STATEMENT SUPPORTING THE DRAFT CONDUCT STANDARD - CONDITIONS FOR SMOOTHED BONUS POLICIES TO FORM PART OF DEFAULT INVESTMENT PORTFOLIOS

FSCA
Financial Sector
Conduct Authority

1 PURPOSE OF THE STATEMENT

1.1 In terms of section 98 of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSRA), before a regulator makes a regulatory instrument[1], it is required to publish the following documents:

(a) a draft of the regulatory instrument;
(b) a statement explaining the need for and the intended operation of the regulatory instrument;
(c) a statement of the expected impact of the regulatory instrument; and
(d) a notice inviting submissions in relation to the regulatory instrument, stating where, how and by when submissions are to be made.

1.2 In fulfilment of the abovementioned requirements, the Financial Sector Conduct Authority (FSCA) have prepared this document to explain the need for, expected impact and intended operation of the Conduct Standard - Conditions for Smoothed Bonus Policies to form part of Default Investment Portfolios (Conduct Standard) as required in terms of section 98(1)(a) of the Financial Sector Regulation, 2017 (Act No. 9 of 2017) (FSRA).

1.3 The objective of the Conduct Standard is to prescribe the conditions with which a smoothed bonus policy must comply in order to meet the definition of “default investment portfolio” as defined in the Regulations made in terms of section 36 of the Pension Funds Act, 1956 (Act 24 of 1956) (“Regulations”). In addition, the Conduct Standard proposes to set general high-level Treat Customers Fairly (“TCF”) principles aimed at improving customer outcomes in the context of smoothed bonus policies.

1.4 The FSCA is intending to make this Conduct Standard in terms of paragraph (c) of the definition of “default investment portfolio” as defined in the Regulations and section 106(1)(a) of the FSRA. These sections empower the FSCA to prescribe conditions for the definition of “default investment portfolio” and to make conduct standards necessary to achieve the objectives of the FSRA and relevant financial sector laws.

2 STATEMENT OF NEED - POLICY CONTEXT AND PROBLEM DEFINITION

2.1 On 25 August 2017, the Minister of Finance made amendments to the Regulations. Some definitions were amended and Regulations 37 to 40 were inserted with effect from 1 September 2017. The former Registrar of Pension Funds exempted all funds from the provisions of the Regulations until 1 March 2019.

2.2 Regulation 37(1) requires that the board of a fund with a defined contribution category, to which members belong as a condition of employment, include in the fund’s investment policy statement the provision of one or more default investment portfolios.

2.3 A default investment portfolio is defined in section 1 of the Regulations. Paragraph (c) of the definition empowers the Financial Sector Conduct Authority (Authority) to prescribe conditions that a default investment portfolio must comply with.

Smoothed bonus policies

2.4 Over time the FSCA has identified various stakeholder concerns that arise in the context of smoothed bonus policies.

[1] For the purpose of this Statement, this refers to a Conduct Standard

2.5 A smoothed bonus policy aims to smooth returns over time, which creates inter-generational cross subsidies. In addition, the inclusion of guarantees in the design of some of these policies means that the capital costs are higher.

2.6 Typically insurers exercise a significant amount of discretion when it comes to bonus declarations under smoothed bonus policies. Approaches in calculating and determining such bonuses vary and are often opaque, resulting in members not knowing what to expect when it comes to such declarations.

2.7 Members are also not aware of management actions that an insurer might take in managing the smoothed bonus portfolio, and the discretion that accompanies those actions, further resulting in uninformed customers that are unable to make informed investment decisions.

2.8 Charges relating to guarantees forming part of smoothed bonus portfolios are often not disclosed appropriately, and the cost of such a guarantee is often unknown to members. Not knowing the cost of a guarantee also results in members not being able to assess the value of such guarantees.

2.9 In addition to the above, although market value adjustments (MVA's) are critical for the ongoing financial soundness of a smoothed bonus portfolio, it is also one of the main criticisms of such portfolios as it may result in unexpected outcomes for members if not appropriately communicated and fairly applied.

2.10 Asset allocation in the context of pension funds is critical. When a pension fund buys into a portfolio it should know what the underlying investments are and what risk is attached to such a portfolio. Accordingly, it would be unreasonable for anyone managing the portfolio on behalf of a pension fund to deviate from such an investment mandate without informing the pension fund. If for management reasons (e.g. solvency, liquidity) deviation is necessary, the pension fund needs to be informed seeing that the underlying risk, which informed their initial investment decision, may have changed. Currently there are no explicit requirements regulating the above issues.

3 SUMMARY OF THE CONDUCT STANDARD

3.1 The purpose of the Conduct Standard is to prescribe the conditions with which a smoothed bonus policy must comply in order to be considered for inclusion as a default investment portfolio.

3.2 In general, the Conduct Standard aims to provide additional protection to members who are defaulted into a smoothed bonus policy, to ensure that they fully understand the default being provided. The extent of smoothing, the triggers and asset allocations must be defined and considered before including a smoothed bonus policy in a fund's default investment portfolios.

3.3 In particular, it is proposed that a formulaic approach must be established to calculate and determine bonus declarations. The provisions to be included in the formulaic approach are detailed in the Conduct Standard. With the proposed formulaic approach an insurer will have to declare upfront what policy it will follow in declaring bonuses and how this will be done. This approach will therefore improve transparency and drive better outcomes for customers as participants will have a much better idea of what can be expected in terms of bonus declarations.

3.4 It is also proposed that any management actions that may be taken to reduce the risk in the policy must be properly disclosed and documented. Similar to the abovementioned, this requirement is aimed at improving transparency and requiring management actions to be disclosed. This will result in better informed participants as they will be able to decide whether they are in agreement with the management actions or not, and if they are not, they can decide how best to respond to the changes.

3.5 The above requirements will therefore assist in promoting transparency and reducing insurers' current unfettered discretion in relation to the declaration of bonuses.

3.6 It is further proposed that one of the conditions be that charges relating to guarantees provided in terms of a smoothed bonus policy must be commensurate with the risk and be separately disclosed. This requirement is expected to lead to improved disclosure on the guarantee aspect of smoothed bonus policies and will assist participants in better understanding the value (or lack thereof) of the guarantee component.

3.7 It is also proposed that the circumstances under which a MVA may be applied must be pre-determined as it is critical that pension funds know that MVA's might take place, and under which circumstances, so as to avoid unexpected outcomes. In respect of MVA's in the context of retrenchments, the Conduct Standard proposes that an MVA may be applied in the case of retrenchments if the Authority is timeously notified of any MVA on particular retrenchments that is being considered, before any such MVA is applied. It must be noted that this is a "file and use" procedure, i.e. merely notification to the FSCA and no formal approval by the FSCA is required.

3.8 Conditions relating to asset allocation are also proposed, in particular where it relates to a change in strategic asset allocation that is being considered by the insurer. In this regard the draft Conduct Standard proposes, amongst other things, that where a material change in the strategic asset allocation is being considered, the fund must make full disclosure to all stakeholders, and must notify the Authority of the intent to change the strategic asset allocation, including reasons for the change and the scenarios envisaged, before such changes are given effect to. It must be noted that this is also a "file and use" procedure (similar to what is explained in paragraph 3.7 above).

3.9 The draft Conduct Standard also proposes general high-level TCF principles aimed at improving outcomes for members.

4 STATEMENT OF IMPACT OF THE CONDUCT STANDARD

4.1 The limitations being imposed on the smoothed bonus portfolios will result in portfolios which smooth less, over shorter periods. Together with the intended reduction in intergenerational cross subsidies, the reduction in the smoothing period could lead to more volatile returns for members.

4.2 Boards of retirement funds will need to follow a more onerous process, should they opt to include a smoothed bonus policy in their default investment strategy. This will result in more effort, as well as more checks and balances being required. This may disincentivise certain boards from opting for smoothed bonus policies as defaults for their members. The members for whom smoothed returns would be preferable, would then need to specifically opt for these themselves.

4.3 Insurers wishing to have their smoothed bonus policies included in funds' default investment portfolios will need to ensure that their smoothed bonus policies comply with the requirements. While many of the triggers are already part of the processes adopted by insurers, the Conduct Standard will allow insurers less flexibility in such processes. While this makes the processes more explicit and therefore less open to manipulation, it will result in a reduced ability to act speedily and to mitigate risks. This may have an impact on the cost of any guarantees provided and might limit the number of insurers willing to offer smoothed bonus policies that comply with these criteria. This outcome, though, should be understood in the context of enabling (some) flexibility while also having to protect funds and their members.

4.4 A separate smoothed bonus policy that complies with the conditions to form part of the default investment strategy may be required. This will split investments and there may be an increase in the number of portfolios available for investment, i.e. (i) a smoothed bonus policy that complies with the conditions to form part of a default investment portfolio; and (ii) a traditional smoothed bonus policy that is an investment choice.

5 STATEMENT OF INTENDED OPERATION OF THE CONDUCT STANDARD

5.1 A fund wishing to include a smoothed bonus policy in its default portfolios must ensure that the chosen smoothed bonus policy is eligible for inclusion as a default investment portfolio.

5.2 The Conduct Standard determines the conditions with which a smoothed bonus policy must comply, to be eligible for inclusion as a default investment portfolio.

5.3 The draft Conduct Standard will take effect [--] months after publication of the final Conduct Standard.

6 WAY FORWARD

6.1 The Conduct Standard will be submitted to Parliament for a period of at least 30 days while Parliament is in session.

6.2 If no concerns arise from the Parliamentary process, the final Conduct Standard will be made shortly after the period referred to in paragraph 6.1 has elapsed.

6.3 For more information regarding the Conduct Standard and/or this statement please contact the Regulatory Framework Department of the Authority at Roslynne.petersen@fsca.co.za.