

DRAFT REGULATION 28

AS PER SECTION 36(1)(BB) OF THE PENSION FUNDS ACT 1956

**NATIONAL TREASURY PRESENTATION
ASISA ANNUAL CONFERENCE – 15 MARCH 2010**



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REPUBLIC OF SOUTH AFRICA

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INTRODUCTION

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- MoF makes regulations limiting the extent to which a pension fund may invest in particular assets & asset categories
- Draft regulation released for public comment on 17 February 2010
- Comments on the proposed amendment may be submitted in writing on or before Friday 16 April 2010
- NT / FSB to engage stakeholders, esp. wrt proposed definitions, investment categories & investment category limits



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BACKGROUND

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Key reasons for the amendments to Regulation 28 are:

- **References other Acts and regulations** that have been amended or substantially altered since 1998 (reference is made to the Acts directly as well as provisions contained therein).
- **Inconsistent application of definitions, asset categories & the structure of limits** between pension funds & other investment funds.
- **Investment channels available to pension funds have significantly changed** with the incorporation of derivatives, structured products and foreign investments, & are not explicitly accommodated.
- The **exclusion of insurance policies which incorporate a guarantee** allows insurers to offer retirement savings products enabling trustees to exceed the limits prescribed in Regulation 28, allowing for the by-passing of prudential limits.
- **No provision for Islamic-compliant pension fund's to diversify risk**, through interest-equivalent instruments.
- **Global financial crisis** has exposed pension funds to greater risk, and hence the need to update the investment channels that prudent pension funds can invest in.



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THE CURRENT REGULATION

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The maxima are broadly:

- No more than 75% may be invested in equities
- No more than 25% may be invested in property
- No more than 90% may be invested in a combination of equities and property
- No more than 5% may be invested in the sponsoring employer
- No more than 15% may be invested in a large capitalisation listed equity, and 10% in any single other equity
- No more than 20% may be invested with any single bank
- No more than 15% may be invested off-shore (recent excon limit changes upwards provided for upon application to Registrar i.e. imposed limit is 20%)
- No more than 2,5% may be invested in “other assets”



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PROPOSED AMENDMENTS

PROPOSED AMENDMENTS I

DEFINITIONS

- **Current Law** – Definitions outdated & incomplete due to new products like derivatives, changes to the market that have taken place since 1998, and changes to governing legislation across the financial services sector that impact pension funds and pension fund management.
- **Proposal** - Definitions added & amended to specify the meaning of terms used in the regulation and aligned across the investment management regulatory regime to ensure consistency

INDIVIDUAL MEMBER CHOICE

- **Current Law** - Reg 28 applies only to the fund as a whole and therefore may expose an individual member wholly to a high risk asset category.
- **Proposed Amendment** - Where a fund provides an individual member with an option to elect his or her underlying investments and that member is directly exposed to the return on the elected underlying investments, the underlying investments must now comply with Reg 28 and its spreading requirements.

PROPOSED AMENDMENTS II

SCOPE OF REGULATION 28

- **Current Law** - Retirement annuity policies (that provide a guarantee) are excluded from Reg 28 limits, and may be excluded from the Long-term Insurance regulation if its value is linked to underlying assets.
- **Proposed Amendment** - Exemption removed, ensuring all retirement annuity policies invest within Reg 28 limits.

APPLICATION OF THE “LOOK-THROUGH” PRINCIPLE

- **Current Law** – Not provided for, meaning that pension fund investment managers can circumvent prudential limits by investing through layers of investment vehicles to mask the underlying investment exposure.
- **Proposed Amendment** - Look-through principle will apply for calculating exposures wrt derivative, foreign asset exposures & investments in underlying asset class through another fund.



PROPOSED AMENDMENTS III

INVESTMENT REQUIREMENTS FOR ASSET CATEGORIES

Definitions & Categories

- **Current Law** - Inconsistency of definitions and asset categories applied in Reg 28 and other legislation governing investment fund managers.
- **Proposal** - Definitions aligned to SSA & CISCA & Islamic-compliant instruments defined. Categories & limits aligned with CISCA categories.

Credit Rating Agencies

- **Current Law** - No oversight of CRA. Within asset categories assets treated the same irrespective of credit-risk profile.
- **Proposal** - Registrar to prescribe which CRAs may issue credit ratings. For asset categories exposed to credit risk, credit rating bands are created, consistent with CIS.

Islamic-compliant pension funds

- **Current Law** – Can still comply with Reg 28 by spreading investments across the categories of non-interest generating investments but principle of spreading undermined & members exposed to reduced risk management.
- **Proposal** - Money market and a bond “equivalent” Islamic investment instrument defined to create Islamic-compliant long- and short-term fixed-income type investments

Property as an asset class

- **Current Law** - No distinction between listed/unlisted or regulated/unregulated
- **Proposal** - Distinguish direct holding of an underlying property and mortgages/loans from indirect exposure to property through a listed property investment instrument (which it is proposed fits within the listed securities asset category).

PROPOSED AMENDMENTS IV

ADDITIONAL INVESTMENT REQUIREMENTS

- **Current Law** - Modern investment products & changed excon regime not accommodated.
- **Proposal** -

Borrowing: Pension Fund Circular 21 provisions inserted to protect the fund against irresponsible borrowing, in particular to ensure that the fund is not exposed to liquidity risk or inappropriate loan covenants.

Foreign investments: Aligns excon regulations allowing 20% of assets in investments outside of the Republic.

Foreign Investments into Africa: Aligns excon regulations allowing an additional 5% to foreign exposure limit of 20% for investment into African assets.

Securities lending: To promote income generation & capital market liquidity, funds permitted to engage in securities lending subject to limits and conditions, to be prescribed by Registrar. Draft Notice to be released for public comment.

Derivative instruments: Investment permitted for purposes of efficient portfolio management and hedging against an investment held by the fund s.t. provisions & conditions prescribed by Registrar. No gearing or leverage allowed. Draft Notice governing investment by pension funds into derivatives to be released for public comment.



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THE BIG 6

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1) Structure of reg 28 draft

- Harmonise SSA/CISCA/PFA & excon developments

COMMENT ON: Do proposed definitions & categories make intuitive sense, are asset categories consistent with risk management decision making, which definitions/regs are clear and which may be st abuse?

2) Derivatives, gearing & hedge funds

- Look-through applies to derivatives for regulated investment vehicles
- No gearing allowed by pension fund or any investment vehicle, BUT HF exempted – FOR NOW - & st derivative rules *to be prescribed*, incl must be covered & disclose full exposure
- Will review subject to improved reg of alternative investment industry

COMMENT ON: Impact, potential benefits/harm to PF of HF exposure, current HF exposure & on what basis, counter-proposal... AND consider Draft Notice on derivatives

3) Unlisted securities

- Only interest rate products, no equity, st credit rating bands to avoid “creativity”
- Private equity = unlisted equity = other assets = 2.5%
- Current wording problematic so: 1) rename or 2) expand listed securities to incl. equity instruments

COMMENT ON: Role/benefits/dangers unlisted securities (& private equity in particular), where private equity should be accommodated & why & what limits



THE BIG 6

4) CRA & CR bands

- Limits st refinement, esp *assets in liquid form*
- CRAs to be st registration & oversight, Bill planned for public comment 2010
- Phased in approach:
 - PHASE 1 => Registrar to prescribe qualifying CRA & bands, consistent with CIS though limits may differ as sector appropriate
 - PHASE 2 => Interface with reg CRA

COMMENT ON: Concept rating bands, impact, BUT ...wait for Draft Notice for detail!

5) Property

- Separate listed/indirect property exposure from unlisted/direct
- Require overall property exposure limit = 25%
- Consider decreasing direct property exposure limits

COMMENT ON: Treatment of listed vs direct property holding exposure & risks i.e. how treated from risk management view, appropriate limits, impact on PFs if reduce direct holdings limit & whether reduction wise from prudential risk management perspective

6) ETFs

- Apply SSA definition = derivative = apply look-through so commodity ETFs prohibited (as commodity underlying not provided for)
- Consider expanding Kruger Rands category (Table 1 Category 2)

COMMENT ON: Role/potential benefits/dangers ETFs and commodity funds in particular, view on if/how to accommodate & why & what limits



END OF PRESENTATION

WHO TO CONTACT?

National Treasury:

Katherine Gibson

Director: Financial Markets and Competitiveness

Financial Services Board:

Alta Marais

Head: Research and Policy

FOR COMMENTS:

Query Linda van Zyl, National Treasury

012 315 5698

Submit comments to: reg28@treasury.gov.za





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QUESTIONS?