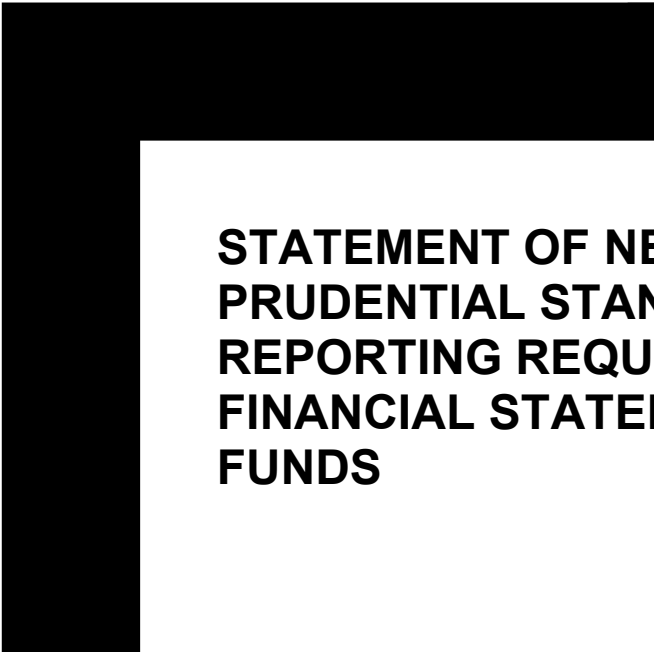
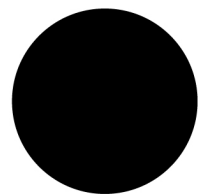




STATEMENT OF NEED AND IMPACT OF DRAFT PRUDENTIAL STANDARD – REGULATORY REPORTING REQUIREMENTS AND AUDITED FINANCIAL STATEMENTS FOR PENSION FUNDS



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* This version incorporates changes that were made to the original version of the “Statement supporting the draft Prudential Standard – Regulatory Reporting Requirement and Annual Financial Statements for Pension Funds” that was published in November 2022

1 PURPOSE OF THE STATEMENT

- 1.1 The purpose of this Statement is to explain the need for, and expected impact and intended operation of the draft Prudential Standard – Regulatory Reporting Requirements and Audited Financial Statements for Pension Funds (draft Prudential Standard) as required by section 98(1)(a) of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSR Act).
- 1.2 The Financial Sector Conduct Authority (FSCA) is intending to make the draft Prudential Standard under section 15 of the Pension Funds Act, 1956 (Act No.24 of 1956) (PFA) and section 105(1) of the FSR Act, read with section 292(2)(b), (3) and (4) of the FSR Act.

2 STATEMENT OF NEED - POLICY CONTEXT AND PROBLEM DEFINITION

- 2.1 Internationally it is accepted that International Financial Reporting Standards are not wholly appropriate for the pension funds industry. It is anticipated that if global standards are developed for pension funds, South Africa will follow those standards. However, it is unlikely that global standards will be developed in the near future. To ensure consistency, it is important that financial reporting requirements for pension funds are, to the extent practical and possible, aligned to the International Financial Reporting Standards.
- 2.2 Auditing and reporting type requirements for pension funds are currently set out in different Board Notices that were issued under the PFA. More specifically:
- Board Notice 14 of 2009¹ (BN 14) sets out the recognition and measurement principles to be used in preparation of the financial statements and also provides guidance relating to disclosure and presentation in the prescribed format of the financial statements as stipulated in BN 14, which serves as an accounting guide for the pension funds industry.
 - Board Notice 77 of 2014² (BN 77) prescribes the financial statements applicable to different categories of funds. BN 77 requires funds with assets above R50 million to have its financial statements audited and reported on by an auditor in terms of section 15(1) of the PFA.
 - BN 77 also exempts funds which has assets less than R50 million at its financial year-end from the requirement to have its financial statements audited and reported on by an auditor in terms of section 15(1) of the PFA
 - However, funds with assets below R50 million but above R6 million must appoint an auditor in terms of section 9(1) of the PFA to perform agreed upon procedures in line with international standards as adopted by IRBA.
 - Currently funds with assets below R6 million need not appoint an auditor to perform agreed upon procedures.
- 2.3 The regulatory reporting requirements, including the formats for reporting, are to some extent outdated. For example, in March 2018 and 2022 the Independent Regulatory Board for Auditors (IRBA) approved two new illustrative auditor's reports to be used by registered auditors.³ IRBA also recently approved the revised section 15 illustrative reports in terms of ISRS440. Despite various new formats approved by IRBA, BN 77 still prescribes the outdated formats. The only way in which the FSCA could facilitate the use of these new formats was by issuing exemptions (see FSCA RF Notice 5 of 2020 and FSCA RF Notice 5 of 2022). This

¹ Published in Government Gazette No. 31838 of 4 February 2009.

² Published in Government Gazette No. 37844 of 18 July 2014.

³ "Auditor's report template: Audit of the Financial Statements of a Large Retirement Fund (Schedule D)" and "Assurance Report on Compliance with Regulation 28 of the Pension Funds Act".

is therefore an example of where the requirements contained in BN 77 are no longer appropriate.

- 2.4 It has also become evident that it is imperative that the financial statements of all pension funds be audited to ensure that the FSCA has better oversight on all funds irrespective of size. This is to ensure all pension funds consistently apply the recognition and measurement criteria contained in the revised accounting guide and the presentation and disclosures contained in the revised prescribed financial statements format and, as such, the general standing exemptions contained in BN 77 needed to be reconsidered and withdrawn. Other exemptions that need to be withdrawn includes the cash basis of reporting and the two general exemptions contained in FSCA RF Notice 5 of 2020 and FSCA RF Notice 5 of 2022. issued in 2020 and 2022. The look through reporting exclusions for guaranteed policies, contemplated in Regulation 28(8)(b)(iii), also needs to be reconsidered (read with LTIA Ai 157). The withdrawal of the various applicable exemptions will ensure equal protection of members accumulated funds in small funds versus large funds as well as equal protection before the law.
- 2.5 The revised Regulation 28 as gazetted in July 2022 has also required additional reporting requirements in relation to infrastructure assets and other amendments to the asset spreading requirements. For further detail kindly consult the National Treasury media release of 8 July 2022 and the Gazette itself. The regulatory reporting requirements for pension funds therefore need to take into account the amendments to Regulation 28 and ensure that pension funds appropriately report on these matters.
- 2.6 Therefore, a need exists to update the regulatory reporting requirements and the prescribed format of financial statements to further align to the International Financial Reporting Standards, International Accounting Standard and local auditing requirements; ensure consistency in the application of financial reporting requirements across all pension funds; and to consolidate all related requirements into one instrument.

3 CONSULTATION ON THE DRAFT PRUDENTIAL STANDARD

- 3.1 On 9 November 2022, the FSCA published a draft Prudential Standard - Regulatory Reporting Requirements and Audited Financial Statements for Pension Funds (draft Prudential Standard), for public consultation. The comment period on the draft Prudential Standard closed on 18 January 2023.
- 3.2 Subsequent to the publication of the draft Prudential Standard, comments were considered and the draft Prudential Standard significantly revised. The major revision relates to the approach and format of the draft Prudential Standard.
- 3.3 The previous version of the draft Prudential Standard provided detailed requirements, reporting templates, Schedules and Notes to the Schedules. In addition, the draft Standard included a list of changes being made to the current RRR.
- 3.4 One of the consistent issues that emanated from the consultation was that the approach set referred to at paragraph 3.3 was a concern. Commentators proposed that the draft Prudential Standard be limited to setting out the principles rather than including the entire RRR templates as annexures. That the draft Prudential Standard set out the principles and the detailed reporting templates are in separate documents on the FSCA's website, may be more practical. The separate reporting template can be changed far more easily than trying to change a template embedded as an annexure to the draft Prudential Standard. This is particularly applicable in rapidly evolving reporting areas such as the reporting on ESG investments where the information users of the RRR (including board members, fund members and the FSCA)

want to see and is available, may change rapidly from one year to the next.

- 3.5 Further, it was suggested that the draft Prudential Standard itself should not include a list of changes being made to the current RRR. That the draft Prudential Standard, should only include what a person preparing or reviewing the fund's return in a few years' time would need to see. The extensive use of cross referencing to specific paragraphs in specific IFRS standards may also make the Standard harder to keep up to date.
- 3.6 Considering the above, the FSCA acknowledges the practical difficulties in respect of having detailed requirements, Annexures, Notes and Schedules in the draft Prudential Standard instead of determining these separately.
- 3.7 Accordingly, the draft Prudential Standard has been revised and detailed Schedules, Annexures and Notes will be issued in a separate determination. Chapter 3 of the revised draft Prudential Standard is a revised draft without Annexures, Schedules and Notes. The approach taken was to carve out the Annexures, Notes and Schedules which is the Prescribed Financial Statements Report that the Authority is prescribing as per section 15 of the PFA.
- 3.8 Full details of the formal consultation processes are set out in the Consultation Report pertaining to the draft Prudential Standard.

4 SUMMARY OF THE DRAFT PRUDENTIAL STANDARD

- 4.1 The draft Prudential Standard proposes to consolidate all audit and regulatory reporting requirements into one instrument by replacing, amongst other things, the existing Board Notice 14 and BN 77. Besides providing for prescribed financial statements for funds to be audited, the draft Prudential Standard also incorporates both the regulatory reporting requirements and the format of the financial statements into one document.
- 4.2 A lot of the content of the draft Prudential Standard is based on the content of the existing BN 14 and BN 77. However, the draft Prudential Standard provides enhanced detail relating to reporting concepts, additional definitions have been included and the specific paragraphs of the regulatory reporting requirements are expanded on in line with amendments to the relevant sections of International Financial Reporting Standard and the International Accounting Standard.
- 4.3 In terms of Guidance Notice 1 of 2019 that relates to Sustainability of Investments and Assets in the context of a pension fund's Investment Policy Statement (IPS), funds are encouraged to adopt sustainable reporting practices in the interest of transparency, accountability and fair treatment of its members. In this regard, a fund's board would be required to disclose certain information relating to aligning their IPS to the Guidance Notice as per Schedule E of the financial statements.
- 4.4 It is proposed that the existing exemption that exempts specific funds from the requirements to appoint an auditor and to have its financial statements audited and reported on by an auditor, be removed. This means that the draft Prudential Standard will be applicable to all funds, including funds with total assets below R50 million.

5 STATEMENT OF IMPACT OF THE PRUDENTIAL STANDARD

- 5.1 Through the consultation process commentators expressed differing views in respect of the expected impact of the Prudential Standard. What made the impact responses difficult to

assess was the fact that commentators did not typically differentiate between what specific requirements in the prudential standard will result in this specific impact. The areas of impact commentators pointed out, amongst others, were additional compliance costs; operational costs of the business; and termination of existing arrangements. Further, commentators did not provide quantifiable data as to the cost implication for the above areas. The only exception was a comment that ESG reporting could potentially result in an estimated cost of R60 000 per year.

5.2 Below we set out what we understand as the specific requirements that will lead to notable cost implications, together with our responses:

Comment	FSCA response
Additional compliance costs: Consulting would need to source additional information. Administration would need to keep additional information. Accounting teams would take longer to prepare annual financial statements. Auditors would need to audit additional information. Expected costs is still uncertain.	The Authority notes that expected costs may increase in respect of consulting, compliance administration, preparation and audit of the annual financial statements. However these costs should be anticipated in accordance with nature, scale, complexity and risk profile of the pension fund. Thus these considerations seek to ensure the safety and soundness of pension funds and protecting pension fund members. Further, the Authority has to strike a balance between protecting financial customers and ensuring appropriate disclosures are in place and timely interventions are implemented to maintain the integrity and stability of the retirement sector. Even though expected cost are uncertain, the Board must exercise due diligence by ensuring that members are not prejudiced and funds do not incur exorbitant fees.
Additional compliance costs: Reg 28 look through – funds need to obtain this from the investment managers, and time to capture the product level information. The ESG questions require input from the trustees, principal officer and the investment consultant, time to obtain the information, capture it, and evidence for the auditors Investment fees – where the fees are included in the price, additional effort to obtain the information and adjust the information on the system Additional audit costs and time impact of dealing with the auditors on small funds where previously audit exempt. The audit requirements and costs on retirement funds which have ceased to operate some time ago will impact on members.	We note the comments. A fund auditor would have already been appointed to conduct procedures for the section 15 factual findings report. These funds may use such auditor to perform the audit. The smaller funds should thus make provision for sufficient audit fees to perform the audit.
Affect operational costs of the business: The commentator stated its fund does not anticipate a huge increase in operational cost – however, there is anticipation that the costs will increase.	Comment noted. However even though expected cost are uncertain, the Board must exercised due diligence by ensuring that members are not prejudiced and funds do not incur unjustified exorbitant costs.
Termination of existing arrangements: Commentators were unable to	The Prudential Standard will have an immediate financial impact on all funds that were not previously subject to the audit requirements, for example funds that are terminating and those that had previously been exempt from the audit requirements as they had total assets that did not

provide feedback on this question as this cannot be determined at this point in time. Some commentators said small funds will therefore certainly incur additional costs, especially auditing costs, but one can make an argument that an asset size as low as R 50 million is below the threshold for viability (i.e. such funds should be terminated in any case). The extra requirements and costs (specifically, the extra auditing costs) may hasten the termination of smaller funds.	exceed R50 million. No significant financial impact is envisaged in respect of funds that were not previously exempted since the above-mentioned changes related mainly to the notes to the financial statements and the new limits in the regulation 28 disclosures. Funds that were not previously subject to the audit requirements will therefore have to make adequate provision for audit expenses relating to financial statements required in terms of section 15(1) of the PFA. Funds should therefore plan their audit engagements appropriately and ahead of time to ensure that audits would not result with delays in having the financial statements submitted timeously to the Authority as required in terms of section 15(1) of the PFA. Funds with under R6 million in assets have the option of moving to umbrella funds to share costs but the Authority also expects proportionality in audit fees charges based on size and complexity of funds. For example, a smaller and simpler structured funds are expected to have lower audit fees unlike larger, complex structured funds. In addition, supervisory experiences have shown that smaller funds have less stringent governance and oversight requirements. Therefore, the Authority is of the view that such funds must be subjected to audit requirements. Further, funds with assets below R50 million and above R6 million, although a full scope audit was not required before, these funds already have appointed an auditor to conduct the agreed upon procedures section 15 factual findings report. These funds may use the same auditors to conduct the full scope audit. Therefore, the Authority does not expect a major financial impact of this Prudential Standard on funds with above R50 million in assets. The impact on smaller funds will mostly be manageable however it's imperative for such funds to make a provision for the audit fees timeously to avoid having no sufficient funds left for an audit to be performed.
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- 5.3 In conclusion, it must be acknowledged that it is inevitable that legislative interventions will have a cost implication. The key is finding an appropriate balance between the expected costs and the envisaged benefits.
- 5.4 Viewed holistically, the FSCA is of the view that the current draft of the Prudential Standard strikes an appropriate balance between mitigating key risks whilst not creating an excessive cost burden for pension funds.

6 STATEMENT OF INTENDED OPERATION OF THE PRUDENTIAL STANDARD

- 6.1 The draft Prudential Standard is consistent with the objects of the FSR Act and PFA, and specifically the mandate of the FSCA⁴ to protect financial customers by promoting the fair treatment of financial customers by financial institutions.
- 6.2 The draft Prudential Standard will become effective on 1 January 2026. Practically, this means the draft Prudential Standard will apply to pension funds with a financial year ending after 1 January 2026.
- 6.3 Following the implementation of the Prudential Standard, the Authority will assess and evaluate the effect of the Prudential Standard on a continuous basis as part of its regulatory and supervisory responsibilities.

⁴ As exercised in terms of section 292(2)(b), (3) and (4) of the FSR Act.

- 6.4 The FSCA will monitor compliance with the draft Prudential Standard by using pro-active supervisory approaches in which potential areas of concern, with a greater emphasis on pre-empting negative customer outcomes where possible, are identified.