Shedding light on the Regulation 28 amendments

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Amendments to Regulation 28 of the Pension Funds Act ("PFA") have gone through a lengthy process since February 2021. These amendments were gazetted on 1 July 2022 and National Treasury ("NT") published another media statement on the matter on 5 July 2022. It is important to remember that the increase in foreign exposure for institutional investors has been allowed since 23 February 2022. The other long-awaited amendments to Regulation 28 that were gazetted now, will only be effective as from 3 January 2023.

Foreign exposure

Regulation 28 stipulates that the aggregate exposure to foreign assets is limited to a percentage, or amount, as prescribed by the South African Reserve Bank ("SARB"). During the February budget speech, the Minister of Finance confirmed that this exposure will be increased for institutional investors (therefore retirement funds, long-term insurers and collective investment scheme managers) from the respective 30% and 40% to a single limit of 45%. Therefore, the limit of 45% in aggregate applies to all applicable investments outside of South Africa. It is no longer necessary to distinguish between foreign as opposed to Africa. This increase came into effect on 23 February based on the publication date of the SARBs 'Exchange Control Circular'. The Financial Sector Conduct Authority ("FSCA") also confirmed this increase in March with the publication of a formal FSCA Communication.

Practically this means that retirement fund members may invest a maximum of 45% of their investment portfolios offshore. In the context of life insurance policies (such as endowments and sinking funds) as well as living annuities, the increase translates to life companies being able to possibly offer more foreign exposure as they may invest a maximum of 45% of their retail assets offshore.

The purpose of Regulation 28

Simply stated the intent of the regulation is to protect the savings of retirement fund members against a lack of investment diversification by prescribing exposure limits to particular asset classes. The PFA provides that the Minister of Finance may determine these limitations and currently they are provided for in Regulation 28.

The changes to this regulation (outside of the increased foreign exposure) that have now been made law, will only be effective 3 January 2023 but the industry will be preparing for implementation until that date. The said changes relate to the asset classes and exposure percentages. A prescribed percentage means that a retirement fund may only invest up to a stated percentage of the aggregated fair value of the total assets of such a fund.

The actual amendments

Infrastructure

The purpose of this change is to enable longer-term investment into infrastructure to assist economic development. The first point of importance is to understand that the amendments did not categorise infrastructure as a separate or new asset class. The main asset classes in the regulation remain cash, debt instruments, equities, immovable property, commodities, hedge funds and private equities. In addition, there are also limitations on housing loans in a pension fund, investing in the business of a participating employer and exposure to 'other' assets (excluded from the said categories).

"Infrastructure is simply now recognised for the purposes of limitation and reporting, within the existing asset classes of Regulation 28" says PG Marais, legal adviser at Sanlam Corporate. Retirement funds will be required to measure the apportionment to infrastructure per asset class and report thereon. Strict reporting requirements in this regard are made provision for with the addition of a 'Table 2' in the regulation. Fortunately for the industry the final amendments only prescribe the reporting via the new table for the top twenty holdings in infrastructure as opposed to all, as initially proposed. A retirement fund will have to indicate the percentage and rand value allocation to infrastructure per each asset class.

What exactly infrastructure means is of obvious importance. Investopedia defines infrastructure as the physical systems of a business, region or nation that are vital for economic development and prosperity. Examples according to this definition include transportation systems, communication networks, sewage, water and electricity systems. These projects are normally funded publicly, privately or via a partnership.

The definition for infrastructure in the regulation has gone through various changes. Initially the definition referred to only *installations, structures, facilities, systems and services or processes relating to the national infrastructure plan*, which in turn refers to the development of public infrastructure. Private sector, as well as developments in the rest of Africa, were not included. In a second attempt at the definition there was reference to *assets constructed for the provision of social and economic utilities or the benefit of the public*. At the time it was explained that the reference to *social benefit* will allow for incorporating impact investments which is merely investments that aim to generate positive and measurable social and environmental impact alongside that of financial return. The word *social* was removed from the final definition.

Now infrastructure refers to assets with (or operating with) a primary objective of developing, constructing or maintaining physical assets and technology structures (and systems) for a specific purpose. The purpose must be to provide utilities, services or facilities to the benefit of the economy, businesses or the public. “Infrastructure therefore now includes the private sector and the definition is quite wide” says PG Marais. The industry might be requesting guiding principles on the interpretation of this definition. Retirement funds need to report on the percentage apportionment to infrastructure per asset class and also confirm the percentage infrastructure investment that relates to the rest of Africa. Guiding principles will be welcome as the wide definition could result in unintended consequences. The reference to a primary objective for the asset could also be one that is open to wide interpretation.

There has been some industry opinion that due to the wide scope, the maximum allowable exposure to infrastructure should be even higher than the final gazetted limit of 45% to direct infrastructure investment per fund. It is important to note that with the overall limit to infrastructure across all asset classes, there are specific instruments excluded from the asset classes in this context. The excluded instruments are debt instruments issued by the government, loans to the government and debt or loans guaranteed by the government.

Hedge funds and private equity

Regulation 28 previously defined hedge funds, private equity and other excluded assets as one combined asset class with a collective limit of 15%. Separately this means a maximum allocation to hedge funds of 10%, private equity of 10% and other excluded assets of 2.5% is allowed as long as the collective exposure is not above 15%. These three asset classes have now been separated. There is no overall collective limit anymore. Private equity exposure is up from 10% to 15% whilst hedge funds remain at 10% and excluded assets at 2.5%. This is only effective as from 3 January 2023.

The amended definition of a hedge fund means that retirement funds, as an example, may only invest in hedge funds approved in terms of the Collective Investment Schemes Control Act (“CISCA”).

The amendments now clarify that any direct or indirect exposure to a hedge fund or private equity must in fact be reported as an investment into one of these asset classes. A look-through is not required other than for the requirement to check and report on the percentage infrastructure investment in these asset allocations.

Look-through principles

The look-through principle in this context could be explained as the requirement to assess and include for reporting purposes, the composition of underlying investment instruments used in a particular investment structure or investment portfolio. Regulation 28 explains the look-through principle as a rule that states an investor may not circumvent the exposure limits by ignoring the make-up of an underlying asset and must include and disclose the exposure to which the underlying assets relate.

With the amendments, the look-through principle now applies to collective investment schemes ("CISs") and insurance policies, for example, in all circumstances, even if an audit certificate was issued. This addition will strengthen the understanding of the authorities around underlying exposure to enable proactive supervision.

Housing loans

This rule does not apply to retirement annuity funds or preservation funds. The asset allocation to housing loans granted to pension fund members is down from 95% to 65% for new loans granted after 3 January 2023. This specific rule in the regulation applies to the limit on total exposure via the *loan book* of a pension fund in the context of 'investing' in housing via members and the loans granted to them. Explained differently it means that a specific pension fund could previously have an investment allocation of up to 95% into housing loans for members but may, as from 3 January 2023, only have a maximum of 65% invested into these loans. According to the media statement the reason for the decrease in exposure is to curb the abuse of housing loan schemes by fund members. NT did promise to continuously monitor whether this limit truly enables the intent as they do recognise the importance of home ownership in wealth creation and retirement provision.

PG Marais explains that section 19(5) of the PFA also regulates this type of investment for pension funds and that an amendment to this section of the Act may also be required to give effect to NT's intention of curbing abuse of housing loans by fund members. Although section 19(5) has not been amended, he argues that limiting the value of housing loans to members to only 65% of the member's fund value, would be in line with NT's intention.

Crypto currencies

The amendments now clearly prohibit the investment into crypto currencies because of volatility and a lack of regulation. There is also a rule that these types of assets may not be added under the grouping of 'other excluded assets not included'. One must be reminded of the fiduciary duties of retirement fund trustees towards their members. Investopedia explains 'fiduciary duty' as being bound legally and ethically to act in the best interest of another.

Excluded assets

There is a list of assets which may be excluded when applying the limits of Regulation 28 on a retirement fund level. This list includes participation in collective investment schemes and long-term insurance policies, as long as the underlying assets in these structures separately comply with the limits.

The amendments now read that as from 3 January 2023 this list of assets may no longer be excluded for the purposes of complying on a retirement fund level. The look-through principle should therefore apply to the underlying instruments used in these assets and the use of the assets will count towards the limits set in Regulation 28 on a retirement fund level as well.

Exposure to a single entity

The 25% limitation on exposure to any one particular entity or company has been amended as well. Currently this limitation only applies to certain sub-categories of asset classes but as from 3 January 2023 will apply to all asset classes. It means that no retirement fund may invest more than 25% across all asset classes in any one particular entity or company. Again, the only exception to the rule is for debt instruments issued by the government, loans to the government and debt or loans guaranteed by the government.

Conclusion

The above amendments are only effective as from 3 January 2023. The FSCA confirmed that they are in the process of finalising the standard on reporting requirements that will be aligned with the revised Regulation 28 and this standard will be issued for public comment soon.

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