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Botswana Pensions Society 2016 Annual Conference

Theme; Retirement funds and economic development

Topic; *Understanding the Prudential Rule; the revised PFR 2*

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Objectives of the presentation

- The objectives of the presentation are:

1. To discuss the revised PFR 2 as a tool for pension regulation and supervision in Botswana (BW).
2. To discuss opportunities and challenges of the revised PFR 2; and
3. To discuss the way forward post the revised PFR 2.

Main Arguments

1. That since the past recent financial crisis, regulation of the financial sector, including pensions, has assumed pride of place in public discourse.
2. That pension fund members are increasingly demanding more governance, not government, of their pensions.
3. That pension regulation and supervision entail both benefits and costs, hence, the need for the CBA [Cost Benefit Analysis] of pension regulation & supervision and de-emphasis on regulation & supervision activism.
4. That the govt must not be the only focus of pension regulation & supervision, therefore, self-regulation & self-supervision are key.
5. That the pension industry must view PFR 2 as entailing both challenges & opportunities, hence, the need to leverage on the opportunities associated with the PFR 2.

Key Questions

1. Why is there a current drive for pension regulation & supervision, e.g., through the revised PFR 2?
2. What are the cost implications of pension regulation & supervision, e.g., through the revised PFR 2?
3. What is the cost of regulation & supervision activism?
4. In your judgement, is the NBFIRA a regulator? Supervisor? Both?
5. What opportunities & challenges does the revised PFR 2 entail for pension funds?

Outline of the presentation

- Part I; Intro:

1. Definitions of key terms; regulation & supervision.
2. Theoretical basis for regulation and supervision.
3. Pension regulation & supervision.
4. Distinction btwn pension regulation & supervision.
5. The organisation of the pension supervisory agency.

- Part II; Meat and potatoes:

1. Revised PFR 2 [
2. Opportunities & Challenges.
3. Way Forward.

Theoretical Basis for the need for regulation & supervision

- Address Market Imperfections and Failures.
- Compensate for Asymmetric Information.
- Control Potential Moral Hazard.
- Overcome Consumer Myopia.
- Stimulate Competition and Efficiency (Richard Hinz, 2014; *Regulation and Supervision of Pension Funds*).

Regulation & Supervision

- The regulation and supervision of pension funds is a critical part of building public confidence in a funded-pension system.
- Confidence is best bolstered by an independent, autonomous and transparent supervision agency, particularly when previous systems had failed.
- The choice between proactive and reactive supervision depends on previous experience of self regulation in a country's financial sector. (Demarco & Rofman, 1998; *Supervising Mandatory Pension Funds*: *issues and challenges*).

Distinction btwn pension regulation & supervision

- *Regulation*: legal foundations and system of rules and regulations governing the structure and operation of pension funds.

–Establish form of system and “empower” various parties to perform functions or protect interests.

- *Supervision*; oversight and enforcement of compliance with the rules.

-Collection of information and monitoring of system to support review and analysis (Richard Hinz, 2014; *Regulation and Supervision of Pension Funds*).

The organisation of the pension supervisory agency

- *Regulation or supervision*?

- Although regulation (i.e., setting the rules) and supervision (i.e., enforcing the rules) of pension funds are distinct functions, they could be assigned to the same institution, or clearly assigned to different institutions.

- Using a single institution has the advantage of defining control routines regardless of the personal preferences of regulators.

- The second allows supervisors to approach their job without preconceptions (Richard Hinz, 2014; *Regulation and Supervision of Pension Funds*).

- How does the NBFIRA fit into the above matrix? Is it a regulator? Supervisor? Or a combination of both?

Main Aspects of Regulation Common to All Systems

I. Rules Defining the Structure and Organization of Funds

II. Requirements for the Operation of Funds

III. Authority for Supervision, Sanctions & Remedial Action (Richard Hinz, 2014; *Regulation and Supervision of Pension Funds*).

Circular No. 2 of 2015

- Addresses: Pension & Provident Funds; Asset Managers; Asset Consultants; Fund Administrators; BPS.
- Issue Date: 5 October 2015.
- Effective Date: 1 November 2015.
- Subject: revised Pension Investment Rule (PFR 2); appointment of Risk Mgt Committee; and transitional arrangements for Pension Prudential Rules.
- PFR 2 promulgated in terms of sec 50 of the NBFIRA Regulatory Act.

Background to Circular No. 2 of 2015

- Pursuant to concerns by the industry on limits imposed in terms of circular 1 of 2013, NBFIRA resolved to suspend PFR 2 pending extensive & full consultations with the industry.
- A working committee was made up of reps from Fund Administrators, Asset Managers & Trustees of various Pension Funds to review PFR 2 with NBFIRA.
- In addition, the MFDP was involved in working committee meetings.
- The 1st working committee meeting was held on 12/12/14; and the last meeting was held on 16/12/14.
- In the subsequent, the revised PFR 2, with input from the industry, was tabled to the NBFIRA Board for final approval.

Revised PFR 2; key requirements

- Subsequent to the consultative process, NBFIRA issued PFR 2 which superseded Circular 1 of 2013.
- NB, the revised PFR 2 provided the retirement fund industry with the revised quantitative limits on assets to be held by a retirement fund.
- In addition, every retirement fund must:

1. Establish a Risk Committee.
2. Appoint a Risk Officer who should be a member of the Risk Committee.
3. Formulate an Investment Policy.

Transitional Arrangements

- The effective date is 01/11/2015.
- However, in terms of sec 6 of the revised PFR 2, retirement funds have a transitional period of 6 months to review and ensure compliance with the quantitative limits as per sec 7 of PFR 2.
- NBFIRA expects compliance with quantitative limits & other requirements set out in PRF 2 by <u>no later than 30 April 2016.</u>

PFR 2 (contents)

1 *Introduction*

- 1.1. Definitions

2. *Investment Policy*

- 2.5 Certification by the Actuary
- 2.4 Communication with Members
- 2.5 Individual member choice
- 2.6 Returns

3. *Valuation of Assets*

- 3.1 Valuation Methodology
- 3.2 Disallowed Assets
- 3.3 Derivatives
- 3.4 Limits on Asset Classes
- 3.5 Limitation on Foreign Investment

5. *Risk Management*

Regulatory Authority’s Exemption

6. *Transitional Arrangements*

- Time limit to comply

7 *Investment Restriction per Asset Class*

PFR 2; salient points

- 3.6 *Limitation on Foreign Investment*;

Subject to the transitional rules set out in section 6, no fund shall, in respect of its fund investment strategy, invest less than thirty (30)% of its total assets in Botswana; provided that assets consisting of shares in a company incorporated outside Botswana shall, if such shares have –

a) been designated by the Regulatory Authority for the purpose of this paragraph; and

b) been acquired on the Botswana Stock Exchange

shall be regarded as assets invested in Botswana.

PFR 2; salient points

- 5. *Regulatory Authority's exemption*;

5.1 The Regulatory Authority may on prior written application by a fund, grant such fund exemption from any of the provisions of this prudential rule upon such conditions as it may impose.

5.2 In particular:

i. A fund may be exempted from the quantitative limits set out in section 7 where the fund demonstrates to the Regulatory Authority that the fund is of sufficient size and has access to appropriate expertise to enable it to determine and manage its own investment strategy.

ii. A fund shall have a period of three (3) months from the reporting date at which a breach is first reported to the Regulatory Authority in which to comply with this prudential rule: provided that the fund satisfies the Regulatory Authority that the breach was a result of market movements.

PFR 2; salient points

- 6. *Regulatory Authority's exemption*;

The Regulatory Authority may agree a time limit with a fund for that fund for its compliance with this rule where that fund is in breach of this rule at the time that it becomes mandatory: provided that the time limit shall not be less than six (6) months from the date on which this rule becomes mandatory.

Opportunities & Challenges of PFR 2

1. That consultation lies at the core of regulator-pension industry relationship as evidenced by consultations regarding the revised PFR 2.
2. That pension regulation & supervision, e.g. thru PFR 2, will enhance pension governance.
3. That pension regulation & supervision, e.g. thru PFR 2, will give members a level of comfort regarding their pensions.
4. That pension regulation & supervision entails high compliance costs.
5. That high compliance costs will negatively affect the balance sheet of pension funds.
6. That pension regulation & supervision treat all animals [pension funds] as equals; however, some are more equal more than others, so, can better absorb compliance costs.

Conclusion & Way Forward

- That PFR 2 is a legal instrument that is here to stay, there4, the pension industry must run with it.
- That there is a need for an incubation period to trouble-shoot implementation bottlenecks of the revised PFR 2.
- That there is a need for continued and continuous engagement with the regulator on the revised PFR 2.
- That funds can must make use of the window of opportunity in terms of exemptions and extensions.
- That smaller funds can engage in cost-saving measures, for example, they can source independent trustees from sister organisations (however, this is does not mean 'an independent trustee at any cost' by compromising quality).
- That there is a need for continual improvement and self regulation & supervision to ward off regulation & supervision activism.