NATIONAL
TREASURY

REGULATION 28: RESPONSE DOCUMENT TO PUBLIC COMMENTS RECEIVED

2 DECEMBER 2010

The first draft of Regulation 28 (in terms of section 36 of the Pensions Fund Act, 1956) was published as part of the 2010 Budget in February this year. Thirty-one comments were received thereafter. This document presents National Treasury's response to the comments, and also elaborates on new issues incorporated into the second draft.

1. EXPLAINING REGULATION 28

Pension funds play an important role in today's global and national economies. Given South Africa's low savings rate, pensions are even more important here. Pension funds, smartly invested, provide a mechanism for unlocking savings, stimulating economic growth and ensuring that pensioners are provided for in retirement. By regulating them appropriately, governments can protect the elderly against poverty, facilitate investment and reduce systemic risk.

South African households have approximately R4.5 trillion invested in financial assets.[1] Of this, roughly a third is invested in pension funds.

The Pension Funds Act, No. 24 of 1956 (the PFA) governs how private pension funds are run, and provides specifically for how the industry's assets, held on behalf of a fund's members, should be invested. To this end the Act empowers the Minister of Finance to define classes of assets into which a pension fund can invest, and set maximum investment limits across these classes. These requirements are intended to optimise a pension funds investment return for the risk that it may take. The chief way in which Regulation 28 does this is by ensuring that a pension fund's assets are diversified, but it also

[1] South African Reserve Bank Quarterly Bulletin No. 257 of September 2010.

protects pension fund members from being overly invested in high-risk assets that could lose the member his or her entire life savings.

The National Treasury recognises the crucial link between retirement savings and economic growth as influenced by the level of savings and its allocation towards productive assets. But government's foremost priority for pension fund investment regulation must be member protection. It is the state's responsibility to help ensure that pensioners have saved enough money during their working life to enjoy a reasonable quality of life on retirement. This also reduces the fiscal pressure on the state to provide for these citizens through social security programmes. To achieve that goal it is crucial that members' retirement savings are not at the mercy of asset managers who may be incentivised to take more risk than what a prudent person would allow, resulting in an undiversified or overly risky portfolio. The tax incentive offered by government on retirement products also prompts a more paternalistic approach to fund and member choice, which means that retirement savings can be considered as a social good and base safety net that should always be the safest part of a person's aggregate savings. Members who want to save beyond this base level can opt to invest in other less restricted savings products, which may in any event be subject to regulation like a collective investment scheme (CIS), or not like a property investment company or private equity fund. Different tax treatment may apply across these alternatives, but any investments made by individuals will be after they have paid income tax rather than before, as is the case for most retirement products.

2. A NEED FOR REFORM

Regulation 28 is urgently in need of modernisation. It was promulgated almost 50 years ago, last amended in 1998, and needs to take account of the recent global financial turmoil. Because at least a third of all household wealth is invested in pension funds and there is a lucrative financial services industry that supports these funds, the overhaul of Regulation 28 has been one of the most anticipated pieces of South African financial reform in the last decade.

The broad aims of the Regulation 28 reform process are:

- ***Protecting vulnerable pensioners*.** Unsophisticated pension fund members and trustees may be vulnerable to exploitation by private asset managers not just because trustees are uninformed, but also because the current rules encourage tick-box compliance with investment managers looking for loop-holes to bypass requirements and limits.

- ***Closing loopholes.*** A number of loopholes exist, which mask the actual underlying asset allocation through successive layers of diverse investment vehicles and instruments.

- ***Reducing systemic risk.*** Systemic risk may originate more easily in relatively unregulated areas such as unlisted derivatives, private equity, and hedge funds. These markets are characterised by low transparency and disclosure, relatively high leverage, concentration risk, and short-selling. Pension funds should to some extent be insulated from these risks.

3. ISSUES CONSIDERED DURING REVISION

The current revision of Regulation 28 accelerated in 2009 with discussions between the National Treasury and the Financial Services Board (FSB). These discussions culminated in National Treasury's release of a draft Regulation 28 proposal for public comment on Budget Day 2010.

During the revision, the National Treasury considered a number of issues. The first was the extent to which long-term insurance policies issued to a pension fund should continue to be exempt from complying with Regulation 28 spreading requirements, keeping in mind National Treasury's prioritised objective of member protection in addition to risk management.

Furthermore, as asset diversification is only required at the level of the fund, individual members may be overly exposed to certain high-risk asset classes, or crowded out of assets that they should be invested in if the allocation for that asset class is already "used-up" by other members in the fund.

A further issue was how to ensure that pension funds and their trustees are adequately and appropriately taking the credit risk of their investments into account. This is particularly important in light of the recent crisis stemming from mismanaged credit markets.

Moreover, investment channels available to pension funds have significantly changed with the incorporation of derivatives, structured products and foreign assets, but these and other products are not currently accommodated in Regulation 28. Indeed the global financial crisis has highlighted that pension funds may be highly exposed to high-risk products, necessitating an update of the investment channels that prudent pension funds can invest in. Other issues receiving attention, included:

- There is no provision for Islamic-compliant pension funds to diversify risk through interest-equivalent instruments.

- The limits are designed to achieve diversification but neglect to guide retirement fund trustees on what investment strategy would be appropriate for the specific nature and obligations of the fund;

- The limits encourage a "herd" mentality among asset managers and prevent funds from making what may be appropriate investments in, for example, structured products;

- From a technical drafting perspective, Regulation 28 references other acts and regulations that have been amended or substantially altered since 1998; and

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

The February draft attempted to remedy the noted shortcomings of the current Regulation 28. The exemption for linked insurance policies with a guarantee, like retirement annuities, was removed and definitions were added and amended for clarification and alignment purposes. In particular, definitions were aligned to the Securities Services Act and Collective Investment Schemes Control Act (CISCA), and Islamic-compliant instruments were defined. Provisions were inserted to protect the fund against irresponsible borrowing and to ensure that the fund is not exposed to liquidity risk or inappropriate loan covenants.

In order to deal with credit risk, the draft proposal relied on credit ratings issued by “recognised” credit rating agencies. This enabled the registrar to prescribe which credit rating agencies may issue credit ratings. Consistent with the treatment of collective investment schemes, credit rating bands were created for those asset categories exposed to credit risk. The draft proposal required investments to comply with Regulation 28 not only at the fund level but also at member level. In addition, it was decided that a look-through principle would be applied for calculating derivative, foreign asset and indirect exposures (which deals with investments in assets through various investment structures like a private equity or hedge fund, or an insurance policy).

The draft proposal was intended to be more aligned with the latest product innovations. To promote income generation and capital market liquidity, it was proposed that funds be permitted to engage in securities lending subject to limits and conditions to be prescribed by the registrar. Derivative instruments were likewise proposed to be permitted, subject to conditions to be prescribed. It was intended that the notice would cover issues such as requiring a derivative to be used only for purposes of efficient portfolio management and hedging against an investment held by the fund. It is anticipated that no gearing or leverage for the purpose of investment would be permitted (unless done by a hedge fund for which special treatment would apply).

The proposal distinguished between the direct holding of underlying property or mortgages, and exposure to property through a listed property investment instrument. Furthermore the proposal aligned foreign asset limits with reserve bank exchange control regulations, permitting 20 per cent of assets in investments outside of the Republic, with an additional 5 per cent for investment into African assets.

Among the more notable decisions to be made in the regulation are: the extent to which credit ratings should be prescribed in regulation; how to treat unlisted assets relative to their listed counterparts; how to treat alternative investments, especially private equity and hedge funds; how to appropriately measure and limit foreign exposure; and how to apply the look-through principle to part-guaranteed policies (in other words how to separate out an insurer’s assets backing the guaranteed “portion” of policies from assets backing the non-guaranteed “portion” of the policy). Specifically the following questions are relevant:

- To what extent should regulation require pension funds to use ratings? If it is decided that requiring credit ratings in the regulation is inappropriate, how can we ensure that the credit risk associated with credit products is correctly assessed?

- What are the potential benefits to a product being listed and flowing from this, what are the appropriate limits for a fund’s assets to be invested in unlisted securities?

- Should the assets backing some insurance policies be exempted from having to comply with Regulation 28? If so, what should be the criteria for exempting them from the look-through treatment and who should approve exemption? Should exemption be granted on a case-by-case basis?

- To what extent can hedge funds and private equity funds add value to pension fund portfolios, and how will the answer to this affect how they are treated in the regulation and specifically the limits table?

- How relevant are currency and country risks, including political risk, to foreign investment decisions? Also, to what extent should we adopt a micro-prudential approach in the consideration of foreign exposure?

- To what extent and how should we align treatment across listed securities across asset classes in the first instance, and unlisted securities across asset classes in the second? Should we treat unlisted property, unlisted bonds, and unlisted equity differently, possibly due to differing listing requirements or general economic nature of the asset classes?

- What should be the per-issuer limits for unlisted property investments and for listed property?

- Are commodities, in the form of Kruger Rands or exchange traded funds, appropriate investments for investment funds given their volatility and non income-producing nature?

4. STAKEHOLDER RESPONSES TO THE FEBRUARY DRAFT REGULATION

Thirty-one formal comments were received from a broad range of stakeholders including asset managers, trustees, actuaries, representative industry associations and the general public.

Submissions primarily supported the policy principles underlying the February draft, although views diverged in terms of how these principles were given effect through the regulation or would eventually be implemented on a practical level. An example of this is highlighted in the proposed removal of regulatory exemption for linked insurance policies that are partly guaranteed. In this instance it is not clear how the two components of this policy (namely that which is guaranteed by the insurer and that which is linked to market movements) can be distinctly monitored for compliance, as would be required. Respondents reflected some frustration over the retained rules-based approach to regulation, arguing that this one-size-fits-all approach could unintentionally undermine risk management, rather than enhance it.

National Treasury received significant guidance from the comments with regards to the categorisation of assets and the treatment of different asset classes. Respondents provided insight into the way pension fund managers and third party managers think about investment strategy and risk management. Respondents also alerted the policy maker about the importance of finding alternative means of assessing the credit risk of different investments so as to avoid a tick-box approach to regulatory compliance (indeed this issue translates more generally to compliance on the whole, raising the question of how to promote compliance with the spirit rather than the letter of the law). It was proposed that assets held for liquidity needs could be more clearly defined.

Respondents on the whole agreed with pension funds needing to take better account of the real economic substance of underlying investments, as opposed to how these are packaged. Having said that, respondents considered the proposed draft regulation significantly more onerous than what is currently permitted, warning that compliance may cause disruption to the pension fund and related sectors.

These issues resound most acutely for unlisted and unrated equity and debt, investments into hedge funds and private equity funds, and investments off-shore (and into Africa in particular). In recognising potential diversification, hedging and growth opportunities for a pension fund investor into these products, not to mention the expected broader developmental impact of growing these market segments, regulation should ideally create a platform for their regulated and controlled use.

Other issues focused on include: treatment of regulation of property and in particular differentiating between listed and unlisted property investments and whether commodities should be accommodated as an asset class and how.

These comments, and National Treasury's response thereto, are reflected in detail in Section 5.2 to follow.

5. REFINING DRAFT PROPOSALS IN A NEW REGULATION 28

To assess the comments received and coordinate and balance policy, regulatory and industry interests, two committees were set up to take the process forward. A steering committee comprising members of the National Treasury and FSB executive would be responsible for determining the high level strategic direction of the review process. Under this committee's guidance, a technical committee was tasked with analysing and resolving key issues raised through public engagement and submitted comments, and to produce a revised draft of the regulation on this basis. Drafts of the notices specified in Regulation 28 would be developed in parallel, namely on securities lending, derivative use, and credit rating agencies, as well as foreign asset exposure (see Section 5.2.7 "Other Matters" for more detail about the considerations going into these draft notices). Because of their technical expertise and the need to obtain data and industry specific information from companies and financial institutions, industry bodies were engaged over the revision process, advising the technical committee of their respective views on policy and technical regulatory issues raised.

There has been a 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:

- The regulatory response must be proportionate to the specific risks identified;

- The structure of rules should to the extent possible be consistent with a typical risk management view;
- Asset categories with similar/equivalent risks should have similar/equivalent limits;
- Rather than "ban" a class of assets where there are greater risks identified for that class, try to the extent possible to mitigate these risks through proper valuation, diversification, transparency to the supervisor and disclosure to the member, and a tighter overall limit; and
- The true nature of the asset should be reported, not the linked-structure, although the linking structure may itself be relevant as well.

5. 1 THE DEBATE OF PENSION FUNDS REGULATION – PRINCIPLES OR RULES?

One way to monitor pension fund investment is to apply rules in the form of percentage limits in terms of asset holdings. But while seemingly clear and ironclad, rules-based regulation has the disadvantage of implying an inherent government endorsement of compliant investment strategies, no matter how much the fund or an investment has disregarded the spirit of the law. Of concern is that trustees and pension fund advisors may apply a tick-box approach to compliance, and be less inclined to monitor financial service providers to the fund and investments being made on the fund's behalf.

Principles-based pension fund regulation on the other hand, while having the advantage of being more aligned with the actual risks facing different pension funds, must rely on informed trustees, preferably well-versed in investment and finance, and able to evaluate the advantages or disadvantages of different pension fund investment strategies.

Despite its observed drawbacks, South African pension fund investment regulation, as reflected through Regulation 28, is rules-based. These rules permeate all three areas of pension fund investment regulation, namely percentage limits to address market risk, per issuer and investment limits addressing counterparty risk, as well as foreign exposure limits to address country and currency risk. There are three main reasons why regulation has to date relied heavily on rules:

- ***Weaker Trustees.*** Despite having a legislated fiduciary duty, there remain concerns over the diligence pension fund trustees apply in executing their tasks. It is also not clear whether a trustee has the necessary skills to make appropriate investment decisions for the fund he or she oversees, in particular to match the asset portfolio to the fund's maturities and risks.
- ***Proliferation of funds.*** Although the industry has recently consolidated from a high of over 13 000 funds, there currently remain over 5 000 registered pension funds in South Africa. Given limited capacity in the Registrar's office, it is easy to see why a prudent person approach (another name for principle-based regulation) will not be possible until the pension fund sector consolidates considerably.
- ***Investor Protection.*** Pension fund regulation should not be concerned only with the sustainability of individual funds or the collective risk of pension funds to the financial system as a whole i.e. systemic risk. The implication of elderly South Africans not being able to provide for

themselves when they can no longer work, means that regulation should also consider investor protection objectives. Indeed as government we have a responsibility to our society to be what some may argue as overly paternalistic in regulating pension savings, especially for products that are tax-subsidised.

Global best practice

International practice varies widely, but most countries have some rules surrounding pension fund investment in the form of maximum percentage limits for investment into different asset categories. The Organisation for Economic Cooperation and Development (OECD) has published the following guidelines with respect to portfolio limits for pension funds:

- They must be consistent with, and promote, the prudential principles of security, profitability, and liquidity pursuant to which assets should be invested;
- The matching of the characteristics of assets and liabilities (like maturity, duration, currencies, etc) is highly beneficial and should not be impeded by for instance minimum limits;
- There should be an established procedure for correcting excesses within specified time limits;
- Self-investment by those undertaking investment management of pension funds should be prohibited or limited;
- Investments in assets issued by the same issuer or by issuers belonging to the same group should not expose the pension fund to excessive risk concentration;
- Investment abroad by pension funds should not be prohibited but take into account country risks, including currency risk and associated matching needs between pension plan assets and liabilities;
- Legal provisions should address the use of derivatives and other similar commitments, taking into account both utility and the risks of inappropriate use. The use of derivatives that involves the possibility of unlimited commitments should be strictly limited, if not prohibited; and
- All legal provisions setting out quantitative portfolio limits should be regularly updated to keep track of market developments and to allow optimal strategies.

Although most are principles, rather than rules-based, developed countries are divided between those that apply [some] investment limits and those that do not. Countries like Australia, Canada, part of the German system, Italy, Japan, the Netherlands, Portugal, the United Kingdom, and the United States are primarily “limits” free. On the other hand countries like Finland, Hungary, Spain and Switzerland apply investment limits across asset categories. Where limits are applied, these in the main are more restrictive for equities and alternative investments relative to bonds, and favour listed over unlisted securities (in many instances the limits apply only to the unlisted space). Property limits are generally more liberal relative to equities or debt although in the exceptional cases of Japan and Poland, property as an asset class is entirely prohibited.

In contrast, nearly all developing countries apply strict limits. While Brazil’s asset class limits and per issuer limits are only slightly lower than that of South Africa, Brazil takes a much stricter approach than South Africa towards allowing foreign exposure. Israel is liberal from an asset class point of view, but has country rating rules around foreign exposure and some rules around self-investment and ownership concentration. Lastly Russia has extremely tight asset class limits and the legislation also includes conflicts of interest rules.

The National Treasury is committed to ensuring Regulation 28 compatibility with global best practice, applied in a way that is sensitive to South Africa’s specific market environment and vulnerabilities.

It is therefore being contemplated that a rules-based approach to pension fund regulation should be retained for the short- to medium-term. To mitigate loopholes, rules should be as complete, explicit and unambiguous as possible. The National Treasury is also exploring ways to guide investment decision makers to comply not only with the letter but the spirit of the law, through for example incorporating supporting principles in the regulation. Consideration of a fully-fledged prudent person approach to pension fund regulation nonetheless remains firmly on the policy agenda.

Benchmarking against our international counterparts, the box on page 8 indicates a preference across developed countries for a prudent person approach to regulation, although in many instances it may pose additional limits. In contrast, developing countries across Eastern Europe, Asia, Latin America and Russia are for more prescriptive. South Africa's rules-based approach therefore fits squarely within this spectrum, and should not be considered an outlier, especially given the existing constraints and limitations of the domestic retirement fund landscape.

5.2 TRANSLATING STAKEHOLDER ENGAGEMENT INTO A NEW REGULATION

5.2.1 RETAINING RULES IN PENSION FUND REGULATION

National Treasury February proposal: Retain rules-based regulation but modernise asset categories and limits applied to these categories.

Comment: The proposal retains its rules-based approach and such a system may be considered outdated and impractical. Furthermore, funds and their members may regard limits as an endorsement of what is "safe" or low risk, while in fact the limits may be overly risky for many funds and members.

Principles-based regulation could help do away with funds hunting for regulatory avoidance loopholes and in doing so better serve South Africa's financial sector objectives. Both in South Africa and internationally, regulatory and revenue authorities acknowledge the challenge of legislation trying to address all future eventualities and possibilities. As a result principles have increasingly replaced rules as a feature of regulation.

Apart from outlining general principles, another way of giving effect to the desire for a more principles-based system would be to allow well-governed funds more leeway with regards to the allowed investment framework. Such a well-governed fund should have the following:

- An investment sub-committee comprising investment professionals;
- A Board of Trustees advised by professional investment consultants and an independent actuary;
- A management team that advises on and reviews the funds' investment strategy;
- Daily compliance monitoring;

- Risk evaluation and reporting structures;
- Asset / Liability review and management; and
- A clear and audited investment policy statement signed off by the asset consultant and the actuary of the Fund.

National Treasury response: For reasons identified, the rules-based approach to pension fund regulation is considered appropriate in South Africa at least for the short- to medium-term. However, in recognising the challenge of tick-box compliance that may not always be true to the spirit of the regulatory intention, principles are introduced to the regulation to guide and inform investment decision makers at each stage of the investment process. These principles should be given effect through an Investment Policy Statement (IPS).

It is proposed that the following principles be incorporated into Regulation 28:

- Promote the education of trustees with respect to pension fund investment, governance and other related matters;
- In contracting services to the fund or its trustees, consider the need to promote broad-based black economic empowerment of those providing services
- Ensure that the fund's assets, including foreign assets, are appropriate for its liabilities;
- Before making an investment into and while invested in an asset perform reasonable due diligence taking into account risks relevant to the investment including but not limited to credit, market and liquidity risks;
- Before making an investment into and while invested in a foreign asset, perform reasonable due diligence taking into account risks relevant to a foreign asset including but not limited to currency and country risk, and operational risk for foreign assets in unlisted equity made in the name of the fund or through a private equity fund or private equity fund of funds;
- In performing its due diligence funds may use ratings issued by a recognised rating agency, but such ratings should not be relied on in isolation for risk assessment or analysis of an asset; and
- Before buying an asset, consider any factor which may materially affect the sustainable long term performance of the investment, including those of an environmental, social and governance character.

In no instance is it proposed that investments by the fund or service providers to the fund should be subject to prescribed minima, in other words compelled. What is contemplated is that a pension fund and its decision makers should explicitly consider each of the bulleted factors in terms of determining its [the pension fund's] approach to investing, and disclose its adopted approach in its IPS for both the supervisor and pension fund members' information.

5.2.2 APPLYING THE LOOK-THROUGH PRINCIPLE TO ASSESS REGULATORY COMPLIANCE

National Treasury February proposal: In calculating a fund's exposure to an asset class or any single investment to that class, the look-through principle should be applied. This includes but is not limited to calculating exposure to derivatives, foreign assets & underlying assets through a linked structure like a linked insurance policy or a debenture.

Collective investment schemes and linked insurance policies that can show Regulation 28 compliance (and have an Auditor certificate issued to this effect) will not be treated as assets of the fund for the purposes of calculating compliance.

Comment: Trying to "regulate" look through to the real underlying may be time consuming, expensive and impractical. It may be better to approach this issue with "substance over form" wording rather than to rely on rules in isolation. The correct wording should compel trustees to be vigilant in relation to such structures, and in effect ensure look-through to the real economic substance of the underlying investment.

The exemption for long-term insurance policies is inconsistent and at odds with the look-through principle. While an insurance policy may be Regulation 28 compliant, due to the compound bets and size of holdings in specific counters and employer companies, if "looking through" to the assets held by the insurer then the pension fund may not be compliant. Also, not recognising the credit risk of insurers creates an anti-competitive environment against other investment types. There are practical difficulties in terms of how to deal with foreign CIS investments held by South African retirement funds, and how to minimise the cost of compliance in terms of reporting.

National Treasury response: The principle of look-through should apply to all pension fund assets, with some clearly defined exceptions. This principle should be affected through a combination of rules and supporting principles that support compliance with the spirit of the law and an anti-avoidance clause (stating that structures should not be used to circumvent regulatory requirements).

A pension fund should report on the underlying assets backing its investments and not just the linked structure (although the structure itself may also be relevant). In other words, if investing into a hedge fund through a debenture or long-term insurance policy, the hedge fund asset must be reported and comply with stated limits and derivative requirements. If accessing unlisted equity through a private equity vehicle, both the unlisted equity investments and the "rights" of the pension fund awarded through the linking structure, e.g. into a partnership or bewind trust, must be understood and reported (See Section 5.2.5 on "Asset Classes and Investment Limits" for more detail in this regard). Notably, no further look-through will apply to assets underlying a hedge fund. In other words, the hedge fund asset itself is what should be reported. Underlying assets and activity is exempt from the rules relating to derivative use, for example.

To control for the added compliance burden, a *de minimis* rule should be applied below which look-through will no longer be required. In other words for an investment by a pension fund that combines assets across asset classes, it may be possible to deem an asset within that combined investment that contributes less than 5% to the total investment, as wholly consisting of the main asset type in that investment. The purpose of the *de minimis* rule would be that pension funds can use it to avoid unnecessary and time-consuming look-through calculation and reporting processes.

In terms of applying Regulation 28 to assets held through regulated entities like insurers and CIS, the default position should be that all pension fund assets should be subject to Regulation 28. Only long-term insurance policies issued with a full guarantee (so that the policy holder, i.e. the pension fund, knows exactly what its benefit will be upon entering into the contract) will be exempt from Regulation 28. In this instance, the policy will be subject only to long-term insurance regulation to avoid regulatory duplication. Policies that are linked in some way to the market value of underlying assets must be Regulation 28 compliant. The Pension Fund and Insurance Registrars will together manage the challenge of part-guaranteed polices, and automatically exempt such policies from Regulation 28 where appropriate (on the grounds that the policy is designed in a way that adequately protects and fairly benefits a pension fund and its members).

Assets held through a linked insurance policy or collective investment scheme may be excluded from the Regulation 28 compliance calculation should an auditor have already proven its Regulation 28 compliance, as evidenced by a certificate issued to the pension fund. It is not intended that an auditor issue a separate certificate for each pension fund invested through the same linked policy or CIS; the auditor can issue one certificate to the insurer or CIS and this can be furnished to any pension fund investor for the FSB as supervisor.

5.2.3 REQUIRING MEMBER-LEVEL COMPLIANCE

National Treasury February proposal: Where a fund provides an individual member with an option to elect his or her underlying investments and that member is exposed to the return on the elected underlying investments, the underlying investments should comply with Regulation 28 and its spreading requirements.

Comment: The practicality and cost of compliance with a member level regime may be prohibitive and unnecessary.

National Treasury response: Requiring Regulation 28 to apply at member level is essential to investor protection. It is reminded that where long-term insurance regulation is primarily prudential in design (to ensure the ongoing sustainability of the insurer), pension fund regulation must in addition protect and enhance each member’s own savings, in a fair and transparent manner. Currently members may be overly exposed to a high-risk asset, or on the other end of the spectrum, be prevented from investing in appropriate assets because the asset allocation for the fund is already filled (in other words other members have taken up the full allocation).

All retirement products must therefore be Regulation 28 compliant at member level, including retirement annuity funds (RAFs). In recognising the difficulty in requiring compliance of an existing contracted policy, grandfathering provisions may be considered in limited instances.[2]

Speaking to RAFs specifically, relevant is the extent to which an RAF can be considered a substitute or a complement to a pension fund. To the extent that an RA is a substitute (which it is for unemployed or self-employed people) regulation of these products should be heavier.

While some may argue this approach is overly paternalistic, National Treasury remains of the view that tax incentivised products may be subject to enhanced oversight.

Recognising the challenge for pension funds to monitor member-level compliance, the Registrar will engage the industry and trustees to see how this can be managed most effectively.

5.2.4 THE STRUCTURE OF REGULATION 28: DELINEATION BY ASSET CLASS OR DEGREE OF INVESTMENT REGULATION?

National Treasury February proposal: Debt and equity are together referred to as "securities" and categorised based on their listed status. The proposed asset categories are:

1. Assets in Liquid Form;
2. Listed Securities and Securities Issued or Guaranteed by a Government;
3. Unlisted Securities;
4. Immovable Property and Claims Secured by Mortgage Bonds Thereon. Secured Loans to and Debentures, both Convertible and Non-Convertible in Property Companies;
5. Kruger Rands;
6. Investments in the Business of a Participating Employer inside the Republic;
7. Loans Granted to Members in Accordance with the Provisions of Section 19(5); and
8. Any other Assets not Referred to in this Annexure.

Comment: The categorisation should reflect the way asset managers generally think about investment strategy and be more consistent. Currently some categories such as "Assets in Liquid Form" and "Property" are asset classes, while "Kruger Rands" is a legal form of investment. The terms "Listed Securities" and "Unlisted Securities" refer to the listed status of the instrument and are therefore inappropriate to use as basis for asset categories. By putting debt and equity into the same categories, the proposal implies that the listed status of a security is of more significance than whether the security is a fixed income or equity instrument. This is anomalous since investment mandates generally make a clear distinction between debt and equity, and not between listed and unlisted securities.

[2] Grandfathering means that long-term insurance policies entered into before the new Regulation 28 is implemented could be exempted from the revised provisions, either for the life of the contracted policy or a limited time period.

National Treasury response: To be in line with how asset managers generally think about the investment universe, the categories of assets should be delineated across the recognised asset classes of cash, equity, debt, property, commodities, and alternative investments, with lower limits set within each of those categories for unlisted and unregulated instruments or vehicles, relative to those that are listed or regulated.[3]

5.2.5 ASSET CLASSES AND INVESTMENT LIMITS

General

National Treasury February proposal: The limits set out in the Table may be exceeded where the excess is due to appreciation or depreciation of the fair value of assets.

Comment: The principle underpinning this provision is agreed to, although comments suggest that it should apply to a wider set of breaches than simply an increase or decrease in the value of the assets. Other reasons why limits may be inadvertently exceeded include corporate actions and changes in market capitalisation of listed shares.

National Treasury response: The provision has been adjusted to reflect National Treasury's agreement with widening the scope of passive breaches, in particular to accommodate market movements, non-optional corporate actions and changes in the market capitalisation of a listed share.

Cash

National Treasury February proposal: The treatment of assets held for liquidity purposes is aligned with the CIS treatment, and as such is defined as "assets in liquid form" to include cash, bank deposits, margin held in margin accounts and money market instruments with a maturity of up to 7 days. It is further proposed that there should be no aggregate limit on assets in this category, although per issuer limits apply and vary depending on the credit rating band of the instrument. Only 5% of assets can be held in a margin account.

Comment: Pension funds should not be allowed to carry 100% of its assets in cash for an extended period of time, because such a strategy would severely compromise the ability of a fund to grow at a rate that would allow pension payouts to meet the needs of pension fund members upon retirement. More than 5% of assets should be allowed to be held in a margin account with an exchange. Margin accounts are held in a bank and therefore as safe as deposits. A higher limit for positive balances in margin accounts would promote the use of listed derivatives which are seen as safer than OTC derivatives.

National Treasury response: The National Treasury agrees that the proposed definition of assets held for liquidity purposes i.e. "assets in liquid form" is cumbersome and confusing, and may not deliver on the desired objective of creating a class of assets that is equivalent to the risks and characteristics of cash. Further, there has been much debate over the delineation between shorter- and longer-dated

[3] The existing category for "Kruger Rands" has been extended to accommodate exchange-traded commodities more broadly, like Gold ETFs (see section on Commodities below).

debt, and whether it is sensible from a prudential perspective to split these up on an arbitrary basis. In other words, from a pension fund perspective, what is the appropriate time threshold below which debt should be deemed cash, as opposed to a broader debt asset?

Therefore for the purposes of Regulation 28, only “true” cash in its various forms like deposits or margin, is considered cash and appropriate to be held for liquidity purposes. Money market instruments are considered as short-dated debt and are therefore combined into the Debt asset category (see the section on Debt to follow).

National Treasury recognises the underestimated security of cash in margin accounts on the basis that the cash here is typically held in a prudentially regulated (and therefore sound) bank, as well as the need to encourage on-exchange derivative trade. Cash held through margin accounts is therefore combined into the broader “cash” asset calculation and does not have a separate limit. As a general measure to mitigate counterparty credit risk, look-through will apply on SAFEX margin accounts so that the margin held can be linked to a bank and contribute to the overall exposure of that bank, for calculation in the relevant counter-party exposure limits.

Debt

National Treasury February proposal: There are no restrictions into South African government issued bonds. Sovereign bonds issued by foreign governments are subject to the overall foreign exchange limit of 20% (plus an additional 5% for Africa). Listed corporate bonds within specified credit rating bands are subject to a 25% limit. Investment into unlisted but rated bonds is limited to 5%. Investment into unlisted and unrated bonds is not expressly provided for, and is accommodated under the asset category “other” with a 2.5% limit.

Comment: The lack of recognition of bonds with low- or no credit ratings limits not only investments into projects or companies that promote economic development and infrastructure, but also limits pension funds’ ability to match their liabilities effectively. Under the proposal if the full allowance for such bonds is used, there is no room left for unlisted equities. Unlisted securities enhance returns and promote socially responsible investment and economic development.

National Treasury response: The South African government debt allowance is retained at 100%. Non-government debt is raised to a significantly higher limit of 75%, although in addition is proposed subject to three main sub-limits of bank issued debt, debt issued by government related entities and other corporate debt.

As already indicated, money market instruments are combined into the debt asset category, which is given more flexible limits to accommodate this greater crowding. In particular, bank debt issued against its balance sheet is given a significantly higher limit of 75% (compared to the current corporate debt allowance of 25%), to match its equity asset class allowance, on the grounds that these entities are prudentially regulated. This is consistent with the view that debt features more highly than equity from an investor perspective (as will be paid out first), and should give more flexibility to South African banks in their capital structuring, further promoting stability to the financial system as a whole.

Quasi-government agencies like state-owned-entities and provincial and local governments are introduced into the revised draft Regulation. This is in recognition of the need to support capital raising for these entities and relieve pressure off the state for all their funding requirements.

For other corporates, although the National Treasury recognises that holding all else constant, debt features more highly than equity issued by the same entity, the limit of 25% is retained. This is because current debt listing requirements do not necessarily enhance transparency, pricing efficiency or liquidity of the debt instrument. To be clear, a debt instrument can be constructed from any anticipated cash-flows, be it from a company, deal transaction or other. The fact that a debt instrument is listed therefore does not necessarily mean it is of sound quality, and it is doubted whether pension fund trustees are skilled enough to make these distinctions.

As the existing Regulation 28 does not distinguish between listed/unlisted and rated/unrated debt, many pension funds will be holding these instruments in varying proportions. Therefore to avoid disruption to the pension fund sector and in recognising that unlisted and unrated debt can be beneficial to pension funds and pension fund members, this treatment is in the main retained, although will be subject to tighter limits. A lower limit is therefore applied to unlisted debt (relative to listed debt) on the grounds that no regulatory protection is afforded these instruments, and credit ratings have been opted away (see the discussion on credit ratings in Section 5.2.7 on "Other Matters"). In the place of rating requirements, reliance is increasingly placed on asset class and asset diversification, as well as appropriately independent valuation (on which the Registrar may give guidance). Irrespective of the individual limits imposed across unlisted and unrated assets in different asset classes (that on the whole have been notably relaxed), to give greater protection to pension funds an overarching limit is imposed across all unlisted assets of 30%. Investments into unlisted debt will therefore contribute towards this 30% limit.

Equities

National Treasury February proposal: The limit on listed equities remains unchanged at the existing level of 75%, subject to per issuer limits of 15% and 10% depending on the issuer's market capitalisation. Unlisted equity is not expressly provided for, and is accommodated under the asset category "other" with a 2.5% limit.

Comment: The limit for investments into listed equities excluding listed property and listed commodities should be increased, and the market capitalisation measure for per issuer limits should be removed. The limit for unlisted equities should be increased (to at least the 5% currently allowed).

National Treasury response: National Treasury remains of the view that the existing limit of 75% for listed equity adequately provides for younger pension fund members with a higher risk-return appetite, especially if read together with allowances in other asset categories like property, commodities and alternative investments.

Notably market capitalisation segments may not always be the best proxy for asset soundness and may have unintended consequences in that it causes a trap for smaller listed companies, making it hard for them to access the capital needed to break into the Top 100 or Top 40. However the National Treasury remains of the view that this proxy is necessary, and alternative criteria like liquidity and JSE ranking have similar implementation challenges. To more appropriately scope the equity investment universe, three segments are proposed of smaller, medium and large stocks. Rather than inflexible limits that become outdated over time, the Registrar is empowered to adjust these limits to maintain their relevance.

Investment into unlisted equity, whether held directly in the name of the pension fund or indirectly through a private equity investment vehicle, is considered desirable for pension funds for diversification and growth potential, and may support economic development through more efficient allocation of capital to SMMEs and environmental, social and corporate governance (ESG) investments. It is therefore appropriate that investment into this asset type be permitted and expressly provided for through the regulation, both in South Africa and internationally (and especially Africa). To guard against risks of over or inappropriate exposure to a single asset or this asset category, an overarching limit is applied across unlisted equity (irrespective of the investment structure) of 10%. Unlisted equity will also contribute towards the overarching limit for all unlisted/unrated assets of 30%. Valuation of unlisted equity remains a challenge and as with unlisted debt, guidance may be given by the Registrar in this regard. In light of recent concerns expressed by the Registrar that trust and partnership investment structures may be in contravention of the PFA, provision will be made to exempt these structures from the PFA subject to grounds determined by the Registrar to mitigate risks these structures pose to a pension fund and its members.

Commodities

National Treasury February proposal: The asset category “Kruger Rands” is retained but the limit is reduced from 10% to 5%.

<u>Comment</u>: The Kruger rand category should be renamed “Commodities” and provision should be made for other types of commodity instruments including commodity exchange traded funds (ETFs) like ABSA’s Newgold product. This category should have a 10% limit. Restricting direct investments in commodities to Kruger Rands is a very narrow view of commodities.

<u>National Treasury response:</u> After reconsidering the role of commodities in pension fund portfolios, and the increasing irrelevance of gold as a rand and market risk hedge, the National Treasury will expand the “Kruger rand” category to include listed commodity products, including commodity ETFs, and retain the existing 10% limit.

Immovable property

National Treasury February proposal: For exposure to immovable property, investments into directly held and managed property are distinguished from exposure obtained through a listed property company or CIS (PUT). Listed property investments contribute to the higher equity limit of 75%. Directly held property is retained at 25%. The existing definition of "property company" is retained, as determined in the main by the minimum level of investment by the company into immovable property (set at 50% of income earned or assets held).

Comment: All property related investments should be housed under a "property" category with subdivisions that recognise the difference in risk between directly and indirectly held property.

Some stakeholders are of the view that the current definition of property companies (at 50% of assets and income) appears to be defined very widely compared to bond investments and therefore suggests that the percentage holding be increased to strengthen the assessment of property companies on substance.

Some stakeholders are also of the opinion that property related debt instruments are more appropriately grouped with bonds. It is argued that the security of property is not indicative of the inherent risk of an investment and is not sufficient to be treated as a distinctly separate asset class, particularly where there is no reference to the value of the security compared to the debt. It could also create situations where an asset can be classified under different sections; debt instrument or property. It is thus proposed that the category be restricted to direct property (immovable) and indirect property (property loan stock, listed property shares).

National Treasury response: National Treasury agrees that property is a distinct asset class from other listed securities, and notes that there may be significant differences in risk between property exposure obtained through an investment fund (like a PUT or property loan stock company) where the liquidity and operational risk is managed by professionals, or owned and managed directly by the pension fund (which may or may not have the skills to do so). Therefore while all immovable property is restored to the 25% aggregate limit and 5% per property/issuer limit (as appropriate), property owned and managed directly by the pension fund is to be subjected to a lower sub-limit of 15%. As with all investment limits, a pension fund in contravention of this limit can apply to the Registrar for exemption.

In terms of defining property companies that substantively represent exposure to immovable property as an underlying property asset, it is deemed appropriate to increase the income and asset tests to 75%. This approach recognises that while some flexibility should be given to enable property development and property service provision, the dominant activity of an immovable property investment should be income streams from holding immovable property.

Conscious of the potential challenge in distinguishing between property related and other debt, the National Treasury will continue to engage on this issue, and proposes that these instruments will be subject to the lower proposed sub-limit of 15% (as discussed in the paragraphs above).

Alternative investments

National Treasury February proposal: As hedge funds and private equity funds will be "looked-through" to their underlying asset exposure, these are not expressly provided for in Regulation 28.

Comment: A major weakness in the regulation is the exclusion of hedge funds and private equity funds. Being explicit about these funds would result in fewer funds trying to find creative ways to access these investments, through insurance wrappers for example, thereby possibly exposing pension fund members to greater risks in the process. Further, hedge funds are a proven portfolio risk mitigation tool which does not compromise on a retirement fund's ability to achieve its long term return objectives. Socially responsible investments should also be explicitly recognised, whether it be as a rule or a principle.

National Treasury response: National Treasury agrees that private equity and hedge funds can add value to a pension fund portfolio, through risk mitigation, diversification or capital growth potential. Furthermore, expressly providing for these assets in the regulation, supported by an anti-avoidance clause, is believed to reduce the potential for creative (and false) reporting of such asset exposures. Rather than ban this products completely, a higher limit of 15% is proposed for alternative investments (to span hedge and private equity funds, as defined, as well as other assets not specified in the rest if the regulation). However in the interest of investor protection and given the sometimes unpredictable nature of the underlying investments of these funds, the increased flexibility proposed should be supported by stronger requirements of asset and asset class diversification (to minimise the risk of loss should any investment not deliver on its believed potential), and valuation and reporting standards as already highlighted. It is also critical that these investments offer limited liability.

Credence is given to the role of a fund of funds in generating added protection to the investor through diversification and management expertise, and therefore these are proposed to be subject to higher "per fund" limits relative to an investment into a single hedge or private equity fund.

Given the constant innovation in financial products and the relative newness of the debate of where and how alternative funds should be accommodated in Regulation 28, it is proposed that the FSB be given the authority to, in future, impose other rules specific to these different investment categories that would deal with specific regulatory risks, even risks that have not yet been identified.

As indicated, private equity investments are "looked-through" to constitute unlisted equity, which in turn will contribute towards the unlisted equity limit of 10% (this is irrespective of whether a private equity fund holds listed securities or not). Hedge funds on the other hand will not be looked-through to the underlying instruments – the hedge fund itself may be seen as the asset and be subject to a 10%

limit. This means that a hedge fund as defined will not be limited by the restrictions imposed by the regulation on derivative use and gearing. Both hedge fund and private equity fund investments contribute towards the 15% alternative investment limit, which in turn contribute towards the overarching 30% limit for unlisted/unrated assets.

Because of lock-up periods for private equity funds and possibly some hedge funds, as well as the inability to change some contracts midstream, it is agreed that the market impact of the changes to Regulation 28 should be taken into account where pension funds may need to align to the new limits, and transitional arrangements should be put in place.

National Treasury February Proposal: As Regulation 28 deals with asset spreading requirements for risk management purposes and noting that Socially Responsible Investments (SRI) are already accommodated within the regulation, to prescribe minimum levels of SRI may not be appropriate. There are as a result no explicit rules relating to SRI in the draft Regulation.

Comments: The Regulation should allow explicitly for SRI in order to ensure that such investments, which are often into unlisted and unrated bonds for instance, are not crowded out by assets in the "other unlisted" or "other investments" categories. More scope should be given for these investments since they often directly address important constitutional and policy imperatives relating to economic and social development.

National Treasury response: The concept of SRI investment is perhaps more appropriately considered in terms of the broader concept of Environmental, Social, and Governance (ESG) investment and should be expressly considered in the regulation. This is proposed on the grounds that ESG matters are expected to impact the long-term performance of any asset invested in, and therefore should be explicitly considered in a due diligence assessment. Failure to do could mean under- or over-estimating the expected returns of the asset. For example, if a potential asset has a significant carbon footprint that is expected to imply significant tax payments, failure to take these effects into account may lead the pension fund to under-estimate environment risk posed by the asset, as well as the implied costs to be borne by that asset in future, therefore over-estimating returns that would be generated. An alternative asset may perhaps be more appropriate in this instance.

It is not agreed that ESG investments constitutes an asset class in its own right but National Treasury rather sees this a subset in each asset categories, like equities or debt. In other words, an equity asset could meet ESG criteria or it may not. Also, because of the difficulty in defining such investments which are not yet clearly or equally understood by the relevant stakeholders, it is not considered sensible to constrain a definition in the regulation. Rather, in terms of its IPS a pension fund is required to define for itself what ESG means, and by what criteria it will apply ESG principles in assessing existing and future investments made. In addition, a general preamble top Regulation 28 requires a fund to also more broadly consider ESG issues in its general functioning.

Related is the issue of support services provided to a pension fund by advisors, administrators and other professionals. The National Treasury is mindful that a pension fund and its decision makers should consider BEE in its contracting of professional and other services. Similar then to the approach taken for ESG investments (which itself may contain a BEE component), a pension fund will be required in terms of its IPS to define and apply its own stance on BEE in the procurement process.

Lastly, Islamic financial services are not considered necessarily ESG in the context of Regulation 28; as indicated above a pension fund and its Trustees should define ESG investments as it sees appropriate, and this may or may not accommodate Islamic-compliant instruments.

5.2.6 PRUDENTIAL REGULATION OF FOREIGN EXPOSURE

National Treasury February proposal: Foreign exposure for pension funds is raised to be consistent with the revised exchange control limits of 20%, with an additional 5% allowed if that 5% is invested in African assets. Foreign investment is defined in terms of the SARB's view, to mean foreign currency denominated assets or Rand denominated foreign assets acquired through direct or indirect investment.

Comment: Any foreign exposure limit should focus on investments denominated in foreign currencies as opposed to trying to align Regulation 28 with exchange control rules which generally focus on domicile. While exchange control limits are primarily focused on risks linked to capital flows, pension funds are and should be more concerned about currency risk. The foreign asset definition, although in line with the SARB definition, means that some Rand denominated securities will have to be re-classified as foreign assets.

National Treasury response: There are two issues at play here. The first deals with the restriction of capital flows as evolved out of exchange control rules governed by the SARB. The second deals with micro-prudential regulation of foreign exposure by a pension fund. While stakeholder comments around the definition of "foreign" is appreciated (as applying to the capital flows part of the debate), this discussion lies beyond the scope of Regulation 28 and should form part of the broader exchange control liberalisation process underway; capital flows related to pension fund investments cannot be divorced from other capital flows and therefore policy must be designed holistically for South Africa. More pressing in this forum then is the consideration of appropriate micro-prudential requirements for pension funds, to apply appropriate consideration to country and currency risks through exposure to foreign assets as allowed within the SARB limits (of 20% with an additional 5% for Africa).[4] Operational risk is also a consideration for investments into unlisted equity. Such is given expression through the principles overlay, as described in Section 5.2.1.

[4] As determined by the Financial Surveillance Department of the SARB.

Because of the ongoing reform in exchange control policy and the need to align Regulation 28 to these changes, it is sensible to afford the FSB the power to change foreign exposure limits over time (to link directly with any SARB announcements on this matter). To leverage existing regulatory capacity to monitor adherence to this limit, the National Treasury will explore the possibility of the SARB performing some of the regulatory function regarding foreign exposures.

National Treasury February proposal: Investments into foreign securities must primarily either be listed on a recognised exchange, which requires the exchange to be a full member of the World Federation of Exchanges (WFE), or issued or guaranteed by the foreign government concerned.

For Africa, within which most exchanges are not yet WFE members, pension funds can still invest in these listed securities subject to first performing due diligence on the relevant exchange.

While some allowance is given to investment into foreign assets outside of these requirements, such is limited to the 2.5% limit for the "Other Assets" category.

Comment: Care must be exercised in coming up with a definition of "listed foreign security." African investments should not be required to be listed if wanting to promote investments in Africa.

National Treasury response: Allowing pension funds to invest only in securities listed on exchanges which are members of the WFE may result in sub-optimal investment into foreign securities. A major consideration in this case was therefore whether to allow foreign investment into non-WFE exchanges, and if so, on what basis and the extent that such should be permitted.

To ensure the benefits associated with an equity being listed (and therefore being within a strictly regulated environment) are upheld, the definition of a recognised exchange is necessarily strict, and is therefore retained to mean a South African exchange or an exchange that is a full WFE member. However, the National Treasury sees value in investing through exchanges that are not WFE members, in particular to gain exposure to growth on the continent while at the same time to channel capital to these markets to support such growth. To accommodate these investments, a pension fund may invest in an asset listed on an exchange that is NOT a full WFE member, but such will be subject to tighter limits, and in effect combined into the unlisted equity treatment (i.e. will be considered as unlisted equity and therefore contribute to its 10% limit). As an extra protection, these investments are also subject to the discussed due diligence procedures required for investment into foreign assets. An equivalent treatment should apply to the other asset classes.

This approach is also in line with am envisaged move towards a more principle-based regulation and additionally felt comforted by the fact that FSB circular PF 130 requires pension fund trustees to outsource certain processes when it is clear that they do not have the in-house expertise to perform them. Evaluating the risk of securities listed on non-WFE exchanges would fall into this category and National Treasury felt that asset managers who perform risk analysis functions on these securities on behalf of pension funds would be able to do this with sufficient rigour.

5.2.7 OTHER MATTERS

National Treasury February proposal: Counterparty risk should be mitigated through a 30% limit on aggregate exposure to any one issuer, supported by per-issuer limits for each asset category.

Comment: The current limit for aggregate exposure to a single issuer is not appropriate because it doesn't take into account the difference between issuer and underwriter, or between issuer and guarantor, of a particular issue. In addition there are practical obstacles to the implementation of this proposal, as well as the potential forfeiting of valuable investment opportunities. Costs may go up as multi-managers, who are mandated by retirement funds and then appoint more than one investment manager to manage the assets of a retirement fund, will have to manage those exposures across investment managers. Further complications include the fact that in the case of underwritten retirement funds it is usual for 100% of policies to be issued by the same underwriter i.e. insurer, so many such investments may immediately fall foul of such a new rule. Lastly, the rule seems to apply to government as well and stakeholders feel that exposure to the government as issuer should not be limited at all.

National Treasury response: After further consideration, the National Treasury agrees that an aggregate exposure limit in terms of the current regulation would impose practical challenges to many pension funds, and severely strain the multi-manager business model (which can give sound value to the pension fund contracting its services). Under the proposal, managers would be expected to ensure compliance across asset classes, some of which are not under their mandate. As an interim measure to what is considered an important issue that needs further consideration down the line, a simpler approach will be to rely on counterparty limits per asset class. The look-through principle will encourage trustees to look to the real entity standing behind an issue. The National Treasury does however remain of the view that aggregated counterparty exposure is a relevant risk to the pension fund environment, and stronger controls should be considered in future. This should include a pension fund's exposure to a single insurer if it is fully underwritten.

National Treasury February proposal: On the basis that assets within a given asset class may reflect different credit risk profiles and therefore warrant different regulatory treatment, within debt categories credit bands are created based on different credit risk ratings. The registrar will prescribe which credit rating agencies may issue credit ratings.

Comment: There is a clear moral hazard of endorsement of the ratings methodologies of credit rating agencies. No firm should have a monopoly on intellectual capital, financial analyses, or the ability to assign ratings. Additionally, incorporating credit ratings would further exacerbate the position with regards to an inability of pension funds to adequately and optimally diversify their bond holdings since credit ratings are mostly only arranged by borrowers with listed debt instruments.

National Treasury response: Regulation 28 should move away from reliance on credit ratings. Instead the principle of requiring effective due diligence on all investments should be instilled and more reliance should be placed on diversification and independent valuation for investment assessment and risk management. In recognising the cost and asset-comparison efficiencies that may be derived from using credit ratings, ratings can be used to assess the credit risk of a potential or existing asset, but should not be relied upon in isolation, and must form part of a broader due diligence process.

National Treasury February proposal: To generate income for the fund and promote capital market liquidity, funds are permitted to engage in securities lending subject to limits and conditions as set by the Registrar, designed to protect the solvency and liquidity of the fund. A draft Notice governing securities lending by pension funds will be released for public comment and form the basis for stakeholder consultation.

Comment: Alignment with the likes of the CISCA and the Long Term Insurance Act (LTIA) in terms of securities lending may be questionable given the differences in mandate between pension funds, collective investment schemes, and insurance companies. Securities lending counterparty exposures should be made subject to limits.

National Treasury response: While to date securities lending has in principle been allowed by the Registrar, compliance officers have frequently prevented activity not expressly allowed for by Regulation 28. Furthermore, securities lending that is taking place is not governed by appropriate regulation. Securities lending rules should be aligned with those applied under the LTIA and CISCA, on the grounds that the risks and regulatory concerns posed by this practice will be similar across the various funds and institutions. A draft Notice giving guidelines to the way in which securities lending can take place is released for public comment.

National Treasury February proposal: Having been defined, the investment into derivatives is permitted subject to provisions and conditions to be prescribed by the Registrar. A draft Notice governing investment by pension funds into derivatives will be released for public comment and form basis for stakeholder consultation.

Comment: Derivative instruments should be explicitly recognised in the Table and index derivatives should be allowed.

National Treasury response: Regulation 28 determines what assets and asset classes a pension fund can invest in, and within what limits. Derivatives, recognised as assets, do not however constitute an asset class. Therefore derivatives are expressly provided for in the Schedule to the regulation, but should not form part of the Table delineating the asset classes. Rather, the derivative should be "looked-through" to see the underlying asset exposure, and it is this potential gross exposure that should feed through to assess compliance with the assets Table.

Investment into derivative instruments should be permitted for purposes of efficient portfolio management and hedging against an investment held by the fund. However, derivatives will not be allowed for gearing or leverage purposes. These provisions have to date been applied by the Registrar of Retirement Funds but were not set out in formal regulation and derivative use is therefore exposed to abuse. Derivatives have very specific uses in collective investment schemes and long term insurers that should not appear in pension funds. Therefore derivative treatment will not be aligned with LTIA and CISCA.

The requirement with regards to derivatives is that they must be covered, therefore the retirement fund must either hold an amount equivalent to the notional value of the derivative in cash, or the actual underliers. Retirement funds therefore have a choice in this regard.

A draft Notice is released for public comment.

National Treasury February proposal: A money market and a bond "equivalent" Islamic investment instrument are defined to create Islamic-compliant long- and short-term fixed-income type investments, to accommodate their use in the pension fund framework and thereby promote improved portfolio risk management for Islamic-compliant pension products.

Comment: Largely agreed.

National Treasury response: The proposed provisions for Islamic-compliant investment instruments make adequate provision for Islamic retirement funds to manage their risk more appropriately. More detail related to Islamic investments in the context of SRI is contained in Section 5.2.5 under "Alternative Investments".

National Treasury February proposal: Housing loans granted to members against their retirement savings as surety is retained.

Comment: The limit should be reduced because such lending exposes the fund or members to too much credit risk, especially if loans are made directly to members (members at risk) as opposed to intending to provide pension fund assets as security for housing loans (fund at risk).

National Treasury response: Further to this comment, the National Treasury acknowledges experiences of abuse, in particular where retirement savings are accessed through this provision but used for a variety of other reasons. As access to retirement savings for buying a home is considered an important support mechanism to providing for one's old age, this provision should be retained, but tightened to limit credit risk to the effected member and the fund. Direct loans to members by the fund are therefore distinguished from guarantees issued against a housing loan given to a member by a bank, with the former having a significantly lower limit of 5%.

Although the National Treasury notes the possible importance of other items like education as a family's investment for the future, extending the provision to allow for other purposes is not deemed appropriate at this stage as could worsen existing abuse of the provision and aggravate problems of retirement savings leakage. This matter is rather flagged for consideration as part of the broader savings promotion and retirement reform processes.

6. CONCLUSION AND WAY FORWARD

The National Treasury appreciates the pension fund industry's openness to engage on this reform of Regulation 28. The comments provided valuable insights as to how the regulation can be further developed to deliver on its investor protection and micro-prudential risk imperatives. While not all views have been agreed with and therefore adopted, all responses were comprehensively read and evaluated against the policy maker's concerns. National Treasury looks forward to further engagement as the review process concludes.

A revised draft of Regulation 28 is hereby released for public comment. Also for release is an explanatory memorandum that explains the technical detail of the draft, this document that reflects on the analysis that formed basis for conclusions drawn and decisions made, as well as the draft Notices referenced in the regulation. Given the extensive engagement since the February draft, only comments of a technical nature will be considered in this round, although submissions relating to broader principles are not prevented. Comments should be submitted by email or fax before 28 January 2011.

To further support stakeholder understanding of the intention and principles underpinning the revised draft regulation, the National Treasury with the FSB will host public forums for stakeholder engagement in both Cape Town and Pretoria, scheduled for December 2010. This is to ensure that feedback given to the National Treasury is relevant and mindful of what the regulation is trying to achieve and why.

The National Treasury is sensitive to the fact that the new Regulation 28 may pose significant challenges to some pension funds to achieve compliance, as these funds may at present be operating widely outside of the proposed asset class limits. Even for those pension funds that are broadly compliant with the existing regulation, a tighter approach in instances like member-level compliance, part-guaranteed policies and unlisted debt may require a period for adjustment. The National Treasury and the FSB will engage on appropriate transition arrangements that will best protect a pension fund and its members.

It should also be kept in mind that the National Treasury remains informed by international best-practice in this area while being sensitive to South Africa's local context. Stakeholder representations have been extensively considered and tested against our financial sector policy objectives of member protection, sector stability and efficiency, as well as broader objectives of channeling savings for investment to promote economic growth, and environment, social and governance considerations.