NATIONAL
TREASURY

EXPLANATORY MEMORANDUM

ON THE FINAL

REGULATION 28 THAT GIVES EFFECT TO SECTION 36(1)(bB) OF THE PENSION FUNDS ACT 1956

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I. INTRODUCTION

Section 36(1)(bB) of the Pension Funds Act, No 24 of 1956, empowers the Minister of Finance to make regulations limiting the amount and the extent to which a pension fund may invest in particular assets. Of the R5.2 trillion total household savings in South Africa, Regulation 28 currently applies to all private retirement fund assets worth R1.1 trillion, and may be extended to the Government Employees Pension Fund (capturing an addition R1 trillion in assets).

The aim of retirement fund investment regulation is to ensure that the savings South Africans contribute towards their retirement is invested in a prudent manner that not only protects the retirement fund member, but is channelled in ways that achieve economic development and growth.

To achieve this, rules governing retirement fund investment should allow for inflation-beating capital growth for younger members and inflation-matching income for older and retired members. This can be reflected through the right mix of low risk-return “safe” assets with higher risk-return innovative products. The rules should likewise strike a balance between regulatory paternalism and empowering those entrusted with the management of retirement fund assets to do due diligence and make decisions of what investments are most appropriate for their fund’s particular liability and liquidity profile.

An important consideration is the level of expertise on boards of trustees and their ability not only to make investment decisions, but also to delegate certain tasks (but never their ultimate responsibility) to advisors like asset managers, asset consultants and risk consultants. To the extent that trustees are inadequately informed of investment and liquidity requirements, governance, and risk management, the regulation must give stronger direction through rules rather than guiding principles.

II. PROCESS

The National Treasury released a first draft Regulation 28 for public comment on 17 February 2010. After deliberating on comments received on this draft, a second draft was released after the 2010 MTBPS on 2 December. Another round of public comments and industry engagement followed and has culminated in this final Regulation 28.

The feedback received from the December 2010 draft was overwhelmingly positive and mostly proposing technical refinements, although important issues were put forward, namely:

- The proposed treatment of cash and debt instruments could artificially restructure the market in a way which could undermine liquidity management by a fund.
- Debt limits proposed remain perhaps overly strict and could be relaxed in certain controlled instances.
- Limits on alternative investments, and unlisted equity in particular, were likewise considered overly strict in a manner that could impede investment into this pro-development funding channel.
- Investment into Africa, while better facilitated, could be further promoted to support economic growth in the region and the positioning of South Africa as a regional financial centre.

The National Treasury has in response brought about several changes which we hope improves the December 2010 draft. The Regulation now better recognises and promotes the responsibility of funds and boards of trustees towards sound retirement fund investment. It expands the allowance for debt issued by listed or regulated entities. This supports a stronger corporate debt market and addresses the bank structural funding mismatch between short-term borrowing and long-term lending, whilst crucially still protecting retirement funds and their member's savings. The Regulation better enables investment into unlisted and alternative assets to support economic development that may be funded through such capital-raising channels. Investment into Africa is likewise supported through providing for alternative ways of accessing this market in a responsible way. Importantly, the Regulation continues to better align retirement fund regulation with other government policy objectives like socially responsible investments and transformation. These revisions are explained in greater detail in Part V of this Explanatory Memorandum.

III. BACKGROUND

The key reasons to update Regulation 28 are:

- It references other Acts and regulations that have been amended or substantially altered since 1998.
- There is inconsistency in the application of definitions, asset categories and the structure of limits between retirement funds, insurers and other investment funds.
- The rules-based approach to diversification neglects to guide retirement fund trustees as to what investment strategy would be appropriate for the specific nature and obligations of their fund.
- There are significant loopholes and many retirement funds have been able to circumvent the rules.
- New investment channels are not explicitly accommodated nor expressly prohibited, exposing funds to unregulated entities and behaviour.
- Increased foreign exposure to retirement funds brought about through the relaxation of exchange controls, while good for investment diversification, requires a specialised knowledge by trustees and fund advisors.
- The exclusion from Regulation 28 of insurance policies with any form of a guarantee, irrespective how minimal, has allowed insurers to offer products to retirement funds that systematically exceed the asset limits and yet give minimal underwriting protection.
- The limits may encourage a “herd” mentality amongst asset managers and prevent funds from making what may be appropriate investments into, for example, alternative investments or structured products.
- Regulation 28 applies only to a fund as a whole and therefore may overly expose an individual member to a high risk asset category, or alternatively mean that a member cannot invest in an asset suited to his or her portfolio because the aggregate limit for the retirement fund is already reached.
- Credit risk may be an issue as assets within an asset category attract the same limits irrespective of their credit-risk profile.

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

IV. THE CURRENT REGULATION

Regulation 28 prescribes maxima for various types of investment that may be made by a retirement fund. The maxima relate to the fair value of the assets of the fund under the direct control of the trustees, and exclude from consideration insurance policies that (i) provide any form of guarantee; (ii) where performance is linked to the performance of underlying assets and the investment of the underlying assets conforms to the requirements of regulation; and (iii) collective investment schemes which conform to the requirements of Regulation 28.

The prevailing maxima are broadly:

- Not more than 75 percent may be invested in equities.
- Not more than 25 percent may be invested in property.
- Not more than 90 percent may be invested in a combination of equities and property.
- Not more than 5 percent may be invested in the sponsoring employer.
- Not more than 15 percent may be invested in a listed equity with a defined large market capitalisation, and not more than 10 percent in any other single equity stock.
- Not more than 20 percent may be invested with any single bank.
- Not more than 15 percent may be invested off-shore, although increased foreign limits by the South African Reserve Bank are accommodated by the Registrar of Retirement Funds on an application basis.
- Not more than 2,5 percent may be invested in "other assets," which are not specified.

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

Derivative instruments are not defined, leaving them to fall within the category of "other assets". No guidance is given as to how derivatives may be used.

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

There is provision for the Registrar to exempt funds from some or all of these maxima on prior written application. It was on this basis that the Registrar adjusted foreign exposure limits for retirement funds in line with revised exchange control limits.

V. EXPLANATION OF THE NEW AND FINAL REGULATION 28

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1. DEFINITIONS

Building on the Budget 2010 and December drafts of the regulation, definitions have been refined to mitigate the risk of regulatory avoidance, better support the governing limits and requirements, and take account of the changing investment landscape. In this regard, derivatives, hedge funds and private equity funds are explicitly defined and referenced in the Regulation. The definition for a property company is tightened to ensure that these entities more closely reflect the risk-return profile related to rental income rather than property development or other property related services. More generally, references are updated to reflect changes in the exchange control environment, as well as other relevant governing legislation like the Collective Investment Schemes Control Act of 2002 and the Security Services Act of 2004.

2. PREAMBLE AND PRINCIPLES

A preamble frames the Regulation. It highlights the fiduciary responsibility of a retirement fund's board to invest members' savings in a way that promotes the long-term sustainability of the asset values when taking into account environmental, social and governance (ESG) issues. Read together with the principles, the preamble represents a new approach to Regulation 28, and better guides trustees to consider what investment strategy would be appropriate for the specific nature and obligations of their fund. Recognition is given to the fact that an overly conservative investment strategy (dominated for example by cash and non inflation-linked bonds) can be as damaging to long-term savings as one that is overly exposed to perceived risky assets.

In the context of approximately 3 500 active retirement funds (recently consolidated down from 13 000 funds) and a general lack of investment expertise among trustees, the Regulation remains primarily rules-based. However principles are introduced into the Regulation to strengthen the investment decision making processes, and improve the transparency and accountability to a fund's members and the Registrar. In effect these principles, as captured through an Investment Policy Statement (IPS), should inform a fund's investment approach related to the aspects identified in the Regulation. These include:

- Promoting relevant trustee education.
- Monitoring compliance by the fund and its agents.
- Ensuring asset/liability matching by the fund.
- Performing appropriate due diligence on investments, making sure not to rely wholly on credit rating agencies for assessing credit risk.
- Taking into account the long-term sustainability of investments, in particular considering the impact of ESG aspects.

The IPS should also contain other details relevant to investment policy, including for example asset mix and rate-of-return calculations. These will be provided for by the Registrar by Notice (to give effect to what is currently contained in Annexure B to the PF Circular 130).

3. ASSET LIMITS

3.1 GENERAL

A fund may only invest in assets specified in the Regulation and within the issuer and aggregate limits defined. Provision is however made for involuntary breaches that fall beyond the control of the Board, brought about for example by market movements or corporate actions.

In making investment decisions, a retirement fund should be guided first and foremost by what is best for the fund and its members, and should invest accordingly; indeed what is enabled through the Regulation limits may not be in the best interests of each and every fund or member. On the other hand, asset limits imposed should not prevent a fund from achieving its optimal investment allocation. Where funds begin to meet the limits and think it prudent to exceed them, the Board should engage the Registrar on a possible exemption. The National Treasury has in some instances taken a more conservative view on limits in this final Regulation 28 with the idea that these can (and should where appropriate) be tested by market participants in the future.

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 such time that any material contractual provisions related to that arrangement are changed.

Ahead of the explanation on asset categories to follow, consider firstly that the definitions of the various assets serve as a funnel: cash, equities and immovable property are narrowly defined, meaning that anything outside of these definitions would most likely be placed under debt, unless it is a private equity or hedge fund, as explicitly defined (or another alternative investment), in which case it must be disclosed in that category. Consider also that significantly tighter limits apply to unregulated and unlisted products, relative to those that are regulated and/or listed. In addition to the category and issuer limits that are identified, overarching limits are applied to unlisted and alternative assets (at 35 percent) and unlisted equity held directly or through a private equity fund (at 15 percent, consistent with exposure limits to unlisted assets in other asset classes, like debt and property).

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. Instead, as already explained the Regulation requires a fund to explicitly consider its approach to ESG issues (with respect to its investments) and transformation (with respect to services provided to a fund). Moreover, economic development is more strongly supported by increased flexibility afforded to investment into private equity funds and public entity debt.

3.2 CASH

To better align the "cash" asset class to comprise instruments collectively used for liquidity management, money market instruments are included back into this definition (which in the December 2010 draft separated out physical cash from all other debt, including money market instruments). But regulatory concerns remain internationally over maturity transformation in money market funds, which globally are being reviewed as a shadow banking system. Work is therefore being done to strengthen money market fund regulation in accordance with coming international standards, in a way that will better protect investors, including retirement funds, and guard against financial system instability in the future.[1]

3.3 DEBT INSTRUMENTS

To improve diversification across the asset categories, reduce regulatory induced distortions away from longer-dated debt into money-market instruments and equities, and better support the corporate debt markets (for broader economic gains), restrictions on investments into transparent debt products are significantly eased.

All else being equal, for debt and equity issued by the same entity the debt ranks higher in the creditor line and will be paid out first. However, in many instances a lack of transparency in the debt markets means the investor has too little information about the issuer to do a proper risk assessment. Recent developments around increasing transparency in South Africa's listed debt market will go some way to managing these concerns. Nevertheless a fully "visible" issuer is paramount to the new flexibility given to funds.

The aggregate limit for (on-balance sheet) bank issued, corporate and public entity debt is therefore raised to 75 percent, now equal to the overall limit on equities. Within this higher limit, bank issued debt, recognising these entities

[1] This will be considered as part of a National Treasury led project on structural funding for the banks.

as being prudentially regulated, can be held at the maximum (75 percent) if that debt is listed,[2] while listed debt issued by listed corporates and public entities can be held at a lower maximum of 50 percent, and listed debt of unlisted entities at 25 percent. Stricter limits apply across each of these issuer sub-categories for unlisted debt instruments. This recognises the pricing, liquidity and disclosure advantages of listed over unlisted debt.

Funds are not required to apply credit ratings in assessing credit risk. Where ratings are used, such should form part of a broader due diligence and should not be relied upon in isolation.

3.4 EQUITIES

Equities as an asset class is narrowly defined to include only preference and ordinary shares in companies. The overall limit of 75 percent is retained, subject also to per-issuer limits divided into three categories – small (5 percent), medium (10 percent) and large (15 percent). The limits will be checked for inflationary pressures over time and the Financial Services Board is enabled to update these accordingly. The limit for unlisted equities, whether held directly or through a private equity vehicle, is increased to 15 percent, subject to strict investment diversification and valuation requirements.

3.5 IMMOVABLE PROPERTY

As unlisted property may have significantly different risk management implications and risk profile from investing through a listed property vehicle, regulatory treatment distinguishes between listed (25 percent) and unlisted (15 percent) property exposure. Similar to equities, listed property is divided into three sub-categories – small (5 percent), medium (10 percent) and large (15 percent). The market capitalisation limits differ from that of equities to reflect the different structure of the listed property landscape.

Over time the limits will be checked and tested by the Registrar of Retirement Funds, and may be updated accordingly.

Debt instruments backed by property are now classified as debt rather than property, as these better reflect the characteristics of that asset class.

3.6 COMMODITIES

In recognition of hedging potential, a fund can invest in listed commodities of up to 10 percent in gold, or up to 5 percent in other commodities (up to a combined maximum across all commodities of 10 percent).

3.7 OTHER ASSETS AND ALTERNATIVE INVESTMENTS

Hedge funds and private equity funds are defined. If read together with the look-through principle and anti-avoidance clause, the new Regulation

[2] The raised limit on bank issued debt should ease structural funding challenges faced by the banks that may be caused by the prevailing Regulation 28.

prevents these products from being reported as the linking structure (for example a debenture issued against private equity fund cash flows). Instead the hedge fund or private equity fund must be disclosed as such.

Definitions provide guidance to the investment activities of these vehicles, and require that managers be registered under the relevant categories of the Financial Advisory and Intermediary Services Act of 2002 (FAIS). Given the particularly broad activity definition for hedge funds, the FAIS requirement gives added protection that products being disclosed as hedge funds are in fact hedge funds, and not some other product being "wrapped" in a hedge fund guise.

Accessing hedge funds or private equity funds through a fund of funds structure provides a valuable extra layer of due diligence and built-in diversification. Consequently the allowance per fund of hedge funds and fund of private equity funds is 5 percent (compared to 2,5 percent for investment into individual funds).

Provision is made for the Registrar of Retirement Funds to impose additional requirements to investments made through a partnership or trust structure. The Registrar is expected to also impose valuation standards informed by international best practice.

3.8 HOUSING LOANS

The December 2010 draft provided that housing loans issued directly by the fund should be curtailed to 5 percent of a member's accumulated retirement savings, compared to the prevailing 95 percent. Housing loans could still be obtained from a bank using a member's retirement fund savings as surety. This change in approach has been removed. While abuses are observed in the issuing of these loans, the National Treasury agrees that the December proposal exposed the fund to considerable risk. The existing regulatory treatment should therefore prevail.

3.9 FOREIGN ASSETS AND REGIONAL DEVELOPMENT

Foreign assets are currently defined in terms of the South African Reserve Bank's Financial Surveillance Department regulation and requirements. Regulation 28 therefore references this authority.

The concept of a "recognised foreign exchange" as contained in earlier drafts of the Regulation falls away, being incorporated into the definition of "exchange". To be considered as "listed" for the purposes of Regulation 28, a security must be listed on an exchange that is a full member of the World Federation of Exchanges (WFE). In addition, a registered Collective Investment Scheme holding foreign assets on an exchange that satisfies due diligence performed by the manager in terms of guidelines set by the Registrar of Collective Investment Schemes, likewise satisfies the definition. This latter allowance supports exposure by retirement funds to African and other foreign assets through a suitably regulated vehicle. Regional investment is further supported through the higher limits placed on unlisted debt and (directly held) unlisted equity (of 15 and 10 percent, respectively), as this is where securities listed on foreign exchanges that are not WFE members are accommodated. Lastly, it is noted that inward or dual listed securities on a South African exchange will be treated as “listed” for prudential purposes, and therefore be subject to up to the 75 and 50 percent limits for equities and dent respectively (although will of course remain subject to relevant foreign exposure limits). Through this channel, non-South African companies and foreign governments can access significantly more South African capital, and should support building South Africa as a regional financial centre and Gateway to Africa.

4. LOOK-THROUGH

In the past, asset managers would often hold more risky assets such as hedge funds through product wrappers, which would for instance reflect on Regulation 28 disclosure documents simply as “unlisted debenture” under the 25 percent allowance. To deal with this challenge of not seeing the real economic exposure of certain assets to a fund, the look-through principle provides that a fund cannot use an asset structure to circumvent the limits, and must “look-through” the linking structure to disclose the underlying assets.[3]

An exception however is made for private equity funds and hedge funds, where these vehicles themselves are seen in terms of Regulation 28 as the “final” asset, and must be reported as such – in other words no further look-through applies (this means that hedge funds will not be subject to derivatives requirements, and listed equity held by a private equity fund will be classified as unlisted for the purposes of Regulation 28). Tight definitions of hedge and private equity funds seek to ensure that the exemption of look-through is not abused, resulting in these vehicles being used to circumvent limits under the Regulation.

To alleviate extensive disclosure requirements, a *de minimis* rule is applied – 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.

5. BORROWING

Because of the risks involved, the Regulation is clear that funds should never borrow for the purposes of investing that borrowed money. The only time a retirement fund should be allowed to borrow money is when it runs into liquidity issues and needs cash to distribute to members leaving the fund. Even then, this borrowing should be limited in value, time constrained, and

[3] The Registrar of Retirement Funds will in addition require the disclosure of asset exposure obtained through the linking structure. Consider for example an exchange traded note linked to an underlying commodity asset. Applying the look-through principle requires reporting of the commodity exposure under Regulation 28 limits, but the credit risk associated by the issuer of the note is also relevant and will need to be disclosed to the Registrar for monitoring.

stay away from exploitative and/or inappropriate loan covenants, especially with regards to early settlement penalties or collateral arrangements.

6. REPORTING, EXCLUSIONS AND EXEMPTIONS

Not all investments of a fund need to be included in the calculation of the percentage limits. Some investments may be excluded on the grounds that they themselves comply with the Regulation. More specifically, collective investment schemes, linked insurance policies, and guaranteed long-term insurance policies may be excluded in this way.

To promote competition and improve the service offering to retirement funds, an entity that is regulated by the Financial Services Board and offers a Regulation 28 compliant product (like an investment fund managed by a FAIS registered manager), can now be similarly excluded from Regulation 28 limit calculations.

Funds may also apply to the Registrar for exemption from certain provisions of the Regulation for a certain time and with regards to certain limits.

It is important to reiterate that in its investment decision making, a fund should be driven by what is best for the fund, which in some instances may differ from limits imposed by Regulation 28. Where this is the case, funds are encouraged to engage with the Registrar of Retirement Funds to explore the possibility of obtaining exemption from certain limits should these become inappropriate. The National Treasury and the Financial Services Board will monitor the take-up of the new limits over time, to assess their ongoing suitability.

7. IMPLEMENTATION OF THE REGULATION

The Regulation will be effective from 1 July 2011. While certain funds may not be able to comply fully with the Regulation at that time, earlier implementation is intended to give funds the space to begin re-equilibriating to the new, more flexible limits. Those funds that do not expect to meet the compliance deadline should apply to the Registrar before 31 May 2011. Exemption may be granted on the basis that the fund can prove its path towards compliance.

It should be noted that only individual retirement policy contracts entered into before 1 April 2011 will be exempt in terms of the grandfathering clause. It is therefore emphasised that no additional policies that are not Regulation 28 compliant should be sold, as irrespective of any contractual arrangement entered into these will be required to be compliant as at 31 July 2011.

Industry participants are also warned against exploiting the grandfathering provisions to evade Regulation 28 – behaviour will be monitored and the grandfathering provisions will be removed should abuses be observed.

To further support stakeholder understanding of the intention and principles underpinning the final Regulation 28, the National Treasury and the Financial Services Board will host two public forums during March 2011. The purpose of these forums is to ensure that retirement fund and ancillary stakeholders are aware of their responsibilities under the new Regulation 28.

Notices and the guidance note on the treatment of securities lending, derivatives and part-guaranteed insurance policies will be drafted by the Financial Services Board in consultation with the National Treasury, and will be subject to stakeholder engagement. These, as well as a Guidance Note issued by the Registrar of Retirement Funds on hedge funds and private equity valuation, are expected to be finalised by 31 March 2011. A Notice on the appropriate use of credit ratings issued by credit rating agencies will be finalised at a later stage, following from the implementation of regulation of those entities.

VI. CONCLUSION

The revised Regulation 28 is considered rigorous, flexible and fair, attempting to promote transparency in those areas where rules have traditionally been circumvented, but also allowing for some level of innovative financial strategies and instruments where appropriate.

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 channelling savings for investment to promote economic growth and support ESG considerations.

The National Treasury is sensitive to the fact that the new Regulation 28 may pose significant challenges to some retirement funds in terms of achieving compliance, as these funds may be operating widely outside of the proposed asset class limits. Even for those retirement 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 of adjustment. Retirement funds should engage the Registrar of Retirement Funds in this regard.

The National Treasury and Financial Services Board thank all stakeholders for their open and constructive engagement on this Regulation.