodities and commodity ETFs. Kruger Rands have no relevance with respect to the liabilities of a pension fund.

Now:

5.	**COMMODITIES**			**10%**
5.1	**Inside the Republic and foreign assets**			
	(a)	**Kruger Rands and other commodities listed on an exchange, including exchange traded commodities**		

Consider: Risk diversification, inflation hedge, volatile, include ETFs, include other commodities, value to PF if not income producing.

OTHER ASSETS

Current Reg 28: Alternative investments like private equity funds and hedge funds not explicitly defined in the regulation or specified in the applied limits.

Feb Proposal: 2.5% limit is reinforced. Alternative investments not defined, privately pooled funds, including private equity funds and hedge funds not recognised.

Comments: Recognise explicitly to curb avoidance through wrappers. Hedge funds mitigate portfolio risk.

8.	HEDGE FUNDS, PRIVATE EQUITY FUNDS AND ANY OTHER ASSET NOT REFERRED TO IN THIS SCHEDULE				15%
8.1	Inside the Republic and foreign assets				
	(a)	Hedge funds			10%
		(i)	Fund of hedge funds	5%, per fund	
		(ii)	Hedge funds	2.5%, per fund	
	(b)	Private equity funds			10%
		(i)	Fund of private equity funds	5%, per fund	
		(ii)	Private equity funds	2.5%, per fund	
	(c)	Other assets not referred to in this schedule and excluding a hedge fund or private equity fund		2.5%	5%

Consider: Dom vs. foreign market, role of regulation – what about the unlisted / unregulated – overall limits, applying “look-through”, lock-up periods! Limited liability! Role of diversification & valuation, limit single PF investor “significance”

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FOREIGN ASSETS

Current Reg 28: Foreign exposure limits are specified in Regulation 28. No consideration of micro-prudential requirements related to foreign exposure.

Feb proposal: Foreign exposure limits for pension funds adjusted to 20% (and additional 5% for Africa) in line with revised exchange control limits. No consideration of micro-prudential requirements. No investment into foreign unlisted equity.

Comments: Do not align with exchange control regulations. Focus limits on currency instead of domicile.

Now: Limits prescribed by FSB, informed by SARB Financial Surveillance stance. Risks to be considered. Unlisted foreign equity enabled but must be diversified and independently valued.

> *"The sum of aggregate exposure to foreign assets, referred to in Column 1 of Table 1 and expressed as a percentage, may not exceed the maximum allowable amount that a pension fund may invest in foreign assets as determined in terms of an Exchange Control Circular issued by the South African Reserve Bank."*

Consider: Defining foreign assets, unlisteds, foreign exposure risks, broader excon reform.

OTHER MATTERS

DERIVATIVE INSTRUMENTS

Current Treatment: Derivative Instruments not explicitly recognised or expressly accommodated.

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

Comments: Some respondents asked for derivative instruments to be recognised explicitly in the Table as well as for index derivatives to be allowed. CISCA restrictions too limited.

Now: Notional exposure feeds through to asset classes. Not for gearing or leverage. Index derivatives exposure must be “covered.”

Consider: Feed notional exposure through, alignment with CIS and LTI, allow use of derivatives for gearing purposes, allow uncovered positions, derivatives an asset class?

SECURITIES LENDING TRANSACTIONS

Current Reg 28: Securities lending transactions not explicitly recognised or expressly accommodated.

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

Comments: Align with CISCA and LTIA but recognise differences in mandates. Make counterparty exposures subject to limits. Enhances cash flow.

Now: Explicitly allowed subject to FSB conditions

Consider: Activity prevented by "vagueness"? Voting rights? Promotes liquidity? Explicit allowance?

SOCIALLY RESPONSIBLE INVESTMENT (SRI)

Current Reg 28: No explicit recognition of SRI.

Feb proposal: No explicit allocation or recognition of SRI.

Comments: Allow explicitly for SRI. Relax rules around unlisted securities.

Now: ESG included in principles. Funds' IPS must define ESG and how applied, including BEE.

Consider: Negative screening, accounting for risk, impact on performance.

WAY FORWARD

WAY FORWARD

- **Public forums in:** Pretoria, Weds 8 December 2010
  CT, Thurs 9 December 2010
- To extent possible, **comments preferred on technical issues**
- Comments due **Friday 28 January 2011**, submit to: reg28@treasury.gov.za
- Welcome further engagement with industry associations
- **!! FINAL REGULATION 28 – DUE Q1 2011 !!**

QUESTIONS OR COMMENTS