Retirement Fund Update

Quarter 1 of 2016

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Financial Services Board: New Acts, Regulations and practice notes

1. The Financial Sector Regulation Bill, 2015

The Bill was tabled in Parliament and follows the so-called "Twin Peaks" approach to financial regulation. It will establish two separate regulators:

- the Prudential Authority ("PA") within the South African Reserve Bank to oversee the safety and soundness of financial institutions; and
- the Financial Sector Conduct Authority ("FSCA"), responsible for matters relating to market conduct, and aimed at ensuring that financial customers are treated fairly by financial institutions. The FSCA will replace the FSB.

The implementation of the Twin Peaks model in South Africa has two fundamental objectives:

- to strengthen South Africa's approach to consumer protection and market conduct in financial services; and
- to create a more resilient and stable financial system.

The objective of the FSCA will be to protect financial customers by:

- ensuring that financial institutions treat financial customers fairly;
- enhancing the efficiency and integrity of the financial system; and
- providing financial customers and potential financial customers with financial education programs, and otherwise promoting financial literacy and financial capability.

However the power of the Prudential Authority to make prudential standards for certain financial institutions, including retirement funds, with respect to the safety and soundness of those financial institutions and otherwise to achieve the objectives of the Prudential Authority, is also to be exercised by FSCA.

The Bill proposes that the Minister must prescribe in regulations a date for when the requirements proposed in relation to certain matters would be effective, from the date of the Financial Sector Regulation Act coming into effect, given the extent of the transition to the new framework.

The Bill also contains consequential amendments in respect of various relevant Acts of parliament in order to align these Acts, including the Pension Fund Act, with the envisaged Financial Sector Regulation Act. As a result of the FSB being replaced by the FSCA, any reference in the Bill to the Registrar of Pension Funds must be read as a reference to the FSCA.

The powers and duties of the FSCA in terms of the Pension Funds Act are in addition to the powers and duties that it has in terms of the envisaged Financial Sector Regulation Act.

An important mechanism for enhancing both the prudential and market conduct regulation of financial products and services is the provision for the Prudential Authority to issue prudential standards and the FSCA to issue market conduct standards.

If the Pension Funds Act requires a matter to be prescribed by regulation, a reference in the Bill to a matter being prescribed must be read as—

- a reference to the matter being prescribed in a prudential standard or a conduct standard; or
- a reference to the FSCA determining the matter in writing and registering the determination in a Financial Sector Information Register. The National Treasury must establish and maintain the Register. The purpose thereof is to provide reliable access to accurate, authoritative and up to date information relating to financial sector laws, regulations, regulatory instruments and their implementation.

It is envisaged that the Twin Peaks system will be implemented in two stages.

According to the memorandum on the objects of the Bill the first stage establishes the regulators and a uniform system and standards, with existing sub-sectoral (or activity-based) laws (for example on insurance and banking) remaining in place. In the second stage, the focus will be to streamline the current activity-based legislation (separate for banking, insurance, credit, pensions, etc.) into consolidated legislation, to reduce the scope for regulatory arbitrage.

2. Draft Notice on Financial Soundness, 2015

In terms of section 18(1) of the Pension Funds Act ("Act") the Registrar of Pension Funds may direct a fund that is not in a sound financial condition to submit a scheme setting out the arrangements that have been made, or which it intends to make, to bring the fund into a financially sound condition within such period, and subject to such conditions, as determined by the Registrar.

The Registrar intends to prescribe the criteria for financial soundness and the valuation basis in terms of which financial soundness is determined, as well as particulars relevant to a scheme of arrangement.

Prescribed valuation basis for Defined Benefit ("DB")

The prescribed basis for the determination of the value of assets is its fair value (as contemplated in the financial reporting standards) and the value of liabilities must be determined taking into account various prescribed considerations. In the determination of the value of a fund's liabilities, any actuarial assumption must:

- be realistic;
- have regard to the nature of the fund concerned; and
- be guided by past experience, as modified by knowledge or reasonable expectation of changes in the future, including events such as expected changes in taxation regimes or other legislation, which may impact the expected experience of the fund.

In terms of an explanatory memorandum to the draft Notice, boards of funds and their valuators must endeavour to comply with TCF (Treating Customers Fairly) outcomes where assumptions are set to value the assets and liabilities of a fund to determine whether or not it is financially sound.

The draft Notice also contains requirements regarding the following:

- *Determination of the discount rate*
- *Determination of the assumption for general price inflation*
- *Determination of the assumption regarding future pension increases*
- *Contingency reserve accounts and motivation for these. (The establishment and magnitude of any contingency reserve account by a fund must be motivated by the valuator in the relevant report on the statutory actuarial valuation.)*

Valuation results of DB funds

At the date of valuation, the valuator must report on the financial condition of a fund in terms of the following two bases in the relevant report on the statutory actuarial valuation:

- **Bond based basis** excluding the value of contingency reserve accounts.
  (In terms of the bond based approach the valuator must select a discount rate that reflects market yields on appropriate bonds commensurate with the duration, nature and currency of the liabilities at the valuation date); and
- **Funding basis** including the value of contingency reserve accounts which are established or which the board deems prudent to establish on the advice of the valuator
  (A risk premium approach may be used to determine the liabilities on the funding basis.)

The funding basis must be used to:

- determine whether a fund is financially sound;
- determine contribution rates and benefit payments; and
- fund minimum individual reserves.

Distribution of surplus

The greater of the value of the liabilities determined on the bond based basis and the value of the liabilities and contingency reserve accounts on the funding basis must be used to quantify surplus for distribution in terms of section 15C of the Act. In other words the surplus available for distribution will be the smaller of the surplus reflected on the bond based basis and the funding basis (including the contingency reserve accounts).

Pension increases amounting to the higher of the pension increase policy and 100% CPI are not considered a distribution of surplus.

Financial Soundness Criteria

DB categories of a fund

In the case of a deficit the valuator must state the measures taken or recommended to eliminate such deficit and the expected period within which it is anticipated that the deficit will be eliminated, with the consent of the board of the fund and/or the sponsor where this is considered to be appropriate.

The funding level determined in terms of the funding basis must be equal to or exceed 100% for a fund to be financially sound, failing which the board must take steps to bring the fund into a financially sound condition and a scheme of arrangement must be submitted to the Registrar.

Defined contribution ("DC") categories of a fund

The financial position of DC categories of a fund should at all times be such that the fund is financially sound.

The funding level must be equal to or exceed 100% for a fund to be financially sound, failing which the board must take steps to bring the fund into a financially sound condition and a scheme of arrangement setting out these steps must be submitted to the Registrar.

Scheme of arrangement

Any deficit in a fund must be dealt with by the fund in terms of a scheme of arrangement, in consultation with the Registrar.

When any return under the Act indicates a financial deficiency in a fund, the fund must, within three months from the date of such return, submit a scheme to the Registrar setting out the arrangements which have been made or which it is intended to make to eliminate the deficiency, together with a report thereon by a valuator.

A scheme of arrangement must:

- contain the particulars of the remedies which the board of the fund intends to employ to bring the fund into a financially sound condition;
- include a projection of the financial condition of the fund, setting out all the relevant assumptions, taking into account the effect of the remedies once implemented; and
- indicate the timeframe within which financial soundness is anticipated to be restored.

The Registrar will approve the scheme if it is not inconsistent with the provisions of the Act and he is satisfied that the arrangements should suffice to accomplish the objects of section 18 of the Act.

Format of a scheme of arrangement

There must be a resolution by the board of the fund confirming the adoption of the scheme of arrangement and the scheme must be duly signed by the chairperson, a member of the board, the principal officer and be certified by the valuator before submission to the Registrar. Where the scheme requires the consent of the employer or any third party, confirmation of such consent must be included in the submission.

The notice will be applicable for statutory submissions made by a fund with an effective date after the publication of the final Notice, so that prior valuations already in progress will not be impacted.

3. Draft notice in terms of regulation 28: Conditions for investments in hedge funds

Last year hedge funds were declared to be collective investment schemes. The draft notice states that notwithstanding this, any investment by a retirement fund in a hedge fund is still regarded as an investment in a hedge fund as defined in regulation 28.

The draft notice states that the Registrar of Pension Funds intends to prescribe that a pension fund may only invest in a hedge fund which is administered by a manager registered under the Collective Investment Schemes Control Act and authorised to administer a hedge fund.

The Registrar reminded funds that any investments in a hedge fund must comply with the principles set out in Regulation 28(3)(d) which provides that a fund may not invest in a hedge fund or private equity fund, where the fund may suffer a loss in excess of its investment.

In order to accommodate funds currently invested in hedge funds whose managers have not yet been registered as managers of collective investment schemes, the draft notice provides for transitional arrangements.

Observation: *Funds must ensure that the hedge funds they are invested in comply with the requirements and time periods set down by the Registrar of Collective Investment Schemes. If it is apparent to a fund that the person administering the hedge fund is not compliant with the requirements, the fund must inform the Registrar of Pension Funds.*

4. Draft Information letter: Cancellation and replacement of policies

The Registrar does not approve of so-called "negative consent” in terms of which a communication is sent to a policyholder informing him/her that another policy with another insurer will be entered into on behalf of the policyholder unless the policyholder specifically instructs the non-mandated intermediary not to do so. Therefore, explicit prior consent from the policyholder must be secured.

The draft Letter states that where an insurer cancels any policy (or an underwriting manager cancels a policy on behalf of an insurer) the insurer must –

- if the policy is a life policy as defined in section 1 of the Long-term Insurance Act, provide the policyholder with a reasonable period to secure another policy;
- if the cancellation of the policy is related to the cancellation of a binder agreement, inform and provide the Registrar with prescribed information at least 60 days before the expiry of the termination period referred to in the Binder Regulations in terms of the said Act; and

Where an insurer cancels a policy –

- a mandated intermediary may enter into another policy with another insurer on behalf of that policyholder in terms of the written mandate between the mandated intermediary and the policyholder; and
- a non-mandated intermediary may enter into a policy with another insurer on behalf of that policyholder if that policyholder has consented thereto; and all relevant provisions of the FAIS Act have been complied with.

Further, where a policy is cancelled and the intention is to move a policyholder to a specific new insurer, the policyholder must be made aware that he/she has a choice to either move to the new proposed insurer, move to another insurer of his/her choice, or to remain without cover.

Where a mandated or non-mandated intermediary cancels any policy on behalf of a policyholder, the insurer must, if the cancellation of the policy relates to the cancellation of a binder agreement, inform and provide the Registrar with prescribed information at least 60 days before the expiry of the termination period referred to in the Binder Regulations.

South African Revenue services: New Acts, Regulations and practice notes

5. Taxation Laws Amendment Act, 2015

The tax harmonisation of contribution deductibility of the various types of retirement funds as well as limiting lump sum retirement benefits under a provident fund (hereafter referred to as the T-Day changes), were introduced in the Taxation Laws Amendment Act of 2013, which Act was amended in 2014 by postponing the effective date to 1 March 2016. The Taxation Laws Amendment Act, 2015 was promulgated on 8 January 2016 and refines the T-day changes that will apply from 1 March 2016.

The main T-day changes are briefly the following:

- Employer contributions to retirement funds will be taxed as fringe benefits in the hands of employees. For tax purposes these contributions will be deemed to have been made by the employees.
- Employees may deduct up to 27,5% of the greater of remuneration or taxable income in respect of contributions (by employer/employee) to pension, provident and retirement annuity funds, subject to a total annual limit of R350 000.
- Contributions in excess of 27.5% or the R350 000 limit will be rolled over to future tax years. Amounts not previously deductible will be tax deductible upon retirement or withdrawal and if full relief cannot be granted in respect of the lump sum, if any, then the relief that the member has not yet enjoyed will be applied in respect of pension payments.

  Oversight: *The legislature has however omitted to allow the relief on pension payments in respect of pensions paid upon retirement from a provident fund. Hopefully the omission will be rectified soon.*

- Not more than one-third of the retirement benefit from a provident fund may be taken as a lump sum. However, this restriction does not apply to pre-1 March 2016 contributions (and growth thereon) as members have so-called vested rights to full commutation in respect thereof.

  Oversight: *The vested rights provisions have been included in the definitions of other types of funds, but not in the definition of a private sector pension fund, which seems to indicate that pre-1 March 2016 money transferred from a provident fund to a private sector pension fund will not enjoy vested rights. The industry is of the view that this was an oversight and is hopeful that Government will either interpret the Income Tax Act to the effect that the vested rights provisions should be deemed to have been included in the definition of a private sector pension fund, or the oversight will be rectified by an amendment of the Income Tax Act. We hope that clarity will be obtained soon.*

- Provident fund members who are 55 years or older on 1 March 2016 will however be able to commute the full retirement benefit, including contributions made on or after 1 March 2016 (and growth thereon) to the provident fund of which he/she was a member on 1 March 2016. They will therefore have to remain in the same fund until retirement in order to be able to commute the full retirement benefit.

- The commutation threshold upon retirement, sometimes referred to as the de minimis amount, is increased from R75 000 to R247 500. If the benefit (excluding the vested rights portion) does not exceed the threshold, the full retirement benefit may be taken as a lump sum.
- There will be tax-free portability between all tax approved funds, including pension to provident fund transfers.

6. Defined benefit funds and T-Day

In terms of paragraph 12D of the Seventh Schedule to the Income Tax Act a special formula must be used to determine the value (fringe benefit) that a defined benefit fund member becomes entitled to as a result of the employer’s contribution in respect of him/her. The formula basically approximates the increase in value of the annuity and lump sum benefit of the member as a result of one additional year of service, based on the value that the member will be entitled to as a retirement benefit, as a result of the employer’s contributions.

For purposes of the calculations in terms of the formula, a number of variables must be taken into account, for example “defined benefit component”, “defined benefit component factor”, “fund member category factor” and “retirement-funding income”, These variables are defined in either paragraph 12D of the Seventh Schedule, or in the Regulations in terms of paragraph 12D(5)(a) which deal with the determination of the fund member category factor.

Funds with defined benefits (and funds that offer benefits with a defined benefit underpin) must provide the employer with a contribution certificate –

- one month before the commencement of the tax year in respect of which the contribution certificate is issued (unless there have been no changes to benefits since the last certificate was issued), and
- one month after amendments to the rules of the funds that affect the value of or entitlement to any benefit payable to a member of that fund.

The fund must provide a contribution certificate to the employer to enable the employer to determine the value of the fringe benefit to be taxed in the hands of the member. The Regulations issued in terms of paragraph 12D(5)(b) prescribe the information to be contained in contribution certificates. A separate contribution certificate must be provided for each fund member category.

Observation: *This is a very complex area of the law and practice on retirement funds. Our actuaries detected a number of anomalies and oversights and have taken them up with the regulator.*

7. Cancellation of tax directives

SARS issued a letter dated 15 October 2015 to the Institute of Retirement Funds Africa cautioning against the cancellation of tax directives. In terms of the Income Tax Act a lump sum benefit accrues to a member on the date on which an election is made in respect of the benefit. SARS confirmed that the accrual date cannot be changed once a person has made the election and becomes unconditionally entitled to the benefit.

Observation: *The application for a tax directive can only be made after an election has been made (by the member) to take a benefit in a lump sum. Once a tax directive has been applied for, the accrual event cannot be retracted.*

According to SARS the obligation is on the fund to ensure that the member is aware of the income tax implications flowing from his/her election before applying for a tax directive. The SARS' Tax Directive System should not be utilised to determine the taxpayer's tax liability. Information relating to lump sums previously received is provided by SARS if requested by the taxpayer.

Bona fide mistakes

The cancellation of tax directive applications will only be permitted by SARS in circumstances where a *bona fide* mistake has been made, such as the following:

1. The reason for the tax directive application was incorrect, i.e. if withdrawal was ticked as opposed to retirement; or
2. The taxpayer details completed on the directive application form were incorrect, for example, the tax directive was applied for in the name of the wrong spouse in the case of a divorce.

Other regulators: New Acts, Regulations and practice notes

8. Exemption from compiling a PAIA Manual

Most private bodies, including retirement funds, were exempt from compiling a manual as contemplated in section 51 of the Promotion of Access to Information Act until 31 December 2015. On 11 December 2015 the Minister of Justice extended the exemption for a period of five years from 1 January 2016 to 31 December 2020.

Observation: *The Minister has yet again announced the further exemption only days before the deadline. From a good governance perspective we encourage all our clients to prepare and maintain a PAIA manual.*

With recognition to the major contributions made by Anton Swanepoel and Sanlam Employee Benefits: Law Services