Sanlam

Legal Report June 2020

Insurance | Financial Planning | Retirement | Investments | Wealth

Newsletter of Sanlam Corporate: Legal

1. Draft Conduct Standard - Conditions for Living Annuities in an Annuity Strategy

Regulation 39 of the regulations issued in terms of the Pension Funds Act requires the boards of trustees of all pension, pension preservation and retirement annuity funds to establish an annuity strategy. The boards of provident and provident preservation funds whose rules enable a member to elect an annuity upon retirement, must also establish such a strategy.

The Financial Sector Conduct Authority (FSCA) during November 2018 published a draft Conduct Standard on the criteria for living annuities forming part of a fund's annuity strategy. The aforesaid draft Conduct Standard was revised after receiving comments from the retirement fund industry, and a revised draft Conduct Standard was published for public comment on 8 June 2020.

According to the revised draft Conduct Standard the annuity strategy must represent a fund's most appropriate proposal for the average member from a specific category of members, with the purpose of, amongst other things, assisting those members who do not feel comfortable making their own decision at retirement. The annuity strategy may be different for different categories of members.

When considering the inclusion of a living annuity in the annuity strategy, the fund's board must take into account the individual risks that pensioners are generally exposed to, for example, the risks of:

- retirement savings being depleted too soon;
- poor investment returns on capital; and
- excessive fees and charges.

A board may only include a living annuity in its annuity strategy if:

- more protection is afforded to members making use of this strategy compared to members who choose a living annuity based on their own circumstances and research; and
- the sustainability of income is regularly monitored, and clearly communicated to pensioners both at inception, as well as on a regular basis thereafter.

A fund must measure the sustainability of the income from the living annuity by considering the continued payment of a particular income over the lifetime of a pensioner, where the income payments increase in line with a targeted percentage of inflation. The targeted percentage of inflation may not be less than 66%.

Where the living annuity is provided by the fund, the sustainability of income must be monitored by the fund. Where the living annuity is purchased from an insurer, the fund must ensure that the sustainability of income is monitored by the insurer. The sustainable income level of the living annuity may result in a monthly pension which is lower than the amount required as a living income.

Members must at the inception of the living annuity be informed of the reasonably expected commencement income and drawdown rate, as well as details on the risks and sustainability of the annuity. Members must thereafter on at least an annual basis be provided with information on the performance of the annuity and an update on the continued sustainability of the annuity, including warnings where a pensioner is unlikely to achieve the increase targets or income in the long-term. Members must also clearly be informed that there is no guarantee that the annuity is sustainable, even if all the recommended actions are followed.

The Draft Conduct Standard lays down both recommended drawdown rates and maximum drawdown rates. The recommended drawdown rates are rates that a board should aspire to, which rates would result in a sustainable income with a 90% probability, based on an average life expectancy and a balanced investment portfolio.

The maximum drawdown rates are as follows:

Age	Maximum drawdown rate
55	6.5%
60	7.0%
65	8.0%
70	8.0%
75	8.5%
80	9.5%
85	11.5%

The board should encourage members to apply a lower drawdown rate than the maximum, especially in cases where:

- the underlying investment portfolio is conservative or aggressive; or
- the annuity is in respect of a couple.

In the statement supporting the draft Conduct Standard it is further stated that the board must apply their minds as to appropriate drawdown rates, and is expected to apply lower drawdown rates where applicable.

The Conduct Standard, once finalised, will take effect on the date of publication, but retirement funds will be afforded 6 months to adjust their annuity strategy in order to align with the requirements of the Conduct Standard. Further, the Conduct Standard will not apply to members who already retired with a living annuity before or within 6 months after the effective date.

Comments on the draft Conduct Standard must be submitted to the FSCA by 31 July 2020. Sanlam will provide comments via industry bodies.

2. Draft Conduct Standard - Communication of benefit projections

The Financial Sector Conduct Authority (FSCA) on 8 June 2020 published for public comment a draft Conduct Standard on the communication of benefit projections to members of retirement funds. This follows on a draft PF Notice on benefit projections published by the Financial Services Board during February 2018.

In the statement supporting the draft Conduct Standard it is stated that a benefit projection is an important tool in monitoring whether a member is saving enough for retirement. Projections further assist in managing the expectations of members and influencing their behaviour by providing members with information regarding realistic expectations of their future retirement benefits and the potential effect of retirement decisions. The purpose of the Conduct Standard is to standardise the minimum information that should be provided to a member and to ensure that benefit projections are communicated to members throughout the various phases of fund membership.

The Conduct Standard will apply to every fund that is registered under the Pension Funds Act, excluding unclaimed benefit funds and beneficiary funds.

General principles regarding benefit projections

A fund must ensure that any benefit projections provided to members assist in managing the expectations of such members and influence their behaviour (contribution rate, period of saving, level of risk, etc.) by educating such members regarding realistic expectations of their future retirement benefits and the potential effect of retirement decisions taken.

Any communication relating to benefit projections must be in plain language to enable a member to make an informed decision on retirement savings and to ensure transparency to the member throughout the various phases of fund membership.

Frequency of benefit projection statements

A fund must provide a benefit projection statement to a member:

- when joining the fund to enable the member to make an informed decision on retirement savings;
- on an annual basis thereafter;
- upon pre-retirement withdrawal to illustrate to a member the impact of preserving retirement savings until retirement; and
- with regard to living annuities, on an annual basis after retirement to allow a member to consider the sustainability of his/her income and drawdown rates.

Instead of providing an annual benefit projection statement to a member, a fund may include the information that must be contained in the annual benefit projection statement in the member's annual benefit statement.

Information to be contained in the benefit projection statement

The following information must be included in the benefit projection statement:

- the value of the member's projected benefit at retirement as a multiple of salary;
- the projected monthly pension in current day terms;
- the projected monthly pension compared to the projected monthly salary, representing the replacement ratio;
- a note on the underlying risks and assumptions; and
- in the case of a provident fund or a defined contribution pension fund, the benefit projection statement should note that the projected monthly pension represents the projected pension that could be purchased with the projected lump sum available, setting out the underlying assumptions relating to the annuity.

Any benefit projection in respect of living annuities must, taking into account the current drawdown rate chosen by the pensioner, reflect:

- the time until the future income will reduce in real terms;
- the time until the member's savings will start to decline below the current level; and
- the time when the capital will no longer be able to support the current drawdown amount adjusted with inflation.

The information in the benefit projection statement must also include:

- an appropriate disclosure to the member that the aim of the projections is to offer guidance, and that it is not binding or a guarantee;
- a disclaimer to the effect that the final value of the benefit received will probably differ from the projections provided; and
- a statement that the projected retirement benefit from the fund should be added to projected retirement benefits expected from other sources in order for the member to consider the overall adequacy of retirement provision.

Methodology to be applied in the calculation of benefit projections

The draft Conduct Standard prescribes the methodology and assumptions to be applied in the calculation of benefit projections. When a fund provides a calculator to a member with the purpose of providing a benefit projection, the requirements in the Conduct Standard relating to assumptions and the nature of benefit projections must also be applied to such calculator.

Comments on the draft Conduct Standard must be submitted to the FSCA by 31 July 2020. Sanlam will provide comments via industry bodies.

3. Draft Conduct Standard - Conditions for investment in derivative instruments for retirement funds

During 2013, the FSCA published a second version of a draft Notice on conditions for derivative instruments for comment. As a result of the comments received, numerous workshops were held with stakeholders and National Treasury to ensure proper consideration of the comments. The comments necessitated material changes to the draft Notice. The draft Notice has also been converted into a draft Conduct Standard which has recently been published for comment.

A “derivative instrument” is defined in the Financial Markets Act as “*any -*

(a) financial instrument; or

(b) contract,

that creates rights and obligations and whose value depends on or is derived from the value of one or more underlying asset, rate or index, on a measure of economic value or on a default event”.

In the statement supporting the draft Conduct Standard the FSCA states that, although it recognises that there is a role for the use of derivatives within retirement funds’ portfolios, there are a number of major risks inherent in these instruments. Three major risks with the use of derivatives are market transparency, counterparty risk and liquidity risk.

Regulation 28(7) under the Pension Funds Act provides that funds may invest in derivative instruments and empowers the FSCA to prescribe conditions in respect thereof. The draft Conduct Standard sets out the overarching principles for the use of derivative instruments by funds. It also sets conditions relating to, among others, the following –

> *“(a) permissible uses of derivative instruments;*
> *(b) net derivative positions must at all times be covered by appropriate reference assets;*
> *(c) determining maximum allowable economic derivative exposure limits;*
> *(d) valuation of derivative instruments;*
> *(e) determining the allowable counterparties for purposes of derivative instruments;*
> *(f) providing guidance on the calculation of exposure to derivative instruments;*
> *(g) setting out the allowable netting provisions for derivative instruments;*
> *(h) determining the conditions in respect of collateral; and*
> *(i) prescribing the conditions for reporting.”*

Funds will be required to comply with the proposed requirements within 6 months after publication of the final Conduct Standard.

Comments on the draft Conduct Standard must be submitted to the FSCA by 31 July 2020. Sanlam will provide comments via industry bodies.

4. FSCA Communication 33 of 2020 (RF) - Assumptions for determination of minimum individual reserves of members of defined benefit categories of funds

According to the FSCA, "*the purpose of the Communication is to inform funds that, in these times of high market volatility, they should consider adapting their minimum individual reserve assumptions to be in line with market yields at exit date*". The Communication is applicable only in respect of the minimum individual reserves of members of defined benefit categories of funds.

In Board Notice 270 of 2013 the Financial Services Board prescribed the assumptions to be used for the determination of minimum individual reserves of exiting members of defined benefit categories of retirement funds. The Board Notice deals with the assumptions for the period before as well as after the assumed normal retirement date. Communication 33 of 2020 relates to the assumptions to be applied after the assumed normal retirement date.

The following points are made in the Communication:

- When calculating the minimum individual reserve at exit*, "the assumptions to be applied to capitalise the pension at normal retirement date should be as per the valuator, where this is defined to mean that the assumptions must be consistent with those used by the valuator in the accepted statutory actuarial valuation with an effective date coincident with or the closest preceding the date at which the minimum individual reserve is calculated".*

- *"In this period of high market volatility, board members must take reasonable steps to protect the fund, whilst also being fair to all members."*

- *"Rather than waiting for a statutory actuarial valuation report to be accepted, funds may consider adapting the assumptions to be in line with markets, provided the board follows the same methodology in setting the assumptions to capitalise the pension at normal retirement date as was applied in the last accepted statutory actuarial valuation report but basing this methodology on the up to date bond yields at the exit date."*

5. FSCA INS Notice 12 of 2020 - Exemption in respect of long-term insurers that issue investment policies to medical schemes

Regulation 4.2(1) under the Long-term Insurance Act, 1998 contains restrictions on disinvestment during the first five years of a policy. However, these restrictions do not apply to fund policies. The definition of "fund" in the Long-term Insurance Act includes a medical scheme.

However, the definition of "fund" in the regulations was amended to provide that, when an insurer is converted from a registered insurer in terms of the Long-term Insurance Act to a licensed insurer in terms of the Insurance Act, 2017, the definition of "fund" in Schedule 2 to the Insurance Act applies, which definition does not include a medical scheme. This would result in the restrictions of regulation 4.2(1) becoming applicable to an investment policy issued by a licensed insurer to a medical scheme, which would be untenable because of the scheme's obligation to maintain appropriate liquidity in order to satisfy medical claims.

Following a request by ASISA, long-term insurers that offer investment policies have in terms of FSCA INS Notice 12 of 2020 been exempted from the restrictions in regulation 4.2(1) under the Long-term Insurance Act insofar as these relate to an investment policy where the policyholder is a medical scheme. The exemption is welcomed.

6. Commencement of the Protection of Personal Information Act

The Protection of Personal Information Act (POPIA) was signed into law in 2013, but to date very few provisions thereof were operational. The President has however on 22 June 2020 determined that the greater part of POPIA will commence on 1 July 2020.

The sections of POPIA which will commence on 1 July 2020 pertain to, amongst others, the conditions for the lawful processing of personal information and the security of information. All forms of processing of personal information must comply with POPIA within one year after the commencement of the relevant sections. This means that all entities (including retirement funds) will have to comply with POPIA by 1 July 2021.

Retirement funds or other clients requiring more information should not hesitate to contact their consultant.