

7 May 2003

Retirement Funds minimum benefits and surplus legislation:

The regulations, board notices and PF Circulars

1. Introduction

In regulations¹, board notices² and PF circulars³ issued in the course of the last two weeks, the Minister of Finance and the Registrar of Pension Funds have sought to comply with their obligations in terms of the Pension Funds Act⁴ to prescribe a number of matters relating to minimum benefits and the apportionment of actuarial surpluses and to remedy problems which are evident in errors and omission in the Act.

2. The Registrar's compliance with his obligations in terms of the Pension Funds Act.

Most importantly, the Registrar has complied with his obligation in terms of section 14A(1)(a) of the Act to prescribe by notice in the *Government Gazette*⁵ the assumptions to be used by a fund's actuary in determining the fair value equivalent of the present value of a member's accrued deferred pension. This calculation is to be performed both in relation to current in-service member whose service terminates at least 12 months after the fund's surplus apportionment date and in relation to former members who claim their minimum benefit top-ups in terms of section 15B(5) of the Act.

3. Steps possibly taken in excess of statutory authority

3.1. Section 36 of the Pension Funds Act grants to the Minister of Finance the authority to make regulations not inconsistent with the provisions of the Act "as to all matters which he considers it necessary and expedient to prescribe in order that the purposes of this Act may be achieved".⁶

¹ The new regulations 34, 35 and 36 published in *Government Gazette* 24780 in Notice No 558 of 22 Apr 2003.

² Board notices 35, 36 and 37 of 2003 published in *Government Gazette* 24809 on 25 April 2003.

³ PF Circulars 112 and 113 published on the Financial Services Board website on 5 May 2003.

⁴ As amended by the Pension Funds Second Amendment Act 39 of 2001.

⁵ See Board Notice 35 of 2003 published in *Government Gazette* 24809 on 25 April 2003.

⁶ Section 36(1)(c).

3.2. **Regulation governing minimum pension increases for deferred pensioners**

The Minister has sought to use this authority plug a hole in section 14B(4)(b) of the Act which is the section governing minimum pension increases. The section states that as at the effective date of the first actuarial valuation after 7 December 2001, pensions in payment and deferred pensions must be increased by the “minimum pension increase”. To do this the board must determine a pension increase policy that provides for a targeted pension increase at a percentage of the rate of increase in the CPI from date of retirement. The statute does not make provision for increases in deferred pensions from the dates of exit to dates of retirement. In the new regulation 34 it is stated that, for the purposes of section 14B(4)(b), the pension increase to be determined for a pensioner who was a deferred pensioner prior to retirement is the change in CPI from the date of his or her exit to the effective date of the calculation, with appropriate adjustments for any portion commuted at retirement. In our opinion this regulation is not authorized by the Act because it is not consistent with the wording of the Act. The Act itself does not require that provision be made for increases in the value of pensions from date of exit to date of retirement. Nonetheless it would seem unreasonable for a fund to refuse to do this in the formulation of its pension increase policy and we would be surprised if much was made of the issue.

3.3. **Regulation governing contingency reserve accounts**

3.3.1. In the new regulation 35 the Minister has sought to place restrictions on the power of a board to establish and fund contingency reserve accounts. In sub-regulation (1) the regulation states that no fund may establish a contingency reserve account in circumstances from which it may reasonably be inferred that the account was established in breach of the board’s duties in terms of section 7C(2)(b)⁷ and motivated by bad faith. Now, for us, this sub-regulation does nothing more than state what is the law. Clearly section 7C prohibits conduct in violation of it, whether it takes the form of a decision to establish a contingency reserve account or a decision to award a death benefit to on the basis of a consideration which is irrelevant to section 37C of the Act. The section does not say what the consequences of non-compliance are but we all know that an aggrieved member, for example, can apply to court for an order setting aside a trustee decision improperly made.

3.3.2. The regulation then requires the valuator of a fund to motivate (*motiveer*) the establishment and magnitude of any contingency reserve account in the fund in his or her report on the statutory valuation of the fund and purports to empower the Registrar to reject the establishment of the account or the

⁷ Which requires a board to act with due care, diligence and good faith.

magnitude of the assets in the account⁸. Jeremy Andrew has pointed out to us that section 16(9) of the Act, read together with section 15(3) of the Act, authorizes the Registrar to reject a valuation report which, in his opinion, does not correctly reflect the financial position of the fund. In that event, the fund is deemed not to have furnished the valuation report. So arguably regulation 35 is unnecessary because the Registrar could use his powers under these sections to reject valuation reports containing contingency reserve accounts which, in his opinion, were inappropriate.

3.3.3. We have wondered whether there was any substance in the argument that the Act does not prevent a fund from basing its surplus apportionment scheme on a report on the valuation of the fund as at the statutory valuation date which is not the statutory valuation report. But we came to the conclusion that, while there may be something in the argument, a court or appeal board which is apprised of the matter is likely to adopt a purposive approach to the Act and say that “but of course your apportionment scheme must be based on the assets and liabilities and reserves set out in the statutory valuation report”.

3.3.4. Even if our tentative argument is right and the board of a fund has the exclusive power to decide on the value of assets to be credited to contingency reserve accounts, that decision will not necessarily be unimpeachable. An aggrieved stakeholder has the right, in the absence of regulation 35, to challenge a trustee decision on the allocation of assets to contingency reserve accounts by means of a complaint to the adjudicator or an application to the High Court for an order setting aside the decisions. And of course actuaries who advise boards on these matters will be mindful of the risk to their status as approved valuers of a finding by the Actuarial Society that they have acted unprofessionally in giving that advice.

3.3.5. The problem, of course, is that members and other stakeholders are often ignorant of trustee decisions on matters such as these. So, we think it would have been appropriate for the Minister to have exercised his powers in terms of section 15B(d)(i) to include in the prescribed information to be conveyed to stakeholders in relation to a surplus apportionment scheme the reasons for the establishment of the fund’s contingency reserve accounts and the value of assets credited to them. Remember that the purpose of providing the information is to enable stakeholders to judge the reasonableness of the scheme⁹ so that, if a stakeholder believes it appropriate, he or she may

⁸ Regulation 35(2).

⁹ Section 15B(9)(d).

exercise his or her right to lodge a complaint regarding the scheme before it is submitted to the Registrar for his approval¹⁰. The documents which will be required to be submitted together with the fund's surplus apportionment scheme will have to include a report by the fund's principal officer setting out the details of complaints lodged with the fund and actions taken to address them. The Registrar will also require a report by an independent actuary if there are unresolved complaints. If, after considering the scheme documents, the Registrar does not believe that the scheme is reasonable and equitable and accords full recognition to the rights and reasonable benefit expectations of members and former members, the scheme will have no force or effect¹¹. The fund will have to refer the apportionment to a special *ad hoc* tribunal established in terms of section 15B(10) and, while the tribunal will not have the power to substitute their decisions on the allocation of assets to contingency reserve accounts for those of the board, a sensible board of trustees will seek to avoid having the fund having to bear the costs of a tribunal and the risk that it will make inappropriate decisions on the apportionment of its surplus.

3.4. Regulation governing treatment of untraced former members

Regulation 35(4) also seeks to restrict the power of a board to exclude from the surplus apportionment former members of the fund that it cannot trace. Section 15B(4)(b), you will recall, states that, provided that a fund has complied with its obligations to try to locate the former members and to reconstruct its records in relation to them, if it cannot reconstruct the records of untraced members, it may either establish a special contingency reserve account into which payments in respect of the former members may be made or it may exclude them from the apportionment of surplus altogether. Regulation 35(4), on the other hand, does not, in our opinion, take the matter much further. We do not believe that the statute permits a fund to exclude from the apportionment altogether untraced former members in respect of whom the fund can reconstruct its records. What the Act does not disallow and which regulation 35 now seeks to disallow, is rules which provide for the forfeiture of claims against a fund after three years from the date on which they vest. The problem is that the regulation does not do this explicitly, as one may have expected, in regulation 30 which sets out what the rules of a fund must provide. And we are not sure that it can be said that this part of the regulation is consistent with the Act. Instead it anticipates the enactment of new legislation, namely the Unclaimed Benefits Fund legislation. The regulation states that, where a board is able to determine the "enhancement due in respect of a particular former member . . . but is unable to trace that

¹⁰ Section 15B(9)(d)(ii) and (e).

¹¹ Section 15B(9)(i).

former member in order to make payment, the board shall put the corresponding enhancement into a contingency reserve account specific for the purpose.” It then says that “[n]otwithstanding anything in the rules of the fund, moneys may not be released from such contingency reserve accounts except as a result of payment to such former members or as a result of crediting the Guardians Fund or some other fund established by law to include such amounts.” The Minister is now doing something the Registrar has been doing for some time – keeping funds in a holding pattern pending the enactment of new legislation. In our opinion this part of the regulation is legally ineffective but practically may work quite well. The Registrar will simply delay making decisions on the approval of surplus apportionment schemes from which untraced former members are excluded or rules amendments designed to allow the transfer of assets from the special purpose contingency reserve account to other accounts within the fund until such time as legislation authorizes him to do so.

3.5. **Regulation 36 governing valuation-exempt funds**

3.5.1. Unfortunately regulation 36, too, has a number of defects. You will recall that, in terms of section 15B(5) of the Act, within 18 months of the first statutory valuation of a fund required in terms of the Pension Funds Act following 7 December 2001¹², the trustees of the fund must submit to the Registrar of Pension Funds, a scheme for the apportionment of the actuarial surplus as it exists on the effective date of that statutory valuation¹³. For funds which have been valuation non-exempt for some time, the timing of their statutory valuations is clear. Section 16 states that a registered fund must, at least once in every three years, cause its financial condition to be investigated and reported upon by a valuator. The report must be made in respect of the position as at the end of a financial year. Funds which are valuation exempt never have to submit a statutory valuation.

3.5.2. To ensure that valuation-exempt funds cannot avoid compliance with the surplus apportionment provisions of the Act, regulation 36 states that the Registrar must on the date of commencement of the regulation, withdraw any valuation-exemption granted to a fund with effect from, in the case of an audit exempt fund as at the end of the financial year following 7 December 2003 and in the case of a non-audit exempt fund, as at the scheme anniversary following 7 December 2003. Now, we do not know when the regulation will commence if it has not done so on its publication in the *Government Gazette*. If the regulations have already commenced and the Registrar has not

¹² The date on which the Pension Funds Second Amendment Act (the “commencement date” as defined in section 1) came into effect.

¹³ Section 15B(1)(a) and (b).

complied with his obligation in terms of regulation 36, what then ? Again – arguments about these matters may assist a fund to win a battle but are unlikely to win any wars.

3.5.3. Having said that the Registrar must remove valuation exemptions from funds, the regulation then says that these now non-valuation-exempt funds must submit schemes for the apportionment of their surpluses as at their financial year ends or scheme anniversaries, as the case may be, following 7 December 2003. We do not know where the Minister gets the authority to set these dates. Section 16 requires funds to submit reports on their statutory valuations at least once in every three years. Subsections (3A) and (4) set out the position of funds that were registered in 1984 but had never previously submitted reports on their statutory valuation or were registered after 1984. In both cases they were given three years to submit their first valuation reports and we think that the Minister does not have the power to reduce the period of three years in which these newly non-exempted funds may submit their reports.

3.5.4. If we are right then the actuaries in this room will be able to spread their valuation work out over a longer period which would be nice for them. Former members, on the other hand, could have a longer time to wait for their minimum benefit top-ups.

3.6. ***Board notice governing treatment of actuarial surpluses in umbrella funds.***

While umbrella funds will be pleased by the board notice¹⁴ which states that each sub-fund within a fund should be treated for the purposes of surplus apportionments as if it were a stand-alone fund, this may not solve the problem that the statute does not provide for this. A board notice cannot override the provisions of a statute and so we may see former members of an umbrella fund in one sub-fund seeking a share of the surplus in another sub-fund. In our opinion a former member could take on review a decision by the Registrar to approve a surplus apportionment scheme for an umbrella fund, or a part of an umbrella fund, which does not provide for minimum benefit top-ups for all the former members of the whole fund.

3.7. ***Board notice governing methods of apportionment deemed to be equitable***

3.7.1. Section 15B(5)(c) empowers the Registrar to prescribe methods which if used in the apportionment of residual surplus will be deemed to be equitable.

¹⁴ Board notice no. 36 published in *Government Gazette* 24809 of 25 April 2003.

- 3.7.2. This the board notice does by deeming equitable a surplus apportionment scheme that provides for –
- 3.7.2.1. a secondary enhancement for former members who were retrenched, subject to conversion from defined benefit to defined contribution or transferred out of the fund;
 - 3.7.2.2. a reserve to which is credited amounts required to fund an amount equivalent to the excess of the value of pension increases determined in terms of section 14(4)(b)(i) and pensioners' reasonable benefit expectations as to future pension increases, on the one hand, and the minimum pension increases actually granted to pensioners on the other;
 - 3.7.2.3. a reserve account within the member surplus account to which is credited the excess of the value of members' individual reserves and their accrued liabilities times the fair value over the actuarial value of the fund's assets as at the surplus apportionment date; and
 - 3.7.2.4. the split of the balance of the surplus between the former members, current members and the employer in proportion to the contributions paid by each class of stakeholder accumulated to the surplus apportionment date using the fund's rate of nett investment return.
- 3.7.3. Significantly, when the board determines the secondary enhancement for former members who transferred out of a fund, it is permitted to take into account surplus previously transferred with them, even if it was not credited to them in their new fund.

4. Remaining problems

There are numerous gaps in the legislation and provisions whose meaning and legal effect remain uncertain. Today we will talk only of those that the Registrar has sought to address in his two recent PF Circulars. There are numerous others which have been discussed in numerous *fora* to date.

4.1. **Former pensioners as former members**

- 4.1.1. Section 15B(5) provides that, as part of the apportionment of surplus in a fund, former members who left the fund from 1 January 1980 onwards¹⁵ must have the benefits paid to them or amounts previously transferred on their behalf increased to the value of the minimum benefit determined in terms of section 14B(2) (described above) as at the dates at which they left the fund. That increase must be adjusted to the surplus apportionment date using the nett investment earnings of the fund over the corresponding period¹⁶.
- 4.1.2. The problem is that section 14B(2) does not take into account pensioners who left the fund as pensioners. The Registrar has tried to fill the gap by stating in PF Circular 112 that such former members for whom annuities were purchased on retirement must be granted the minimum individual reserve as at the date of exit calculated in accordance with section 14B. If the former member was already a pensioner at the time that the annuity was purchased for him or her, he or she must be granted the present value of his or her pension after increase in terms of section 14B(4) at the effective date of the purchase of the annuity.
- 4.1.3. In our opinion this PF circular is ineffective and former members for whom annuities were purchased on or after retirement probably will have no claim to a minimum benefit top-up unless the Act is amended as it should be.

4.2. **Adding the value of “past improper use” to the actuarial surplus to be apportioned.**

- 4.2.1. The Act provides that, within 18 months of the first statutory valuation of a fund required in terms of the Pension Funds Act following 7 December 2001¹⁷, the trustees of the fund must submit to the Registrar of Pension Funds, a scheme for the apportionment of the fund’s actuarial surplus as it exists on the effective date of that statutory valuation¹⁸. The term “actuarial surplus” is defined in the Act
- 4.2.1.1. in relation to a fund which is subject to actuarial valuation as “the difference between –

¹⁵ Section 15B(4).

¹⁶ Section 15B(5)(b).

¹⁷ The date on which the Pension Funds Second Amendment Act (the “commencement date” as defined in section 1) came into effect.

¹⁸ Section 15B(1)(a) and (b).

- (a) the value placed by the valuator on the assets of the fund less any credit balances in the member and employer surplus accounts; and
- (b) the value that the valuator has placed on the liabilities of the fund in respect of pensionable service accrued by the members prior to the valuation date together with the value of those contingency reserve accounts already established or which are to be established by the fund's board on the actuary's advice";

4.2.1.2. in relation to a fund which is exempt from valuation, "the difference between –

- (a) the fair value¹⁹ of the fund's assets less any credit balances in the member and employer surplus accounts; and
- (b) the sum of the values of all the accounts held for individual members, whether contributory or paid up; plus any other liabilities; plus the values of any investment reserve account set up to facilitate the smoothing of investment returns credited to member accounts and such and contingency reserve accounts as the board deems prudent."

4.2.2. The Act then says that, for the purpose of the surplus apportionment, the "actuarial surplus" must be increased²⁰ by the amount of actuarial surplus "utilized improperly by the employer prior to the surplus apportionment date"²¹.

¹⁹ A definition of "fair value" has been inserted in the Act in terms of the Pension Funds (first) Amendment Act of 2001 which came into effect on 7 December 2001 as follows:

"fair value', in relation to an asset of a fund, means the fair value of that asset determined in accordance with South African Statements of Generally Accepted Accounting Practice;".

²⁰ It would seem that that, at this stage at least, the "increase" is a notional one.

²¹ Section 15B(5)(a). It is implicit from the reference to the commencement date in section 15B(6)(d) that the improper use contemplated in sections 16B(6)(a) to (c) includes improper use prior to the commencement of the Pension Funds Second Amendment Act. The Act does not say how far back the "improper use" goes. It could be the date on which the fund was established, the date on which the original Pension Funds Act of 1956 came into effect or 1 January 1980, the date from which former members of the fund will have to be taken into account for the purpose of the surplus apportionment.

- 4.2.3. These two provisions, namely sections 15B(1)(a) read with the definition of “actuarial surplus”, one the one hand, and section 15B(5)(a) are inconsistent and there is a strong argument that the former trumps the latter. To dissuade funds from this argument the Registrar has issued PF Circular 113 in paragraph 1 of which he states that the board of a fund must add the value of the “past improper use of surplus” to the actuarial surplus as at the surplus apportionment date before determine whether a surplus apportionment scheme is required to be submitted. There are two problems with this. The first is that, as we know, PF circulars are merely practice notes and do not have the force of law. Secondly the Registrar has made the same mistake in the circular as was made in the statute in that both say that the actuarial surplus as at the statutory valuation date must be added to or increased. But if there is no actuarial surplus as at the statutory valuation date, there is nothing to add the “past improper use of surplus” to and so a fund in that position may be able to get away with not submitting any surplus apportionment scheme. And the participating employer which may otherwise have been on the hook for the “past improper use of surplus” may be able to swim away.
- 4.2.4. The Registrar has also sought to “clarify” the legislation in PF 113 by saying that funds can ignore “past improper use of surplus” in respect of events that occurred prior to 1 January 1980. This seems sensible and funds can probably assume that the Registrar will not reject their surplus apportionment schemes on the grounds that they have ignored those events but they cannot assume that former members whose claim to minimum benefit top-ups may be prejudiced if the funds do not seek to recover amounts in respect of “past improper use before then” may ask a court to override the Registrar on the point.
- 4.2.5. The Registrar has also kindly said that “past improper use” which redressed a previously discriminatory practice or for which employers have committed to pay may be deducted from the amount to be added to the actuarial surplus for the purpose of the surplus apportionment. This, too, could be subject to review.
- 4.3. What is useful about PF Circular 113 is the indication of in what circumstances the Registrar will be satisfied that “past improper use of surplus” was approved by the members or trade unions representing members after a clear and comprehensive communication exercise as part of a negotiated utilisation of surplus by stakeholders. In the circular the Registrar indicates that he will be satisfied as to the approval by members if

at least 75% of them approved the use of surplus or there was an agreement signed by or on behalf of the members concerning the negotiated utilisation of surplus or members were given the opportunity to object to the proposed utilisation and any objections lodged were addressed to the satisfaction of the persons concerned.

5. **Conclusion**

Until such time as Treasury is prepared to take to Parliament a thorough set of amendments to the Act, we are all just going to have to muddle along as best we can, risking our reputations when we advise our clients to either follow the directions given by the Registrar in the board notices or PF circulars or what the Act itself probably requires.

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