Financial Sector
Conduct Authority

**PFA DRAFT CONDUCT STANDARD * OF 2018**

**PENSION FUNDS ACT 24 OF 1956**

**DRAFT CONDITIONS FOR SMOOTH BONUS POLICIES TO FORM PART OF DEFAULT INVESTMENT PORTFOLIOS**

The Financial Sector Conduct Authority, hereby, in terms of Regulation 37 of the Regulations, read with paragraph (c) of the definition of 'default investment portfolio', in the Regulations made in terms of section 36 of the Pension Funds Act, 1956 (Act 24 of 1956) and section 98(1) of the Financial Sector Regulation Act, 2017 (Act 9 of 2017), publish for public comment draft conditions that must be complied with for smooth bonus policies to be considered as default investment portfolios as set out in this Schedule.

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# SCHEDULE

## 1. Definitions

In this Schedule, "the Act" means the Pension Funds Act, 1956 (Act 24 of 1956) and the Regulations mean the Regulations made under the Act and any word or expression to which a meaning has been assigned in the Act or the Regulations bears the similar meaning, unless the context indicates otherwise.

**"Authority"** means the Financial Sector Conduct Authority established in terms of section 56 of the Financial Sector Regulation Act, 2017 (Act 9 of 2017);

**"market-value adjustment"** (MVA) means a reduction that is applied to the smoothed value of a policy to provide a value that is consistent with the market value of the policy; and

"**smoothed bonus policy**" or "**policy**" means a life insurance policy with discretionary participation features, underwritten by an insurer licensed in terms of the Insurance Act, 2017 (Act 18 of 2017), in terms of which any bonuses declared over a period, whether such bonuses are vested or non-vested, may be different to the fund return earned over the same period so as to smooth the portfolio return.

## 2. Purpose

The purpose of this Draft Conduct Standard is to determine conditions for smooth bonus policies to be considered as part of the default investment portfolio as contemplated in Regulation 37 read with the definition of 'default investment portfolio'.

## 3. Conditions

(1) A fund may include a smoothed bonus policy as a default investment portfolio, provided the policy complies with the requirements in Regulation 37 and the definition of 'default investment portfolio' in the Regulations.

(2) A fund must ensure that the policy sets out the necessary governance and disclosure requirements as provided for this Conduct Standard and that it is eligible for inclusion as a default investment portfolio.

(3) To be eligible for inclusion as a default investment portfolio, such policies must comply with the following conditions:

(a) A formulaic approach must be established to calculate and determine bonus declarations, both vested and non-vested[1]. The approach must:

(i) include the triggers for the possible removal of non-vested bonuses and the method of removal;

(ii) provide for the triggers that dictate the provision of shareholder capital to maintain the financial soundness of the policy;

(iii) clarify the extent to which shareholder capital is viewed as a loan which will be repaid to shareholders with future investment returns versus a cash injection that will not be repaid from future investment returns;

(iv) specify the minimum and maximum levels of the stabilisation reserve and the remedial actions which will be triggered should these limits be breached;

(v) limit the smoothing period by spreading any excess bonus stabilisation reserve over a period not exceeding 24 months;

(vi) result in a long-term funding level not exceeding 105%; and

(vii) be disclosed to all stakeholders.

(b) The policy may provide that-

(i) the insurer may deviate from sub-section (3)(a)(v) temporarily, in exceptional circumstances and after prior communication with the Authority; and

(ii) The deviation must be appropriately and timeously communicated to the fund and the fund must communicate timeously to its stakeholders.

(c) Any management actions that may be taken to reduce the risk in the policy must be properly disclosed and documented.

(d) The charge in respect of any guarantee provided in terms of the policy must be commensurate with the risk and there must be separate disclosures of guarantee charges and the other costs relating to the policy.

(e) The policy may allow an insurer to apply a market-value adjustment (MVA) in pre-determined circumstances as stipulated in the policy, provided that the payment of any individual benefit under a policy must not be subject to any adjustment, for example where such payment is triggered by death, retrenchment[2] or retirement.

(f) The policy may not allow for any disinvestment penalties to be levied by the insurer.

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[1] The formula may allow for a deviation of not more than 2% per annum from the calculated target bonus to include allowance for expectations with respect to future market movements.

[2] Provided that an MVA may be applied in the case of materially significant retrenchments by an employer. The application of an MVA in the case of material retrenchments must be clearly specified and communicated before entering into a contract. Should it be contemplated to apply an MVA on particular retrenchments, this would need to be communicated to the Authority.

(4) Asset allocation

(a) (i) Asset allocations between the different asset classes significantly affect investment risk and returns. The asset allocation of the policy must therefore remain within disclosed limits around the strategic asset allocation and must comply with the asset spreading limits set out in Regulation 28.

(ii) The exclusion noted in Regulation 28(8)(b)(iii) does not apply to a default investment portfolio.

(b) Where a material change in the strategic asset allocation is being considered, full disclosure must be made to all stakeholders and the Authority must be notified of the intent to change the strategic asset allocation.

(c) Where the change in asset allocation is not in line with the communicated investment philosophy, participants must be given the option to opt out of the portfolio if there is a material change in the exposure, without any penalties or MVA applying, unless the change in asset allocation is required as a result of legislative changes.

(5) Change in investment strategy underlying smooth bonus policy

(a) In extreme market conditions there may be valid reasons to change the investment strategy in order to ensure ongoing solvency and to protect the interests of the remaining stakeholders. The policy must provide that-

(i) in such cases, where material changes to the strategic asset allocation (which are likely to result in lower long-term expected returns) are being considered to protect solvency, full disclosure must be made to all affected parties; and

(ii) application must be made to the Authority, setting out the reasons for the change and the scenarios envisaged, to allow the Authority to consider whether the insurer may be permitted to apply a MVA.

## 4. Treating Customers Fairly

(1) (a) Smoothed bonus policies are perceived to be complex given the smoothing mechanisms and/or guarantees associated with them. Whilst the underlying mechanism may be complex, the provider must ensure that the communication it provides to the fund regarding the portfolio and its performance is accurate, relevant, simple and easy to understand.

(b) In turn, the information provided by the fund to its members must be accurate, relevant, simple and easy to understand.

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(2) A fund[3] must ensure that any smooth bonus policy complies with the following 'treating customers fairly' fairness outcomes, namely:

(a) Funds can be confident that they are dealing with insurers where the fair treatment of funds is central to the culture of the insurer.

(b) Products and services are designed to meet the needs of funds and their members and are targeted accordingly.

(c) Funds are given clear information and kept appropriately informed before, during and after the time of entering into the policy. In turn, funds must give clear information to members whilst their monies are invested in this investment option.

(d) Where funds receive advice, the advice is suitable and takes account of their circumstances. Equally, the information provided by the fund to its members must be sufficient to allow a suitably qualified independent advisor to give appropriate advice.

(e) Funds are provided with products that perform as the insurers have led them to expect and the associated service is both of an acceptable standard and what they have been led to expect.

(f) Funds do not face unreasonable post-sale barriers to change product, submit a claim or make a complaint.

**5. Default policies prior to 1 March 2019**

(1) A fund may apply for an exemption for a specified period in terms of Regulation 37(3) where-

(a) the fund employed a smooth bonus policy as part of its default strategy at the effective date of this Standard; and

(b) it would be prejudicial to members if the investment in the policy must be immediately terminated.

(2) (a) Only the assets invested in the policy as at the effective date of this Standard may remain invested in the policy.

(b) All contributions or lump sum transfers received after the effective date of this Standard must be invested in a default investment portfolio that complies with the Regulations and this Standard, where applicable.

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[3] The responsibility to comply with the TCF principles is that of the fund. The fund may, therefore, not choose a policy that does not meet the TCF criteria. If an insurer wishes to have their policy considered as a default portfolio by a fund, the insurer would therefore need to provide a product to the fund which complies with these requirements. It is the responsibility of providers to ensure that appropriate information is given to funds for them to comply with their requirements.

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## 6. Short title and commencement

This Standard is called the Conditions for Default Smooth Bonus Policies and commences on 1 March 2019.

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