DRAFT DEFAULT REGULATIONS

DRAFT AMENDMENTS TO THE REGULATIONS ISSUED IN TERMS OF SECTION 36 OF THE PENSION FUNDS ACT, 1956 (ACT 24 OF 1956)

Definition

1. In these regulations "the Regulations" mean the Regulations published by Government Notice R.98 in *Government Gazette* 162 of 26 January 1962, as amended by:

Notice	*Government Gazette*	Date
R.99		26 January 1962
R.2144	9437	28 September 1984
R.1790	9892	16 August 1985
R.1037	10249	28 May 1986
R.232	10601	6 February 1987
R.1452	11992	7 July 1989
R.1920	12079	1 September 1989
R.2361	13536	27 September 1991
R.201	14572	12 February 1993
R.2324	15312	10 December 1993
R.141	15453	28 January 1994
R.1838	16833	24 November 1995
R.1677	17500	18 October 1996
R.801	18978	19 June 1998
R.1020	19131	14 August 1998
R.1154	19225	11 September 1998
R.1218	19269	25 September 1998
R.1644	19596	18 December 1998
R.853	20267	9 July 1999 w.e.f 1 July 1999
R.896	21545	8 September 2000 w.e.f 1 September 2000
R.337	22210	6 April 2001
R.100	23080	1 February 2002
R.1037	23689	1 August 2002
33	24264	24 January 2003
558	24780	22 April 2003
R.1739	25776	28 November 2003
R.1355	27012	19 November 2004
R.1105	28226	14 November 2005
R.491	28884	29 May 2006
R.843	29139	18 August 2006
R.1217	29446	1 December 2006
R.73	31837	4 February 2009
BN 10	33954	28 January 2011
BN 26	34024	14 February 2011
BN 61	34152	25 March 2011 w.e.f. 1 April 2011
R.183	34070	4 March 2011 w.e.f. 1 July 2011

Amendment of definitions

2. The definitions in the Regulations are hereby amended:

(a) by the insertion after the definition of "accounting person" of the following definitions:

"best estimate assumption" means an actuarial assumption that:

(a) is realistic;

(b) depends on the nature of the business concerned; and

(c) is guided by past experience, as modified by any knowledge or expectation of the future, including events, such as changes in tax or legislation, which impact the expected experience of the fund.

"collective investment scheme" has the meaning assigned to it in section 1 of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002);

"default annuity strategy" means the terms on which a member's retirement savings are used to provide an annuity or pension income after the member has retired, unless the fund has been otherwise instructed by the member in writing, which annuity product or set of rules at least -

(a) complies with the requirements of regulation 39(2);

(b) comprises a combination of one or more of the options described in regulation 39(3) to (5);

(c) may be made conditional on any or all of —

(i) the aggregate value of each individual member's retirement savings when they retire

(ii) the amount of each individual member's pre-retirement pensionable salary over the year before they retire, and

(iii) the health status of each individual member when they retire, and

(d) complies with any conditions that may be prescribed from time to time.

"default investment portfolio" means an investment portfolio in which the retirement funding contributions of a member of a fund must be invested unless the fund has been instructed by the member in writing to invest them in another investment portfolio and which portfolio

(a) at least complies with the requirements set out in regulation 37; and

(b) the composition of which portfolio may differ from member to member only in respect of any or all of

(i) the age or likely retirement date of each member

(ii) the then aggregate value of the retirement savings of each member, and

(iii) the then pensionable salary of each member; and

(c) any conditions that may be prescribed.

(b) by the insertion after the definition of "deferred pensioner" of the following definitions:

"derivative instrument" has the meaning assigned to it in section 1(1) of the Financial Markets Act, 2012 (Act No. 19 of 2012);

"fair value" has the meaning assigned to it in financial reporting standards and includes any other conditions as may be prescribed;

"financial reporting standards" has the meaning assigned to it in the Companies Act, 2008 (Act No. 71 of 2008);

(c) by the insertion after the definition of "foreign fund" of the following definitions:

"fund member policy" has the meaning assigned to it in Part 5A of the Regulations issued under the Long-term Insurance Act;

(d) by the insertion after the definition of "insurer" of the following definitions:

"investment portfolio" means an identifiable portfolio of assets whether those assets are

(a) owned by the fund;
(b) owned by an insurer which has issued to the fund a policy in terms of which policy benefits are directly or indirectly based on the returns on the investment of those assets;
(c) assets held by a collective investment scheme or pooled fund of which the fund or an insurer contemplated in part (b) is an owner or co-owner,

in which a fund has invested retirement funding contributions of its members and/or has decided to include in the range of investment portfolios in which retirement funding contributions may be invested;

"listed" means to be compliant with the listings and disclosure requirements of an exchange made in terms of sections 11 and 14 of the Financial Markets Act, 2012 (Act No. 19 of 2012), and any other condition as may be prescribed;

"living annuity" has the meaning assigned to it in section 1 of the Income Tax Act, 1962 (Act No 58 of 1962);

"Long-term Insurance Act" means the Long-term Insurance Act, 1998 (Act No. 52 of 1998);

"long-term insurer" means a person registered as a long-term insurer in terms of the Long-term Insurance Act;

"normal retirement age" means the normal retirement age as defined in the rules of a fund;

"paid-up member" means a deferred pensioner;

"paid-up membership certificate" means a certificate issued by a fund in respect of a paid-up member which records, in a format which may be prescribed, at least the following:

(a) the name, address, registration number and contact details of the retirement fund;
(b) the name, address and contact details of the retirement fund administrator;
(c) the name, address, ID number, tax number, fund membership number and contact details of the member in respect of whom the certificate is issued;
(d) the date at which the member in respect of whom the certificate is issued became a paid-up member, and the date on which the certificate was issued;
(e) the aggregate value of the retirement savings of the paid-up member in respect of whom the certificate is issued held in the fund at the date on which such member became paid-up;
(f) the investment portfolios in which such retirement savings are invested; and
(g) any other information which may be prescribed.

"pension funding ratio" means the ratio or ratios determined by dividing the fair value of each separate pension pool of assets maintained in respect of each portion of the in-fund pension liabilities of a fund other than living annuity liabilities in respect of which members ensure the fund's financial soundness by accepting variations in their retirement incomes, by the value of each respective portion of such liabilities, determined by the valuator of the fund using best estimate assumptions.

"**pooled fund**" means a collective investment undertaking, including investment compartments of a collective investment undertaking, constituted in any legal form, including in terms of a contract, by means of a trust, or in terms of statute, which–

(a) raises capital from one or more investors, to facilitate the participation or interest in, subscription, contribution or commitment to a fund or portfolio, with a view to investing it in accordance with a defined investment policy for the benefit of the investors; and

(b) does not require approval as a collective investment scheme in terms of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002);

(e) by the insertion after the definition of "privately administered fund" of the following definitions:

"retirement benefits counsellor" means an individual who:

(i) has qualifications as may be prescribed;

(ii) explains the default annuity strategy, and assists individuals whose retirement savings are used to provide an income in retirement in terms of the default annuity strategy,

(iii) explains the default preservation policy, and assists individuals whose retirement savings are preserved in the fund in terms of the default preservation policy, and

(iv) may not receive income either directly or indirectly in respect of any choices the individuals who are members of the fund may make as a direct or indirect consequence

of their retirement or withdrawal from the fund, other than any income paid to them by the retirement fund.

"retirement funding contributions" means, in relation to a member, the balance remaining of

(a) the contributions already paid and/or which will be paid

(i) to the fund; or,

(ii) in the case of a wholly underwritten fund, to the insurer which underwrites the retirement benefit liabilities of the fund in terms of a policy issued by the insurer to the fund,

by the member or by anyone else for the benefit of the member; and,

(b) if applicable, any other amount paid or transferred or that will be paid or transferred to the fund from another fund for the benefit of the member,

after the deduction from those contributions of amounts deductible in terms of the rules of the fund to meet current fund expenses and the costs of providing risk benefits to members: Provided that all such contributions are paid in respect of defined contribution benefit components other than risk benefits..

"retirement savings" in relation to a member at any date means the then aggregate of his or her retirement funding contributions to a fund from time to time increased or decreased, as applicable, by fund return less charges deductible from those returns or those retirement savings in terms of the rules of the fund read with the terms on which the retirement savings were invested by the fund in investment portfolios;

Insertion of new regulations

3. The Regulations are hereby amended, by the insertion after regulation 36, of the following regulations:

37. Default investment portfolio

(1) The rules of all retirement funds must provide for a default investment portfolio, unless exempted from this requirement after application in writing to the Registrar.

(2) Fund Boards must ensure, and be able to demonstrate to the Registrar on request, that –

Default investment portfolios are appropriate for the members who will be automatically enrolled into it

(a) the design of the default investment portfolio, including its

(i) high-level objective;

(ii) underlying asset allocation;

(iii) fees and charges; and

(iv) the risks and returns to which it exposes members whose retirement savings are or will be invested in the default investment portfolio;

takes account, as far as is reasonable, of the likely characteristics and needs of that category of members whose retirement savings are or will be invested in the default investment portfolio, including

(aa) their appropriate preferences for balancing risk and return;

(bb) their likely future term of membership in the retirement system;

(cc) their financial sophistication; and

(dd) their ability to access individual financial advice;

The objective, composition, performance, of the default investment portfolio are adequately communicated to members

(b) the high-level objective, underlying asset allocation, and fund return net of all fees and charges in respect of the default investment portfolio are communicated to fund members on a regular basis, in clear and understandable language, and in a format which may be prescribed;

Default investment portfolios are good value for money

(c) the fees and charges received by fiduciaries and service providers in respect of the default investment portfolio or the assets held in respect of the default investment portfolio are reasonable and competitive, taking account of market conditions, the size, asset allocation and other characteristics of the fund as a whole and the default investment portfolio in particular;

All fees and charges, and their impact on members' benefits, are disclosed accurately and regularly

(d) all fees and charges, whether borne directly by the fund or paid directly or indirectly out of assets, or implicit in trading assets or in trading or holding derivative securities or policies purchased in respect of the default investment portfolio and the management of the underlying assets, as well as the impact that such fees and charges will have on members' actual and prospective benefits, are disclosed on a regular basis to members, in clear and understandable language, and in a format which may be prescribed;

Passive or enhanced passive investment of listed assets must be considered

(e) they consider the passive or enhanced passive investment of listed assets as all or part of the default investment portfolio;

Default investment portfolios are purely for investment purposes

(f) No risk benefits may be paid to members in respect of any portion of their retirement savings invested in the default investment portfolio;

(g) the benefits paid or amounts accruing to any member or the fees and charges deducted from the retirement savings of any member in respect of the portion of their retirement savings invested in the default investment portfolio do not depend on that member's retirement, permanent or temporary disability, death, withdrawal from the fund or the reason for such withdrawal;

Performance fees are not permitted in default investment portfolios

(h) no service provider receives fees or charges in respect of the assets held in respect of the default investment portfolio that depend on the return earned in respect of those assets;

No loyalty bonuses or other complex fee structures

(i) no fees or charges deducted from or amounts credited to members' retirement savings or retirement funding contributions or otherwise paid to members by any service provider in respect of the default investment portfolio may depend on the length of time that member has been a member of the fund, the number of contributions made by the member or any similar measure;

The assets in the default investment portfolio comply with Regulation 28

(j) the assets held in respect of the default investment portfolio comply with Regulation 28;

Members are not locked into the default investment strategy

(k) members may instruct the fund to transfer their retirement savings from the default investment portfolio into any other investment portfolios offered in terms of the rules of the fund at intervals not exceeding three (3) calendar months, in respect of which transfer the Fund may deduct reasonable administration costs from the account of members concerned

The default investment portfolio is regularly reviewed

(l) fund boards review the default investment strategy on a regular basis to ensure that it continues to comply with this regulation.

38. Default preservation and portability

(1) *(a)* If members are enrolled into a retirement fund as a condition of employment, the rules of that fund must make provision for paid-up members.

(b) When members leave the service of the participating employer, such members —

(i) must be made paid-up members of the fund until the fund is instructed by the member in writing to pay out the benefits due to the member in terms of the rules, and

(ii) must be presented with a paid-up membership certificate within one (1) calendar month of leaving the service of the participating employer,

provided that the aggregate value of their retirement savings is greater than an amount which may be prescribed.

(c) Paid-up members in a defined contribution category of fund, or who are entitled to receive a defined contribution benefit component, must have their retirement savings in respect of such benefits or benefit components invested in the fund's default investment portfolio unless the fund has been instructed otherwise by the member in writing.

(d) Fees and charges in respect of the portion of retirement savings that is invested in the default investment portfolio may not differ depending on whether members are paid-up members or are still in the service of the participating employer.

(e) No charges may be levied on the retirement savings of a member as a direct consequence of that member becoming a paid-up member.

(f) The rules of that fund must make provision to accept any amount or amounts paid or transferred, or which will be paid or transferred, to the fund from another fund for the benefit of a member or members, provided that such transfers may comprise a defined contribution benefit component, and all such retirement funds must –

(i) within two (2) months of a member joining the fund, obtain, in a manner which may be prescribed, a list of all paid-up membership certificates in respect of any retirement savings in respect of that member,

(ii) request, for each paid-up membership certificate, in a manner which may be prescribed, whether members wish to allow the retirement savings held in respect of each paid-up membership certificate to remain outside the fund, and

(iii) arrange, on behalf of the member, in respect of each paid-up membership certificate where members did not indicate in terms of sub-paragraph (ii), that they wished to allow their retirement savings in respect of that paid-up membership certificate to remain outside the fund, the transfer of all such retirement savings into the fund, without levying a charge on such amounts in respect of the transfer.

(2) The rules for paid-up members must specify that—

(a) no new contributions to the fund may be permitted in respect of this class of member;

(b) paid-up members are not eligible for risk benefits;

(c) the value of defined benefit components for paid up members upon withdrawal, retirement and early retirement may not be less than the member's benefit entitlement in terms of the rules of the fund at the date they became paid-up members, increased or decreased by the change in the Consumer Price Index until the date they withdraw or retire;

(d) eligibility rules for retirement and early retirement are the same for paid-up members as for active members of the fund; and

(e) members are given access to a retirement benefits counsellor before any withdrawal benefit is paid to them or any transfer is made on their behalf to another retirement fund.

39. Default annuity strategy

(1) The rules of all retirement funds must provide for a default annuity strategy.

(2) Boards must ensure, and be able to demonstrate to the Registrar on request, that:

Default annuity policies are appropriate for the members who will be automatically enrolled into it

(a) the default annuity strategy should, as far as is reasonably ascertainable by the Board, be appropriate for retiring members of the fund, in at least the following respects:

(i) the level of income provided to those members whose retirement savings are used to provide an annuity or pension in retirement in accordance with the

default annuity strategy, considering the accumulated value of each member's retirement savings;

(ii) the degree of income security provided to those members whose retirement savings are used to provide an annuity or pension in retirement in accordance with the default annuity strategy, and to their surviving spouse(s) in the event of long life;

(iii) the investment, inflation and other risks inherent in the income received in retirement by those members or former members whose retirement savings are used to provide an annuity or pension in retirement in accordance with the default annuity strategy;

(iv) the decisions required by members as part of the on-going operation of the default annuity strategy, considering the financial expertise of the members of the fund, and their ability to afford on-going financial advice; and

(v) the level of income protection granted to beneficiaries in the event of the early death of members or ex-members whose retirement savings are used to provide an annuity or pension in retirement in accordance with the default annuity strategy;

The objective, composition, performance, of the default annuity strategy are adequately communicated to members

(b) the default annuity strategy, its high-level objective and the average incomes and changes in the incomes in respect of the default annuity strategy of fund members and ex-fund members whose retirement savings were used to provide a retirement income in terms of the default annuity strategy are communicated to fund members on a regular basis, in clear and understandable language and in a format which may be prescribed;

Default annuity strategies are good value for money

(c) the fees and charges received by fiduciaries and service providers in respect of the default annuity strategy or the assets held in respect thereof are reasonable and competitive, considering the benefits provided to members or ex-members of the fund, the size, composition and asset allocation of the fund and the default annuity strategy in particular;

All fees and charges, and their impact on members' benefits, are disclosed accurately and regularly

(d) all fees and charges, whether borne directly by the fund or paid directly or indirectly out of assets, or implicit in trading assets or in trading or holding derivative securities or policies purchased in respect of the default annuity strategy and the management of its underlying assets, as well as the impact that such fees and charges will have on members' actual and prospective benefits, are disclosed on a regular basis to members and ex-members whose retirement benefits are provided in terms of the default annuity strategy, in clear and understandable language, and in a format which may be prescribed;

Members are given access to a retirement benefits counsellor

(e) members are given access to a retirement benefits counsellor not less than three (3) months before their retirement date;

The default annuity strategy is regularly reviewed

(f) fund boards review the default annuity strategy on a regular basis to ensure that the default annuity strategy continues to comply with this regulation.

(3) Living annuities may be chosen as part of the default strategy or a customised default strategy: Provided that ─

(a) living annuities are paid out of the fund.

(b) no more than three (3) investment portfolios be offered as part of the living annuities.

(c) all such investment portfolios are consistent with regulation 37.

(d) the drawdown rate of such living annuities is

(i) for members younger than age 60, not greater than 7% *per annum*;

(ii) for members younger than age 65, but older than age 60, not greater than 8% *per annum*;

(iii) for members younger than age 70, but older than age 65, not greater than 9% *per annum*;

(iv) for members younger than age 75, but older than age 70, not greater than 10% *per annum*;

(v) for members younger than age 80, but older than age 75, not greater than 12% *per annum*;

(vi) for members younger than age 85, but older than age 80, not greater than 15% *per annum*;

(vii) and for members older than age 85, not greater than 17.5% *per annum*.

(e) fund boards must monitor the sustainability of living annuities paid to members, and —

(i) identify members who may be vulnerable to substantial risks of falls in income;

(ii) warn the members referred to in part (i) in writing;

(iii) make arrangements to convert such living annuities to life annuities, unless members request otherwise;

(f) the assets held by the fund in respect of these annuities are compliant with the provision of Regulation 28.

(4) *(a)* A pension payable by the fund in terms of the rules of the fund as long as a member or their beneficiaries are alive may be chosen as part of the default annuity strategy.

(b) If the fund does not provide a guarantee of the level of the pension income —

(i) members must be informed in clear and understandable language that the fund does not guarantee pension amounts and that pension amounts and increases or decreases may fluctuate in line with the value of the underlying assets, the longevity of fund members and any fund expenses;

(ii) a separate asset pool or pools must be maintained for the purposes of paying pensions, which pool or pools must —

(aa) be reduced by any pension payments made to pensioners, any lump sums paid to members or their dependents on the death of members, any amounts transferred on behalf of the member to an insurer, and any fund expenses reasonably attributable to pensioners as a class by the Board: Provided that such deductions are in respect of pensions deemed to form part of the liabilities of the fund backed by each pool of assets respectively;

(bb) be augmented by the fair value of fund assets of retiring members that is allocated towards providing this type of pension at their retirement, and augmented or reduced, as appropriate, by any investment returns, whether dividends, income or realised or unrealised capital gains or losses on the assets held in each pool;

(cc) comply with Regulation 28;

(dd) have an asset mix determined by the Board on the advice of the valuator which pays due regard to —

(A) the nature and term of the class of pension liabilities of the fund backed by the pool or pools;

(B) the pension increase policy of the Fund as explained to members in the default annuity strategy statement;

(C) the risk and expected return of different underlying assets and asset classes; and

(D) the consequent risks and likely magnitudes of falls in pension income, and the ability of pensioners and their dependents to bear these.

(ee) have a pension funding ratio which is regularly communicated to members, which is calculated using best estimate assumptions, which assumptions—

(A) must be used for pricing the pensions paid to retiring members when these are notionally purchased, and

(B) must be regularly updated to reflect the valuator's best estimate of economic and demographic conditions.

(iii) fund rules must provide that all actuarial surplus or actuarial deficit arising from deviations of the best estimate value of the pensioner liabilities backed by each pool of pensioner assets from the pricing and valuation assumptions must be distributed to members over a period of no more than two years in the form of increases or decreases to pensions in payment,

(iv) pension increases or decreases may not differ by member or class of member within each pool, except for CPI increases in terms of section 14B(4)(c) of the Act,

(v) the pension increase policy for existing pensioners may only be changed if a separate pool of assets and liabilities is maintained for members who retire after the pension increase policy is changed; and

(vi) noting that this method of calculating the value of the pool or pools of assets backing the pension liabilities of the fund, the pension liabilities of the fund, the pension funding ratio and the consequent level of pension increases or decreases are deemed to be consistent with the principles underling sections 14B(4)(a) (b) and (c) of the Act, in terms of section 14B(4)(d) of the Act.

(5) Annuities other than living annuities provided by a long-term insurer may be chosen as part of the default annuity strategy or a customised default annuity strategy: Provided that –

(a) annuity increases are linked to a formula which is verifiable from publically available information produced independently of the insurance company paying the annuity or any related company;

(b) direct sales commission is not paid out of member accounts; and

(c) trustees are satisfied with the long-term financial strength of the insurer."

Short title and commencement

4. These Regulations are called the Amendments to the Pension Fund Regulations, 2015, and shall come into operation on a date to be determined by the Minister in the *Government Gazette*.

national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM ON REGULATIONS 37, 38 AND 39 ISSUED IN TERMS OF SECTION 36(1)(C) OF THE PENSION FUNDS ACT, 24 OF 1956

1. BACKGROUND

The Minister of Finance announced proposals in his 2012, 2013 and 2014 Budget Speeches to reform the retirement industry. In those Budgets, and explanatory documents issued with them, the Minister has expressed his concern that although current law gives boards of retirement funds substantial duties to protect the interests of members, in many instances, fund boards appear to have given insufficient emphasis to simple initiatives which would substantially improve the retirement outcomes of members of their funds. In order to remedy this lapse, the Minister has felt compelled to clarify the duties of fund boards in order to deal with the following observed shortcomings:

- In many cases, members have been automatically enrolled into excessively complex, unreasonably expensive or otherwise inappropriate default investment portfolios;
- Few, if any, fund boards have implemented initiatives to facilitate preservation and portability of retirement savings between funds. The *de facto* default for most funds appears to be that retirement balances are paid automatically, in full and in cash when members leave the employment of the participating employer;
- Most defined contribution (DC) funds appear to ignore their responsibilities to ensure that fund members are able to convert their accumulated fund credits into an income when they retire in the most efficient, transparent and cost-effective way.

The duties of trustees will be clarified in these respects by issuing new regulations under section 36(1)(c) of the Pension Funds Act, No 24 of 1956, which empowers the Minister of Finance to make regulations "on all matters which he considers necessary or expedient to prescribe in order that the purpose of the Act may be achieved." The Supreme Court of Appeal (2003 (6) SA 38 (SCA) at paragraph 14) has held that "[t]he general public interest requires that pension funds be operated fairly, properly and successfully and that the pension fund industry be regulated to achieve these objects. That is the whole purpose of the Act."

The regulations released are draft regulations; a public consultation period on the contents of the draft will be held until 30th September 2015, after which a final set of regulations will be released.

These regulations form the first part of further reforms as explained in the policy document titled "*2014 Budget update on Retirement Reform*", released on 14 March 2014.

2. DEFINITIONS

The regulation introduces the following new definitions, not currently included in any law governing retirement funds. These are: "best estimate assumption", "default annuity strategy", "default investment portfolio", "investment portfolio", "paid-up member", "paid-up membership certificate", "pension funding ratio", "retirement benefits counsellor", "retirement funding contributions", and "retirement savings".

3. REGULATION 37: DEFAULT INVESTMENT PORTFOLIO

Current regulations of the Pension Funds Act do not prescribe any specific requirements or conditions for the provision or design of default investment portfolios in retirement funds. This issue is of crucial importance because:

- international evidence is very strong that individuals respond strongly to default options, and South Africa is unlikely to be an exception;
- individuals are, in many cases, automatically enrolled into retirement funds as a condition of employment and may be invested in portfolios with underlying investments which are inappropriate, or with charges that are higher than necessary, or with designs that are complex or which impose high exit penalties;
- for the retirement system to be trusted and effective, members must have a high degree of confidence that default investment options are suitable for them, and that they have been chosen from a broad and representative range of alternatives, through a process which is sufficiently robust to ensure that members' best interests are upheld.

Reflecting these factors, most international jurisdictions, including the US and the UK, provide guidance to retirement funds on the investment portfolios which will be considered suitable for the purposes of defaults. This regulation gives effect to default investment portfolios in South Africa.

The regulation requires all retirement funds registered under the Act, including retirement annuity funds, beneficiary funds, industry funds, umbrella funds, preservation funds and employer-based funds to provide for a default investment portfolio.

The regulation requires fund boards to ensure that the default investment portfolio is suitable for the members who will be automatically enrolled into it, including its high-level objective, underlying asset allocation, charging structure, and the risks and returns to which it exposes members whose retirement savings are or will be invested in the default investment portfolio.

Boards must give effect to this clause by ensuring that the default investment portfolio takes account of the likely characteristics and needs of the members whose retirement savings will be

invested in the default investment portfolio. This includes, firstly, members' appropriate preferences for balancing risk and return, their likely future term of membership in the retirement system (this is intended to ensure that fund boards do not focus excessively on funding a cash lump sum upon exit from the fund, but take a longer-term view, consistent with the purpose of the retirement system, which is to support the consumption of contributors in retirement). Secondly, their financial sophistication, which refers to the member's likely ability to understand complex benefits, charges and policy conditions. Lastly, their ability to access individual financial advice (a looser standard might quite legitimately apply to fund members who can access financial advice).

The regulation requires fund boards to ensure that the overall objective, composition, and performance, of the default investment portfolio are adequately communicated to members in clear and understandable language, and in a format which may be prescribed.

The regulation requires that fund boards ensure that the default investment portfolio represents good value for the members who will be enrolled in it, by ensuring that the fees and charges received by fiduciaries and service providers in respect of the default investment portfolio or the assets held in respect thereof are reasonable and competitive. In the case of employer-based funds, the standard to be applied is not the retail market standard that would apply to members who purchased policies or joined funds on an individual basis, but rather the fees and charges that would apply to the fund in the wholesale market, considering market conditions, the size, asset allocation and other characteristics of the fund as a whole and the default investment portfolio in particular.

Fund boards must ensure that all fees and charges, and their impact on members' benefits, are disclosed accurately and regularly. This includes fees and charges, borne directly by the fund or paid directly or indirectly out of assets, as well as fees and charges that are implicit in trading assets or in trading or holding derivative securities or policies purchased in respect of the default investment portfolio and the management of the underlying assets. This clause would require fund boards that purchase derivative policies or insurance policies to report the lost returns or lost income that are implicit in such purchases as well as the explicit costs of all transactions.

Fund boards are required to report to members the impact that such fees and charges will have on members' actual and prospective benefits, in clear and understandable language, and in a format which may be prescribed.

Fund boards must consider the passive or enhanced passive investment of listed assets as all or part of the default investment portfolio. This is intended to increase the visibility of passive investment of listed assets in South Africa, and to ensure that fund boards are fully informed about the relative benefits of active, passive and enhanced passive investment styles when they decide how to allocate their assets.

One of the primary requirements for any default strategy is that members are able to transfer their retirement savings out of such funds for any reason without incurring unreasonable penalty charges. In order to encourage a competitive market at fund level, the same should be true for funds as a whole. Further, default investment policies are for investment only. Incorporating insurance-type elements into default investment funds – for instance by paying higher investment

values to some categories of exiting members than others – makes investments extremely complex from the point of view of fund boards and members, may result in unfair discrimination against members who, after some time, wish to leave the default policy, and who never gave their direct consent – or received financial advice – to join the fund in the first place. Boards who wish to provide insurance benefits for their members can do so separately, provided that such insurance is consistent with the Act. Fund boards must therefore ensure that the benefits paid or amounts accruing to any member in respect of the portion of their retirement savings invested in the default investment portfolio do not depend on that member's retirement, permanent or temporary disability, death, withdrawal from the fund or the reason for such withdrawal, or the transfer of their retirement savings into other investment portfolios offered by the fund, other than differences caused by reasonable charges intended to cover the costs of administration.

The regulations do not prohibit Boards from choosing to structure default portfolios using non-market-linked insurance policies, such as smoothed bonus policies. However, the requirement that members exiting such policies - or indeed, funds themselves - be paid a policy value that is independent of the reason for their exit does implicitly limit the amount of smoothing between different generations possible in such insurance policies. This may have a significant effect on some funds and their members, and consultation is particularly invited on this point.

In order to assist in the development of a competitive market for fund management, fund boards are obliged to ensure that performance fees are not received by any service provider in respect of any assets held by or in respect of these portfolios. Similarly, loyalty bonuses or any similar arrangement are not permitted as part of the default investment portfolio. The assets held in respect of the default investment portfolio must comply with Regulation 28. Members must be able to transfer their retirement savings from the default investment portfolio into any other investment portfolios offered in terms of the rules of the fund at intervals not exceeding three (3) calendar months.

Fund boards are permitted to customise default investment portfolios to the circumstances of individual members, provided that such customisation depends only on any or all of the age or likely retirement date of each member, the aggregate value of the retirement savings of each member and the pensionable salary of each member. This is intended to allow fund boards to provide different defaults to those who are nearer retirement, or who are less well off, or who earn less.

Fund boards must review the default investment strategy on a regular basis to ensure that it continues to comply with the regulation. This review should include an assessment of the past performance of the default strategy, the proportion of members who elected to remain in the default strategy, and the costs and charges of the default strategy relative to costs and charges of other available options in the market.

4. REGULATION 38: DEFAULT PRESERVATION AND PORTABILITY

Current regulations of the Act do not make provision for the automatic preservation or portability of retirement savings when members change jobs. In many cases, this means that it is the practical default for many funds that benefits are paid out in cash when members leave the

service of sponsoring employers. Even when workers are members of their employer or union fund, those workers who wish to preserve their retirement savings are in many cases forced to remain members of other retirement funds, or use the retail market, increasing complexity and cost.

The intention of introducing default preservation and portability regulation is to facilitate the consolidation by workers of different retirement accounts, and to ease the preservation of such accounts until retirement.

To achieve this, rules governing retirement funds should allow paid-up members to remain within the fund. Further, funds should enable portability of benefits by accepting transfers of existing members' balances from other retirement funds, and the process of portability between funds should be automated when workers change jobs.

The proposed regulation imposes no restrictions on the ability of members to withdraw their money from the retirement system when they change jobs, guaranteeing vested rights.

Portability when members join a new employer

All funds associated with an employer must accept transfers by existing members of their balances in other retirement funds, at the request of members, provided that such transfers comprise defined contribution benefit components.

To facilitate such transfers, the regulation proposes that a list of paid-up membership certificates be procured in respect of new members. Initially, this list may be procured from members, but the regulation also makes provision for the list to be procured from a centralised database of paid-up membership certificates. Members must indicate which funds they wish NOT to have transferred into their new fund, and funds must transfer all other funds into the fund. No charge may be levied on these amounts by the receiving fund in respect of the transfer. The intention is to ensure that members need to do as little as possible to ensure that their retirement savings follow them from job to job, and that these remain in the retirement system rather than being paid out in cash every time members change jobs.

Note that not all types of transfers may be possible for tax reasons, and this regulation is not intended to enable transfers that would otherwise be prohibited. For instance, a member may not transfer from a retirement annuity fund into an occupational fund, and nothing in this regulation is intended to be interpreted otherwise. Since all funds will in future be required to have pension and provident fund sections, all combinations of transfers between pension and provident funds should be possible. If the provisions of the Income Tax Act giving rise to this are not implemented as planned, this draft regulation will be amended to reflect this, to ensure that provident funds are not required to accept transfers from pension funds and *vice versa*.

Preservation when members leave the service of an employer

The regulation requires retirement funds to make in-fund preservation the default for members who leave the service of their employers before retirement age. The rules of any retirement fund into which members are automatically enrolled as a condition of employment must therefore make provision for paid-up members. Preservation funds, retirement annuity funds and beneficiary funds are therefore excluded, but all employer-sponsored retirement funds, union funds and umbrella funds are included.

In these funds, when members change jobs, their retirement savings must be preserved in the fund associated with the employer whose service they are leaving, unless members request access in writing to their funds, in which case the funds will be paid out.

Funds must present members with a paid-up membership certificate, which may be held in digital form in a centralised database as well as in paper form. This certificate is intended to ease the process of portability, ensuring that funds follow members from job to job.

Further, the retirement savings of paid-up members must be placed into the fund's default investment portfolio, unless members request otherwise. To prevent charges from being shifted onto this group of members, recurring charges may not differ between active and paid-up members, and initial charges may not be levied when members become paid-up. Funds must therefore recover charges in respect of paid-up members by levying all fund members. Note that while the administrative burden in respect of tracking and communicating with paid-up members may be higher than for active members in many cases, paid-up members do not make new contributions into the fund, lowering the cost of administering their benefits. The net effect – that is, whether active members as a group will subsidise paid-up members, or the reverse – is therefore unclear. In other countries, notably the UK and Australia, provisions similar to this have been introduced in response to the actual or perceived exploitation of paid-up members, as a class.

Benefit components which are not defined contribution may be preserved either as their defined benefit or hybrid entitlements, or as the transfer value equivalent of these benefits in a defined contribution category or benefit component of the fund, at the discretion of the fund.

Funds may contract with external service providers in respect of the administration of the benefits due to paid-up members, especially those funds that may not have the systems or expertise to deal with large numbers of individuals not associated with an employer participating in the fund. The regulation enables the establishment of an information or other exchange that allows funds, their administrators and others to share information on these members and automatically consolidate member accounts when members change jobs.

Rules for paid-up members must specify that no new contributions are to be permitted for that class of members. This is intended to prevent funds from having to accept contributions from

members who may no longer work for employers associated with the fund. Further, funds are not required to provide risk benefits to paid-up members.

Withdrawal and retirement benefits for paid-up members that are preserved in a defined contribution fund category or fund benefit component are required to be no less than the member's share of the fund on the date they became paid-up members, increased or decreased to the date they exit the fund by their share of the fund return, less any expenses deemed appropriate by the board.

Withdrawal and retirement benefits for paid-up members that are preserved in a fund category or fund benefit component that is not defined contribution are required to be no less than the member's benefit entitlement on the date they became paid-up members, increased to the date they exit the fund by the change in the Consumer Price Index. However, as discussed, funds may elect to enable preservation of these benefits through a defined contribution benefit component by first calculating the transfer value equivalent of the member's benefit entitlement and preserving that in a DC fund section.

Finally, eligibility rules for retirement and early retirement are required to be the same for paid-up members of the fund as they are for active members of the fund.

5. REGULATION 39: DEFAULT ANNUITY POLICY

Currently workers benefit from a strong support structure provided by the retirement system while they are employed, which is effectively withdrawn for the vast majority of these workers after they retire. At retirement the workers are then left to the retail market, where they must bear the risks of retirement on their own, including the risks of poor financial advice, poor decisions, and high charges.

Though the Act allows retirement funds to pay pensions from within the fund, this is an unpopular choice as many boards consider that the Act requires funds to guarantee the level of pensions, impossible unless there is a sponsor willing to take the risk. In fact, there appears to be no prohibition on reducing pensions in payment, provided that not doing so would leave the fund in a financially unsound position. This means that there is currently no prohibition on funds offering in-fund annuities where retired members alone accept fluctuations in their retirement income to maintain the fund's financial soundness. This regulation clarifies the Act in this regard, and lays out the approximate method for determining pension increases which must be used for default annuities, which method is acceptable in terms of Section 14B(4)(d) of the Act.

In the absence of such clarity, most retirement funds have required members to purchase annuities from the retail market from registered life insurance companies. Two types of products are offered as annuities: a life annuity and a living annuity.

Living annuities, currently chosen by over 80 per cent of retirees, allow flexibility about how to invest assets, and how much income to take. They also allow retirees to bequeath any unused funds to their heirs when they die. However, these products are complex, require a great deal of

financial advice on an on-going basis, and expose individuals to substantial risk, including investment risk and the risk of outliving their assets. These products are also subject to complex and layered charges which appear to be high. Many living annuities also offer a surprisingly large number of investment choices, at a cost.

Fewer retirees appear to purchase life annuities, which guarantee an income as long as the retiree or nominated dependents are alive. Though the prices of these annuities may appear to be in line with international benchmarks for the average individual purchaser, they do appear to be expensive for those who wish to purchase an income that increases with inflation, or for those who have shorter life expectancy, such as the poor or those in ill health.

In order to increase the competitiveness of the market for retirement income products, to provide a greater degree of assistance to members of retirement funds who retire, and to require funds to use their considerable purchasing power and skill to provide their members with cost-effective annuitisation options, Regulation 39 requires all funds to adopt a default annuity strategy, and lays out the requirements that fund boards implementing such a strategy must comply with**.**

Members will not be compelled to follow the default annuity strategy, and will be able to opt out of the strategy into products they themselves choose, if they wish to.

The default annuity strategy will specify how the accumulated fund shares/portion of retiring members will be used to provide an income to them in retirement, unless members request otherwise. Funds must abide by both principles and rules when setting the default annuity strategy.

Fund boards must ensure, and be able to demonstrate to the Registrar on request, that the default annuity strategy is suitable for the members whose retirement savings will be used to provide an income in retirement in terms of the strategy. To comply with the regulation, fund boards will need to consider the level of income, the degree of income security provided to members and to their surviving spouse(s) in the event of long life, the investment, inflation and other risks inherent in the income received in retirement by those members or spouses of members, the decisions required by members as part of the on-going operation of the default annuity strategy, considering the financial expertise of the members of the fund, and their ability to afford on-going financial advice as well as the level of income protection granted to beneficiaries in the event of the early death of members or ex-members whose retirement savings are used to provide an annuity or pension in retirement in accordance with the default annuity strategy.

Fund boards will need to ensure that the default annuity strategy, its high-level objective and the average incomes and changes in the incomes of fund members and ex-fund members whose retirement savings were used to provide a retirement income in terms of the default annuity strategy are communicated to fund members on a regular basis, in clear and understandable language and in a format which may be prescribed.

Fund boards will need to ensure that the fees and charges received by fiduciaries and service providers in respect of the default annuity strategy or the assets held in respect thereof are

reasonable and competitive, considering the benefits provided to members or ex-members of the fund, the size, composition and asset allocation of the fund and the assets underlying the default annuity strategy in particular. As in the case of the default investment portfolio, the standard to be applied is not the retail market standard that would apply to members who purchased annuities on an individual basis, but rather the fees and charges that would apply to the fund in the wholesale market, considering market conditions, the size, asset allocation and other characteristics of the fund as a whole and the default annuity strategy in particular.

Fund boards will need to ensure that all fees and charges, whether borne directly by the fund or paid directly or indirectly out of assets, or implicit in trading assets or in trading or holding derivative securities or policies purchased in respect of the default annuity strategy and the management of its underlying assets, as well as the impact that such fees and charges will have on members' actual and prospective benefits, are disclosed on a regular basis.

Fund boards will need to ensure that members are given access to a retirement benefits counsellor before they retire. The retirement benefits counsellor is required to furnish the prospective retiree with information about the default annuity policy, and to otherwise assist individuals whose retirement savings are used to provide an income in retirement in line with the default annuity strategy.

Fund boards will need to review the default annuity strategy on a regular basis to ensure that the default annuity strategy continues to comply with this regulation. Boards may consider, *inter alia*, the proportion of retiring fund members electing to use the default annuity strategy, the performance of any service providers, fees and charges of the service providers and the broader market, the mortality or other experience of retired members when reviewing the strategy.

Living annuities

Fund boards may choose living annuities as all or part of the default annuity strategy, provided that certain conditions are met. These include restrictions on investment choice and annual drawdown rates, which must be less than an age-dependent set of maximum values. Although the regulation requires that default living annuities are paid to members out of the fund, fund boards may consider reinsuring their living annuities with third-party providers by purchasing bulk insurance policies in the name of the fund. These providers could then, as part of the policy, take over administration of the living annuities on behalf of the fund.

Fund boards must monitor the sustainability of incomes drawn by retirees with default living annuities, warn such members, in writing, if their incomes are deemed to be unsustainable, and make arrangements to convert such living annuities to life annuities, unless members or their surviving spouses request otherwise.

Fund boards must ensure that the assets held by the fund or underlying any insurance policy purchased by the fund in respect of such living annuities are compliant with the provisions of Regulation 28.

In-fund pensions

Fund boards may select an in-fund pension as part of the default annuity strategy. These may only be practicable if the fund has a sponsor that is willing to provide a guarantee or if the fund is sufficiently large that mortality risk can be pooled across retired members without resulting in excessive fluctuations in pension amounts from year to year.

Fund boards may select in-fund pensions that pool the experience of retired members, but which are not guaranteed by the fund or the fund's sponsor. Instead, retired fund members maintain the financial soundness of the fund by accepting fluctuations in their retirement incomes. If this option is selected, the regulation lays out various conditions that the default annuity strategy must comply with.

First, members must be informed in clear and understandable language that the fund does not guarantee pension amounts and that pension amounts and increases or decreases may fluctuate in line with the value of the underlying assets, the longevity of fund members and any fund expenses.

Further, a separate asset pool must be maintained for the purposes of paying pensions and determining pension increases, which pool must be reduced by any pension payments made to pensioners and any fund expenses reasonably attributable to pensioners as a class by the board, be increased by the share of fund assets of retiring members that is notionally used to purchase this type of pension, and any investment returns, whether dividends, income or realised or unrealised gains or losses on the assets held in the pool. The value of the asset pool at a particular date is thus to be calculated using a retrospective actuarial method.

The assets in the pool must comply with Regulation 28, and the pool's asset allocation must be determined by the board on the advice of the valuator, and must pay due regard to the nature and term of the pension liabilities of the fund backed by the pool of assets, the pension increase policy of the fund as explained to members, the risk and expected return of different underlying assets and asset classes, and the consequent risks and likely magnitudes of falls in pension income, and the ability of pensioners and their dependents to bear these.

Further, the liabilities of the fund in respect of the assets held in the pension asset pool must be determined using a prospective actuarial method, taking account only of the pensions promised to retired members of the fund and their nominated beneficiaries who are alive at the date of calculation. Best estimate assumptions and the pension increase policy of the fund must be used in such a calculation.

The pension funding ratio of the pension pool must be regularly communicated to members. The initial pension income amounts of retiring members who join the pool must be calculated using the same set of best estimate assumptions that are used to calculate the pension funding ratio, and these assumptions must be regularly updated to reflect the valuator's best estimate of economic and demographic conditions.

Further, in the case of default in-fund annuities without a guarantee, all actuarial surplus or actuarial deficit arising from deviations of the experience of the pensioner portion of the fund from

the pricing and valuation assumptions must be distributed to members over a period of no more than two years in the form of increases or decreases to pensions in payment. Pension increases or decreases may not differ by member or class of member, except for CPI increases in terms of section 14B(4)(c) of the Act.

For default in-fund annuities without a guarantee, fund boards may *not* adjust the pension increase policy of the fund in response to changes in the value of the assets in the pensioner asset pool without creating a separate class of pension liabilities for new retirees. Instead, all changes in asset values must be reflected in changes in pension amounts, at most over a period of two years. The intention of this provision is to ensure that fund members are aware of the underlying risks that are being run by the fund, and that the board selects an asset mix for the pool that pays due regard to these risks. It also ensures that inter-generational cross-subsidies cannot result from changes in the pension increase assumption used at the point that members convert their accumulated retirement savings into an income in line with the default annuity strategy.

Out-of-fund annuities

Annuities, other than living annuities, provided by a long-term insurer may be chosen as part of the default strategy or a customised default strategy.

The regulation leaves fund boards broad discretion in determining the types of annuity policies that they allow, but does specify some conditions that such annuities must comply with. The first is that annuity increases must linked to a formula which is verifiable from publically available information not provided by the insurance company paying the annuity, or a related company. Under this provision, annuities whose payments increase each year by 50% of the change in the CPI, or by the sum of 50% of the change in the FTSE ALSI Total Return Index, and 50% of the change in the ALBI Total Return Index, would be permitted. Policies where increases were at the discretion of the company selling the annuities, or determined by a formula based on the return of a notional portfolio whose underlying investments were determined by the company issuing the annuity policies, for example, would not be permitted. The intention is not to allow fund boards to purchase policies that embody structural conflicts of interest between annuitants and shareholders as part of the default. In the past, there have been cases where such conflicts have resulted in shareholders acting against the interests of annuitants in ways which were not transparent. Other conditions are that sales commission may not be paid out of member accounts, and that fund boards must satisfy themselves that the financial strength of the insurance company offering the pensions is sufficient to ensure that annuitants have a sufficiently low probability of not receiving their promised benefits.

6. CONSULTATION

Submissions are invited on the form and content of this regulation. Please send all comments before the 30 September 2015, to Ms Alvinah Thela, Director: Retirement Funds, National Treasury, Private Bag X115, Pretoria, 0001. Submissions may also be submitted by fax to (012) 315 5206; or by email to retirement.reform@treasury.gov.za.