national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

REVISED DRAFT REGULATIONS 37, 38 AND 39 ISSUED IN TERMS OF SECTION 36(1)(c) OF THE PENSION FUNDS ACT, 24 OF 1956

1. INTRODUCTION

Section 36(1)(c) of the Pension Funds Act, No. 24 of 1956, empowers the Minister of Finance to make regulations "on all matters which he considers necessary or expedient to prescribe in order that the purpose of the Act may be achieved." The Supreme Court of Appeal (2003 (6) SA 38 (SCA) at paragraph 14) has held that "[t]he general public interest requires that pension funds be operated fairly, properly and successfully and that the pension fund industry be regulated to achieve these objects. That is the whole purpose of the Act."

2. PROCESS

National Treasury released a first draft of amendments to the regulations issued in terms of section 36 of the Pension Funds Act on 22 July 2015. Various dedicated workshops were held with stakeholders and industry associations. After receiving and deliberating on public comments received on the first draft, a second revised draft is now being released for further public comment.

The feedback received on the first draft released in 2015 largely agreed with the principles on the introduction of default preservation, investment portfolios and annuities. Major issues put forward were around the practicality of implementing certain requirements of the default regulations.

3. SUMMARY OF COMMENTS RECEIVED

- A common concern was mentioned around the extent of the prescriptiveness in the first draft of the regulations.
- A concern was raised that the permitted degree of customisation of the default investment portfolio is limited, and might require taking into account individual assets outside of the fund, which may be impractical. Commercial umbrella funds argued

that customisation should be permitted at sub-fund level rather than be constrained to be the same across the entire fund.

- The requirement that boards *consider* passive or enhanced passive asset management was misunderstood by a number of respondents as a requirement to only adopt passive investment strategies.
- Concern was expressed that the default regulations have the effect of prohibiting smoothing of investment returns, with consequent unintended member behavioural or other consequences.
- Concerns were expressed about the implied liquidity requirements for funds to allow individual members to switch out of default investment portfolios at intervals not exceeding 3 calendar months. It was argued that this interval was too short and it could impede the ability of retirement funds to take advantage of the premium associated with illiquid investments.
- The blanket ban of the use of performance fees in the default investment portfolio was objected to for a number of reasons, namely:
    - Performance fees incentivise asset managers to outperform the benchmark;
    - Performance fees serve the interests of retirement fund members because they shared risk between the active asset managers and members; and
    - International investment and alternative asset classes such as private equity, infrastructure and hedge funds would be inadvertently excluded from consideration despite them being regulated under Regulation 28 of the Pension Funds Act.
- Given the administrative difficulties associated with employer-based funds having to maintain individual relationships and contact with paid-up members, a request was made that out-of-fund preservation option also be allowed as a default. It was further noted that the regulations are drafted in a manner that does not allow benefits preserved in-fund to qualify for the once-off withdrawal, which could put in-fund preservation at a significant disadvantage to out-of-fund preservation, leading to many members opting out of the default. Also, a number of concerns were raised that in-fund preservation could increase the number of unclaimed benefits as members could fail to inform the fund of any change of their contact details.
- The provision requiring preserved funds to automatically be invested in the default portfolio was found to be burdensome.

- It was requested that the regulations should allow that a benefit from a Defined Benefit ("DB") scheme be converted to a Defined Contribution ("DC") benefit once the benefit has accrued but before it is preserved.
- Clarity was requested on the role and remuneration of a retirement benefits counsellor. There were concerns also that the description of a retirement benefits counsellor as an individual might create challenges for small funds or for highly geographically diversified funds and may increase the administration cost of a fund. The requirement that funds provide *access* to retirement benefits counsellors was also frequently misunderstood to mean that members must be forced to consult retirement benefits counsellors. Clarity was also sought that the counsellor will only provide information/fund options and not advice.
- Clarification was requested on the process outlined in the regulation which made 'pot-follows-member' a default.
- The value to members of preserving very small amounts of money, which will quickly be eroded by charges and raise the costs of administration for all members was questioned.
- Concerns were raised about the implications of automatically defaulting members into annuity products that could be irreversible (for example a life annuity), especially with the new dispensation of members being able to defer retirement or being able to elect when to retire.
- Concerns were also raised that the regulations appear not to allow living annuities to be purchased from an insurer outside of the fund.
- A number of commentators thought that the number of portfolios permitted (3) was too small, especially once Sharia and cash portfolios were allowed for.
- Administrative difficulties were raised on age specific drawdown rates, especially when policy-renewal anniversaries do not coincide with the dates of birth. Questions were also raised about whether individuals who, either initially or subsequently choose drawdown rates above the age-specific maximums would be required to leave the default option.
- Some respondents raised concerns that the requirements that trustees should monitor the sustainability of living annuity incomes and take remedial action when members' incomes are unsustainable were too onerous.

- Some queries were raised on whether the provisions of 37C of the Pension Funds Act would apply to living annuities paid from within the fund.
- Concerns were raised about whether the non-guaranteed annuities were a desirable product for retirees.
- The requirement to pass all actuarial surplus or deficit to every member every two years was found to be unnecessarily restrictive because it would prevent trustees from smoothing pension increases satisfactorily.

4. EXPLANATION OF THE REVISED PROVISIONS IN THE SECOND DRAFT

The default regulations broadly and mainly seek to standardise and simplify, where appropriate, the default investment portfolios members are enrolled into during the accumulation phase, with the aim of promoting transparency and reducing costs. Secondly, the default regulations aim to protect members at retirement or in the de-accumulation phase, by providing them with cost-effective and suitable annuities. Lastly, the default regulations seek to encourage preservation when members change jobs, which is critical in assisting members to retire with decent retirement savings.

Following comments from the public, the first draft of the regulations has been revised with the following objectives:

- Make compliance easy, thereby aiding in reducing compliance costs
- Enable flexibility by using more of a principles-approach to regulation
- Encourage and facilitate better and appropriate decision-making by members

A. DEFINITIONS

The definition of “default annuity” has been clarified to make the purchase of an annuity a “soft” default by having to “opt-in” instead of “opting-out”. This is because being defaulted into certain annuities, like a life annuity, would make it impossible for members to opt-out once defaulted into the product.

“Retirement benefits counsellor” has been changed to “retirement benefits counselling” to give the funds the discretion of choosing how information is provided to members.

Other definitions (i.e. default investment portfolio, retirement funding contributions and retirement savings) have been refined to do away with ambiguity and reflect definition as contained in other pieces of legislation.

B. REGULATION 37: DEFAULT INVESTMENT PORTFOLIO

Characteristics of members

The requirement that boards must take into account the likely characteristics and needs of members whose retirement savings will be invested in the default investment portfolio has been deleted. The guidelines, like an assessment of the financial sophistication of members and their ability to have access to individual financial advice, seemed too prescriptive.

Passive and active investing

The section has been appropriately reworded to allow funds to equally consider both passive and active investment strategies when choosing investment portfolios as a default.

Products with elements of guarantee

Clauses that dealt with default investment portfolios being purely for investment purposes have been deleted. These clauses were interpreted as banning smoothing of returns. Smooth bonus policies, for example, are eligible for inclusion in default investment portfolios if in compliance with conditions, rules and regulations to be set by the Financial Services Board ("FSB"). In considering such products, funds should always aim at treating members fairly, disclosing and using appropriate formulae, managing properly any conflict of interests, and using appropriate benchmarks.

Performance fees

Investments that have a performance fee element will also be allowed subject to, in the interim, compliance with an industry standard that should simplify methodology and disclosure, and funds motivating their use to the FSB as part of their compliance with the default regulations and Regulation 28. The standard could ultimately be supplemented or replaced by an FSB regulatory standard. The appropriateness of performance fees will be monitored during both the industry and FSB sanctioned standard, to enable review of the policy decision if necessary.

The revision is informed by the understanding that retirement funds, as institutional investors and therefore "qualified investors", should be in a relatively better position to assess the appropriateness of performance fees, *vis-à-vis* retail investors. Secondly, the revision acknowledges that certain alternative asset classes which are already regulated under Regulation 28 and other frameworks could be useful in diversifying investment opportunities and risk, and thereby enhancing long-term returns.

Regulation 28 compliance

Assets held in any investment portfolio on behalf of retirement fund members are already required to comply with Regulation 28. This requirement in the regulation was found to be superfluous and has therefore been deleted.

Grandfathering

Default arrangements in place before the regulations come into effect will be exempt from this regulation unless their terms or conditions change. Any new default arrangements (investment, preservation and annuities) that are entered into after the effective date of the regulations should comply with this regulation.

C. REGULATION 38: DEFAULT PRESERVATION AND PORTABILITY

Investment

Automatically moving preserved funds to be invested in the default investment portfolio cannot be possible as the regulations require the member to consent before preserved funds are transferred anywhere. This clause has subsequently being deleted.

Fees

Administration fees are often expressed as a percentage of salary, and not as per member amounts and will therefore differ in Rand terms between members. This method can therefore not be used if administration fees are not allowed to differ. Hence, the second draft has been amended to allow for different methods of calculation of administration fees. However, investment fees should be the same for members; hence the amendment to say investment fees and charges should not differ between active and paid-up members.

"Pot-follows-member"

The regulations have been clarified not to make "pot-follows-member" a "sub-default" after in-fund preservation. This means that a member should remain paid-up until consent from the member is provided for the member's share of the fund to be consolidated or transferred anywhere else. This will enable members to make appropriate decisions and not take advantage of some of the loopholes or current convenient trends in the system (e.g. cashing out), which could be to their detriment.

Members should also be able to access their default preserved funds anytime, and whatever amount.

The regulations do not prohibit out of fund preservation. As a default (i.e. if an active choice is not made) members will have their benefits preserved in-fund. However, members have the option of transferring their accumulated benefit either to a preservation fund of their choice or as per advice.

DB benefits

In the case of DB benefits, the regulations have been clarified to state that a DB benefit should be converted into a DC benefit once they have accrued but before they are automatically preserved.

De minimis

The regulations do not make provision for a *de minimis* amount for preservation. Any amount left by the member should by default be preserved until the member elects otherwise. Prescribing an amount below which preservation might not be possible could encourage unnecessary frequent withdrawals. Further, having a *de minimis* amount would imply that a member no longer preserves by default but as a choice and if the benefit is above the threshold.

The regulations also do not prescribe an amount that a paid-up member can withdraw from the preserved benefit. It is however, not an “all-or-nothing” rule as currently understood by commentators. Fund rules should, therefore, specify whether to allow withdrawal of the entire amount preserved or part withdrawals.

Managing future unclaimed benefits

A process is currently underway at the FSB to resolve the issue of unclaimed benefits, part of the solution being to set up a centralised database. It is envisaged that this database would in the long run be extended to be a depository for the paid-up member certificates. In the interim, it is envisaged that a certificate will be issued by the fund to the paid-member. The new employer (or fund) should enquire about the certificate from the member and request for it if the paid-member decides to transfer the preserved savings.

D. REGULATION 39: DEFAULT ANNUITIES

The “default annuity” has been amended to make the purchase of an annuity a “soft” default by having the member “opt-in” instead of “opting-out”. This is because being defaulted into certain annuities, like a life annuity, would not allow the member to opt-out once defaulted into the product. The “soft default” obviates, to a certain extent, the need for extensive prescription in the regulations. Secondly, the default has been amended to take into consideration current trends and preferences and to still protect members within their particular preferences and biases - a default loses its purpose if many participants opt out of it.

This section has been considerably simplified and reduced largely to principles and conditions.

Out-of-fund annuities

The revised regulations make both in-fund and out-of-fund living annuities eligible annuities provided that the stipulated principles and conditions are met.

Drawdown rates

There is a case to be made that drawdown rates for living annuities should actually be more guided by the capital at retirement, than only or largely by age at and in retirement. A combination of both age and capital factors could be appropriate. In the interim, the drawdown rates should be compliant with an industry standard on living annuities. This could be further enhanced or replaced by an FSB standard.

E. GENERAL RESPONSES

Applicable level of customisation in umbrella funds

The regulations do not prescribe whether umbrella funds should customise their default investment portfolios at fund level (i.e. across the entire fund) or at sub-fund level (i.e. at participating employer level). In addition, the regulations only *allow* but do not *require* or *compel* funds to customise defaults based on the specified member variables (i.e. age or likely retirement date, value of retirement savings and actual/expected retirement funding contributions).

Application of section 37C of the Pension Funds Act to in-fund living annuities

Currently, section 37C does not apply where individuals purchase living annuities outside the fund. The legal position also appears to be ambiguous as some funds do apply section 37C to post-retirement benefits (i.e. annuities) while others do not. No changes have been made to the regulations in respect of this concern.

Application to Retirement Annuities

The regulations on annuitisation will also apply to Retirement Annuities (RAs), given that they are required to annuitise benefits at retirement and it is hoped that the principles in the regulations would benefit individuals in the retail space. The default regulations on preservation will not apply. The default regulations for investment portfolios also seem unnecessary for RAs given that members exercise a choice from inception. It is though, important, that RA providers ensure that their members understand properly the nature of RAs, including the inability to withdraw before retirement, and any other useful information.

5. CONCLUSION

The revised regulations have been amended taking into account numerous comments submitted by the public, industry and other interested stakeholders. The regulations seek to largely promote simplicity, transparency, disclosure, good value products, member protection, and to ensure that the board of a retirement fund always acts in the best interest of fund members during the accumulation and de-accumulation phases of retirement benefits.

6. CONSULTATION

Submissions are invited on the form and content of this regulation. Please send all comments before 28 February 2017, to Ms Alvinah Thela, Director: Retirement Funds, National Treasury, Private Bag X115, Pretoria, 0001. Submissions may also be submitted by fax to 012 315 5206; or by email to retirement.reform@treasury.gov.za.