
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.

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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.

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- 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.

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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

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

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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

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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.