REGULATION 28 PUBLIC FORUMS

FINAL REGULATION 28 AS GAZETTED

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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

Jan: Comments on 2nd draft due

Feb: Budget Speech, Release of Regulation 28

Apr: Notices and guidance notes to be finalised. Grandfathering of RA's only up to 1 April

Jul: New Regulation 28 effective 1 July

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 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.

Oct 2011 Proposal: Mainly rules-based but overlay of principles.

Comments: A fund cannot delegate its responsibility, remove the word “spirit”, allow exemption for well-formulated investment policy, make provision for commitments to invest, make provision for index tracking strategy, clarify intention of word “reasonable” wrt due diligence.

Final Regulation: Principles regarding trustee education, advisor compliance, BEE, asset-liability matching, comprehensive due diligence, changing risk profile of fund assets, and environmental, social, and governance factors, wording clarified.

LOOK-THROUGH

Current Reg 28: No look-through principle.

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

Comments: Clarify de minimis rule, especially as relates to indirect exposure to foreign assets, increase de minimis limit from 5% to 10%, extend exemption possibilities to ETFs and ETNs, include credit risk of insurers, do not look through CISPs, prevent HF from becoming new wrappers.

Final Regulation: Look-through principle provides that a fund cannot use an asset structure to circumvent the limits, if an asset comprises less than 5 percent of the aggregate fair value of the assets of the fund, then the fund need only disclose the categories of underlying assets making up the investment, and not each underlying asset.

INDIVIDUAL MEMBER CHOICE

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

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

Comments: Clarify, fund should act when contact initiated by member, have time limit on grandfathering

Final Regulation: Mindful that individual member protection is as important as ensuring the sustainability of the fund as a whole, retirement products should be compliant not only at fund level but also at member level. However, an exception is made for certain existing individual contractual arrangements, to include retirement annuity, pension preservation and provident preservation funds, that are in place before 1 April 2011 – these products will be allowed to remain outside of Regulation 28 limits until material changes to such arrangement.

EXEMPTIONS FOR LONG TERM INSURANCE POLICIES

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

Oct proposal: 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.

Comments: Give guidelines about unreasonable discretion over long term insurance policy benefits, allow time period for necessary approvals

Final Regulation: Guidance note to be issued

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).

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

Comments: Consider aggregate limit for exposure to equity of a company, recognise that risk depends on rank in cases of distress, apply overall limit to uncollateralised exposure only, clarify involuntary market movements, consider commitment funds.

Final Regulation: No overall per issuer limit. The definitions of the various assets serve as a funnel. The Regulation does not prescribe what assets a fund should be invested in as this would counter the principles guiding a fund to act in its best interests.

“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.

Oct proposal:

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

***October’s Cash category excludes money markets**

Comments: Combine cash and debt, increase per-issuer limit for collateralised deposits

“CASH” (cont.)

Final Regulation:

1.	CASH		100%
1.1	Notes and coins; any balance or deposit in an account held with a South African bank; A money market instrument issued by a South African bank including an Islamic liquidity management financial instrument; Any positive net balance in a margin account with an exchange; and Any positive net balance in a settlement account with an exchange, operated for the buying and selling of assets.	25%	100%
1.2	Any balance or deposit held with a foreign bank; A money market instrument issued by a foreign bank including an Islamic liquidity management financial instrument;	5%	

DEBT

Summary

Asset class	Sub-categories by issuer type	Current	Oct Proposal	Final
Cash				
	SA banks	20 / 100	25 / 100	25 / 100
	Foreign banks	15 / 15	5 / …[1]	5 / …[1]
Debt				
	SA government	100 / 100	100 / 100	100 / 100
	SA banks		10-25 / 75	5-25 / 75
	SA parastatals	20 / 100	5 / 25	5-10 / 50
	Other issuers (listed on main board)			5-10 / 50
	Foreign governments	15 / 15	10 / …[1]	10 / …[1]
	Other issuers (unlisted)	5 / 25	5 / 25 [2]	5 / 25 [2]

1 Subject to South African Reserve Bank foreign exchange control regulation
2 Counts towards 35% maximum on unlisted assets

DEBT (cont.)

Comments on Oct Proposal: Clarify where NCD's fit, delineation between listed and unlisted debt, sov debt, limit foreign exposure only by exchange control policy, clarify why bank exposure limited to 75% when both CISCA and current Reg 28 allow 100%, consider lower limit, credit ratings for bank debt, consider moral hazard of permitting 75% in bank debt only. Increase limit for SOE debt, allow for debt issued by any public entity, do not limit other debt instruments to 25%, clarify discrepancy between listed debt (25%) and listed equity (75%), recognise quality of debt issued by listed entity, confirm whether 25% in total allowed in unlisted and unrated debt instruments.

Additional Considerations: The bank structural funding mismatch between short-term borrowing and long-term lending can be eased by allowing higher limits for long-term bank debt, possibly treating banks differently from other corporates on the grounds that they are prudentially regulated, as long as the debt is issued off the bank's balance sheet.

EQUITIES

Current Reg 28: Distinguishes listed/unlisted equity, 2 per issuer limit categories according to market cap. Unlisted equities 5% limit. PE has 7.5% limit (5% unlisted shares + 2.5% in "Other Assets" category).

Oct Proposal: The per-issuer limits for equities are divided into three market cap 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.

Comments: Confirm treatment of DRs, ETFs, ETNs, dual listings, consider reducing to 10%, 5%, 2.5%, fourth band at 1%, aggregation limits, increase unlisted equity limit

EQUITIES (cont.)

Final Regulation:

	(a)	Preference and ordinary shares in companies, excluding shares in property companies, listed on an exchange: -			75%
		(i)	issuer market capitalisation of R20 billion or more, or an amount or conditions as prescribed	15%	
		(ii)	issuer market capitalisation of between R2 billion and R20 billion, or an amount or conditions as prescribed	10%	
		(iii)	issuer 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		2.5%	10%

Equities as an asset class narrowly defined to include only preference and ordinary shares in companies. Overall limit of 75 percent is retained, subject also to per-issuer limits divided into 3 categories – small (5 percent), medium (10 percent) and large (15 percent).

Limits to be checked for inflationary pressures over time and FSB is enabled to update accordingly. The limit for unlisted equities, held directly or through a private equity vehicle, is increased to 15 percent, subject to strict investment diversification and valuation req's.

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.

Oct 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.

Comments: Consider lowering limits, align mkt. cap bands with that for equities, clarify whether MBS fall under property.

Additional Considerations: Different risk mgmt. implications for listed vs. unlisted, direct vs. indirect property investments, Shariah–compliant funds

IMMOVABLE PROPERTY (cont.)

Final Regulation

	(a)		Preference shares, ordinary shares and linked units comprising shares linked to debentures in property companies, or units in a Collective Investment Scheme in Property, listed on an exchange:-		25%
		(i)	issuer market capitalisation of R10 billion or more, or an amount or conditions as prescribed	15%	
		(ii)	issuer market capitalisation of between R3 billion and R10 billion, or an amount or conditions as prescribed	10%	
		(iii)	issuer market capitalisation of less than R3 billion, or an amount or conditions as prescribed	5%	
	(b)		Immovable property, preference and ordinary shares in property companies, and linked units comprising shares linked to debentures in property companies, not listed on an exchange	5%	15%

COMMODITIES

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

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

Comments: Clarify treatment of long-only commodity funds, lower limit or introduce per commodity limits

Additional Considerations: Volatility, Non income-producing.

Final Regulation:

	(a)	Kruger Rands and other commodities listed on an exchange, including exchange traded commodities: -			10%
		(i)	gold	10%	
		(ii)	each other commodity	5%	

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.

Oct Proposal: More flexibility (15%). PE and HF explicitly defined and included. Contained and monitored investment into alternative and unregulated assets, supported by strict asset & investment diversification limits and appropriate valuation procedures (FSB to guide).

Comments: Require look-through for HFs, clarify treatment of linked life policy linked to fund consisting of blend of long only and HFs, overall limit on unlisted / private equity to severe (at 10%).

Additional Considerations: Closing loopholes, value to pension fund, investor protection, developmental role, SRI, transitional arrangements.

OTHER ASSETS

Final Regulation:

	(a)	Hedge funds			10%
		(i)	Funds of hedge funds	5% per fund of hedge funds	
		(ii)	Hedge funds	2.5% per hedge fund	
	(b)	Private equity funds			10%
		(i)	Funds of private equity funds	5% per fund of private equity funds	
		(ii)	Private equity funds	2.5% per private equity fund	
	(c)	Other assets not referred to in this schedule and excluding a hedge fund or private equity fund			2.5%

FOREIGN ASSETS

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

Oct Proposal: 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."

Comments: Enhance SARB limit with FSB limit, clarify whether dual listings will have to be re-classified as foreign.

Additional Considerations: Currency and country risks, operational risk, micro-prudential approach, capital flows, SARB vs. FSB role, development

FOREIGN ASSETS (cont.)

Final Regulation:

1. Regulation 28 references SARB definition.
2. “recognised foreign exchange” incorporated into “exchange”.
3. “listed” = listed on full member of WFE or exchange that satisfies due diligence performed by the manager in terms of guidelines set by FSB
4. Higher limits for unlisted debt and (directly held) unlisted equity (of 15 and 10 percent, respectively)

OTHER MATTERS

DERIVATIVE INSTRUMENTS

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

Oct Proposal: Notional exposure feeds through to asset classes. Not for gearing or leverage. Index derivatives exposure must be "covered."

Comments: More gradual approach, clarify treatment of index derivatives to hedge large portfolios, clarify how to hedge an offshore position

FSB notice to be released

SECURITIES LENDING TRANSACTIONS

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

Oct Proposal: Explicitly allowed subject to FSB conditions

Comments: Align with CISCA and LTIA

Considerations: To promote income generation and capital market liquidity

<u>**FSB notice to be released**</u>

QUERIES SO FAR

1. Derivatives – like for like, netting, complex derivatives
2. Private Equity – manager/advisor technical issue
3. Implementation – General exemptions
4. Application of Look-Through
    - ETFs
    - Securitisations
    - CLNs

QUESTIONS OR COMMENTS