FSCA CONDUCT STANDARD 1 OF 2023 (RF)

CONDITIONS FOR INVESTMENT IN DERIVATIVE INSTRUMENTS FOR PENSION FUNDS

FINANCIAL SECTOR REGULATION ACT, 2017 (ACT NO. 9 OF 2017)

PENSION FUNDS ACT, 1956 (ACT NO. 24 OF 1956)

The Financial Sector Conduct Authority (FSCA) hereby, under section 106(1) of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSR Act), and regulation 28(7) of the Regulations made in terms of section 36 of the Pension Funds Act, 1956 (Act No. 24 of 1956), prescribes conditions for investment in derivative instruments for pension funds.

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FOR THE FINANCIAL SECTOR CONDUCT AUTHORITY

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SCHEDULE

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CONDITIONS FOR INVESTMENT IN DERIVATIVE INSTRUMENTS FOR PENSION FUNDS

1. Definitions

In this Schedule**, "the Act"** means the Pension Funds Act, 1956 (Act No. 24 of 1956) and **"regulation 28"** means regulation 28 of the Regulations made in terms of section 36 of the Act (GN R.183 of 4 March 2011) and any word or expression to which a meaning has been assigned in the Act and regulation 28 has that meaning unless the context indicates otherwise, and –

"agreement" means a Master Agreement as defined in section 35B(2) of the Insolvency Act, 1936 (Act No.24 of 1936);

"authorised user" means an authorised user as defined in section 1 of the Financial Markets Act;

"Authority" means the Financial Sector Conduct Authority as defined in section 1 of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017);

"**clearing house**" means a licensed clearing house as defined in of section 1 of the Financial Markets Act;

"counterparty" means, in relation to a derivative position, a juristic person who is the opposite party of the fund in a derivative transaction and has a legal obligation to perform under the derivative contract;

"**counterparty exposure**" means any credit or settlement risk exposure in relation to a counterparty;

"**delta**" means the ratio of the change in the price or value of the derivative instrument as a result of a change in the price or value of the reference asset;

"derivative instrument" has the meaning assigned to it in section 1 of the Financial Markets Act;

"effective derivative exposure" means the exposure of a fund to a reference asset or assets taking into account the delta or deltas of the derivative instrument, provided that the effective economic derivative exposure calculation must take into account exposure to embedded derivatives in accordance with regulation 28(4)*(a)*;

"efficient portfolio management" means giving effect to the fund's investment policy for one or more of the following objectives-

(a) hedging;

(b) the reduction of cost; or

(c) the generation of additional capital or income for the fund, with a risk level consistent with the fund's investment policy statement;

"Financial Markets Act" means the Financial Markets Act, 2012 (Act No. 19 of 2012);

"Financial Markets Act Regulations" means the Financial Markets Act Regulations made under the Financial Markets Act as published in Government Notice R98 in *Government Gazette* 41433 of 9 February 2018;

"financial services provider" means a discretionary FSP as defined in the Code of Conduct for Administrative FSPs, 2003;

"foreign insurer" means an institution authorised and supervised by regulator in a jurisdiction determined to be equivalent in terms of section 65 of the Insurance Act;

"hedging" means reducing the risks associated with fluctuations in the fair value of the fund's assets or fair value of the fund's liabilities, the value of the fund's liabilities calculated using assumptions that are consistent with the most recent valuation approved by the Board in terms of PF Notice 2 of 2016;

"Insurance Act" means the Insurance Act, 2017 (Act No. 18 of 2017);

"insurer" has the meaning assigned to such term in section 1 of the Insurance Act;

“Jibar” means the Johannesburg Interbank Average Rate as published daily by the JSE Limited administered by the South African Reserve Bank and any replacement of the Johannesburg Interbank Average Rate;

“leverage” means the use of assets, including derivative instruments, short positions or borrowed capital to increase the exposure of the funds’ assets beyond the value of the fund’s assets, and for purposes of this standard “gearing” has the same meaning;

“net derivative exposure” means the derivative exposure taking into account the offsetting of long and short derivative positions;

“OTC derivative” has the meaning ascribed to it in regulation 1 of the Financial Markets Act Regulations;

“OTC derivative provider” has the meaning ascribed to it in regulation 1 of the Financial Markets Act Regulations;

“reference asset” means the asset(s), group of assets or variable(s) from which the value of the derivative instrument is derived;

“repurchase rate” means the rate determined by the South African Reserve Bank and at which the South African Reserve Bank lends to a South African bank; and

“speculation” means transactions involving unusual and considerable levels of risk intended to take advantage of short-term market movement for commensurate levels of gain.

2. Uses of derivative instruments

(1) A fund may not invest in a derivative instrument for the purpose of speculation, or to leverage or gear the assets of the fund.

(2) Where a fund uses a derivative instrument for the purposes of efficient portfolio management, -

(a) the effective derivative exposure must at all times be covered by appropriate reference assets as determined in paragraph 6(1); or

(b) where appropriate, a fund must hold assets in accordance with the conditions prescribed in paragraph 7(2), with a market value at least equal to the effective derivative exposure.

(3) The maximum effective derivative exposure of derivative instruments per asset category held by a fund may not exceed the value of the reference asset that the derivative seeks to hedge.

(4) The use of derivative instruments by a fund must–

(a) be consistent with a fund's investment policy statement, which must stipulate whether both listed and OTC derivative instruments are allowed, the conditions under which derivative instruments may be used, and the valuation methodology required in terms of subparagraph (6);

(b) take account of the fund's liquidity risk in both stressed and unstressed market conditions;

(c) be subject to reliable, and recognised valuation methodology at least monthly; and

(d) be sold, liquidated or closed out within a reasonable time to enable effective closure of the position, at the fund's initiative.

(5) A fund may only use a derivative instrument where there is a consistent, transparent and recognised derivative instrument valuation methodology to value the derivative instrument, which methodology must be implemented, monitored, and periodically reviewed, and at least provide that -

(a) when a financial services provider or OTC derivative provider which is mandated to make the investment on behalf of the fund values the derivative, it must take into account that the valuation process should take place independently from the investment management decision-making function of the financial services provider; or

(b) the valuation must be done by an independent third party that adopts a consistent and transparent process for the valuation.

3. General

(1) A fund must document, adopt and implement a risk management policy to at least include processes and procedures to identify, measure and take steps to manage

and mitigate, as appropriate, the exposure to and risks of derivative instruments, and the contribution of these to the overall risk profile of the fund's investment portfolio.

(2) A board must ensure on an on-going basis that it is aware of, and regularly monitor, the risks to the fund using derivative instruments, and that such risks are appropriate in terms of the fund's solvency and liquidity position.

(3) Where a board lacks the necessary skills, it must obtain legal and technical advice before investing in derivative instruments.

(4) A fund must ensure that -

(a) it is fully aware of all the fees and costs, including commissions and premiums, associated with the trading of derivative instruments, including those fees and costs which may be netted off the returns of derivative instruments; and

(b) all fees and costs, including commissions and premiums, are reported to the fund in a transparent, clear and understandable manner.

4. Counterparties

A fund may only invest in listed derivative instruments and in OTC derivative instruments where the counterparty is-

(a) an authorised user;

(b) a foreign bank;

(c) a foreign insurer;

(d) an insurer;

(e) an OTC derivative provider;

(f) a South African bank; or

(g) any other person declared by the Authority to be a counterparty

5. Calculating exposure

(1) A fund must, subject to paragraph 2, ensure that the calculation of assets and categories of assets referred to in regulation 28 includes the net derivative exposure.

(2) When a fund calculates the counterparty exposure -

(a) all transactions relevant to such counterparty, including counterparty exposure obtained through derivative instruments, must be taken into account by a fund;

(b) counterparty exposure in respect of collateral must be included;

(c) subject to paragraph 6, a fund may reduce the counterparty exposure by the value of collateral provided by the relevant counterparty, which value must be calculated on the corresponding date of the exposure calculation;

(d) where a derivative instrument is traded on an exchange and cleared through a clearing house, a fund may exclude such counterparty exposure from the calculation, but it must still be reported to the Authority; and

(e) a fund's counterparty exposure may be netted with exposure to the same counterparty, on condition that an agreement is in place, which agreement-

(i) gives legal effect to netting as contemplated in section 35B of the Insolvency Act, 1936 (Act No. 24 of 1936); and

(ii) provides that, where such counterparty defaults, the fund has an obligation to pay only the net sum of the positive and negative market values of the unperformed obligations.

6. Netting

(1) In calculating the fund's compliance with the limits set out in regulation 28, the economic exposure of the assets, and categories of assets, held by the fund may be combined with the net derivative exposure where the reference asset of the derivative instrument is identical or similar to the asset exposure, or categories of assets, held by the fund. Similar in this context means that the reference asset -

(a) is not an index and such reference asset is highly correlated with the fund assets underlying the derivative position thereby leaving no material residual risk;

(b) is an index, calculated and published by an exchange and such index is an appropriate proxy to the fund assets underlying the derivative position thereby leaving no material residual risk; or

(c) is an index that is not calculated or published by an exchange, and such index -

(i) is sufficiently diversified so that price movements of one of the assets included in the index do not unduly affect the performance of the index as a whole;

(ii) represents an adequate benchmark for the market or assets in the portfolio to which it refers, including regular measurement, rebalancing and liquidity appropriate to replicating the index; and

(iii) is highly correlated to the fund assets underlying the derivative position thereby leaving no material residual risk.

(2) Despite subparagraph (1), where a fund uses derivative instruments for the purpose of managing the duration of the debt instruments held by the fund and in calculating the fund's compliance with the limits set out in regulation 28 -

(a) debt instruments held by the fund may be combined with the net derivative exposure where the reference asset of the derivative instrument is-

(i) a debt instrument by the government of the Republic or a foreign asset, JIBAR or foreign equivalent of JIBAR, the repurchase rate, an inflation rate or swap rate; provided that any consequential or residual spread exposure as a result of the netting is disclosed, monitored and managed; or

(ii) a debt instrument with the same issuer but a different term, provided that any residual exposure as a result of the difference in term and spread is disclosed, monitored and managed.

(3) When calculating the net effective exposure of the fund, the economic exposure of any asset may only be offset once against an equal, but opposite, economic exposure.

7. Collateral

(1) Where a collateral arrangement is entered into by a fund, the fund must ensure that the Agreement includes a bilateral collateral agreement.

(2) The assets or instruments eligible for collateral ("collateral assets") in terms of a collateral arrangement must –

(a) be liquid, transparent and identifiable as defined by the South African Reserve Bank ;

(b) be held by the fund, or an approved nominee or an independent custodian in a segregated depository account on behalf of the fund; and

(c) be capable of being valued daily.

(3) For purposes of paragraph 7, "outright transfer" refers to the transfer of ownership to the fund of a collateral asset, provided that the –

(a) fund and the counterparty agreed that in the event of a default, the obligation of the counterparty to return the collateral will terminate;

(b) value of the collateral assets transferred by the counterparty to the fund will be established; and

(c) values referred in item (b) will be netted against each other and the net amount will be an amount payable by the fund to the counterparty or by the counterparty to the fund, as the case may be.

(4) Collateral referred to in this paragraph may be effected through-

(a) a pledge or cession in security to the fund of the collateral asset, or

(b) an outright transfer of the collateral asset to the fund.

(5) Where collateral is received by the fund and the outright transfer method is elected-

(a) where the collateral is held in cash, it must be held in the name of the fund; and

(b) where the collateral consists of money market instruments, debt instruments or equities, the money market instruments, debt instruments or equities must be held in the name of the fund, or by a nominee on behalf of the fund and must be clearly identified as collateral.

(6) Where a fund posts collateral to a counterparty with outright transfer, the net over-collateralised amount (where the collateral posted is greater than the exposure to that counterparty) must be taken into account when calculating the counterparty exposure.

(7) Where collateral is held by an independent custodian as contemplated in subparagraph (2)*(b)*, such collateral does not form part of the assets of that custodian and will not be regarded as counterparty exposure to that custodian.

8. Receiving of information

(1) A fund must ensure that its investment mandates with financial services providers or an agreement with an OTC derivative provider require that the fund receives appropriate and timely information to enable proper management and monitoring of derivative instrument positions and collateral, and compliance with the relevant limits set out in regulation 28.

(2) A fund must receive the following information from a financial services provider at least quarterly:

(a) A full listing of the fund's assets including detailed information for the full identification and disclosure of all derivative instruments in the fund's portfolio(s); and

(b) a statement confirming that derivative instruments are used for efficient portfolio management, a summary of the fund's effective derivative exposure, and the effect thereof on the calculation of the fund's compliance with the limits set out in regulation 28.

(3) A fund must receive the following information from a financial services provider or OTC derivative provider as referred to in subparagraph (1) at least quarterly:

(a) A report showing the counterparty exposure of the fund to each counterparty before and after netting subject to the provisions in paragraph 5; and

(b) a statement confirming that the policy for the valuation methodology of derivative instruments has not changed during the applicable quarter; or if such valuation methodology changed during the quarter, a description of the changes and their effect on the calculations required to measure the fund's compliance with regulation 28.

9. Short title and commencement

This Conduct Standard is called Conditions for Investment in Derivative Instruments for Pension Funds, 2023 and takes effect twelve months after publication.