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In case you missed it…

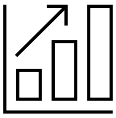
1. January 2021: Seshego Legal Insights

FSCA Conduct Standard 5 of 2020 – Conditions for smoothed bonus policies to form part of default investment portfolios

In October 2020, the Financial Sector Conduct Authority ("FSCA") issued Conduct Standard 5 of 2020, which aims to regulate the operation of smoothed bonus policies when these instruments form part of the default investment portfolio a retirement fund is required to adopt in terms of Regulation 37 of the Pension Funds Act.

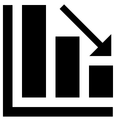
1. What is a Smoothed Bonus Policy?

Smoothed bonus policies (Also known as "guaranteed funds") have traditionally been provided by the major insurance companies. The policy aims to provide smoothed returns with the insurer declaring a "bonus" to the investors.



When markets are performing well, some of the return is held back as surplus.

When markets are falling, the surplus is used to provide a bonus.



The smoothed bonus arrangement is not easy to understand as it is a very complicated structure. Smoothed bonus policies are relatively costly products as it is not difficult for an insurance company to build several hidden fees into this complex structure.

Contributions paid by members and the investment return on these contributions are known as the "book value" but the "market value" is the underlying value of the member's share of the fund which could be higher or lower than the book value and is based on "market value adjustments" by the insurer.

BOOK VALUE (BV)	***MARKET VALUE (MV)***
=	=
Contributions + *Bonus declared*	Value of the underlying assets

- If the MV > BV = Fully funded
- If the BV < MV = Underfunded

A member would usually receive the book value on exiting the fund at a particular point in time but the insurer retains the right to pay the lower of the book value or the market value during periods when the portfolio is underfunded in certain cases such as a switch by the member. This can result in result in unexpected outcomes for members when markets are performing poorly.

2. Why are these policies referred to as "guaranteed funds" and what is actually guaranteed?

The word guarantee implies that a member will receive at least the value of his own contributions on exiting the fund. In practice this is often not the case – the so-called guarantee only applies when a member retires from the fund. However, the guarantee is not funded by the insurer offering the product, it is usually funded by cross subsidisation from the membership.

At present, insurers have complete discretion in declaring bonuses and thus, if due to poor investment performance, the funding level drops below 100%, the insurer will typically restore the level to 100% by declaring poor bonus rates going forwards. As a result, it often happens that in a smoothed bonus arrangement, a member investing R100 will receive only R95 of that amount on exit.

3. Why have the FSCA issued a Conduct Standard regulating smoothed bonus policies?

Regulation 37 of the Act requires that default investment portfolios should be easy to understand, transparent and with no hidden cost structures. The FSCA have realised that smoothed bonus policies fail to meet these requirements and their aim in issuing the Conduct Standard is to provide protection to members who are defaulted into smoothed bonus policies to ensure that they fully understand the default being provided.

4. How does the FSCA Conduct Standard 5 aim to change current practice by insurance companies in relation to smooth bonus policies?

The Conduct Standard aims to prescribe the conditions with which a smoothed bonus policy must comply in order to be considered for inclusion in a default investment portfolio. The FSCA have emphasised the need for transparency and require that management actions be disclosed. The main requirements of the Conduct Standard are set out below:

4.1 Insurers must establish a **formulaic approach** to calculate and determine bonus declarations – this means the insurer will have to declare upfront what policy it will follow in declaring bonuses and how it will be done.

4.2 **Changes to guarantees** in a smoothed bonus policy must be commensurate with the risk and separately disclosed to members. This is aimed to assist members in understanding the guaranteed aspect of smoothed bonus policies and the value (or lack thereof) of the guaranteed component.

4.3 Any **management action** taken by the insurer to reduce the risk (to the insurer) must be properly disclosed and documented. Management actions would include the practice of dealing with underfunding by declaring poor bonus rates which results in cross-subsidisation by the membership.

4.4 The circumstances in which a **market value adjustment** may take place must be pre-determined. Pension funds need to know that market value adjustments may take place, and under which circumstances in order to avoid unexpected outcomes. In particular, the Conduct Standard requires that the FSCA must be notified timeously of any market value adjustments if any retrenchments are being considered before the market value adjustment is applied.

4.5 The smoothed bonus policy may not allow for any **disinvestment penalties** to be levied by the insurer.

4.6 In addition, the Conduct Standard proposes general high-level **Treating Customers Fairly** principles which are aimed at improving outcomes for members.

5. How will FSCA Conduct Standard 5 affect a board of Trustees which has a smoothed bonus policy as part of its default investment portfolio?

5.1 Insurance companies have been given 9 months to comply with the requirements of the Conduct Standard. These requirements will reduce the previous flexibility in the process of managing a smoothed bonus portfolio and it will be less open to manipulation. However, the requirements will also reduce the insurer's ability to act speedily and mitigate risks, which could impact the cost of any guarantees offered by the insurer.

5.2 Board of trustees who wish to include a smoothed bonus policy in their default investment strategy will need to follow a more onerous process to ensure the smoothed bonus policy complies with the requirements of Conduct Standard 5. This should include more checks and balances to ensure the interests of fund members are protected and to guard against unexpected outcomes when members exit the fund. Further, the costs incurred by the insurers in complying with the requirements are likely to lead to an increase in the cost of the product. This could result in boards of trustees finding this investment strategy less attractive.

Should you have any questions regarding the above, please contact your consultant to assist you.