

THE CONVERSION OF MEMBERS' RIGHTS IN SOUTH AFRICAN RETIREMENT FUNDS FROM DEFINED BENEFITS TO DEFINED CONTRIBUTIONS AND THE STATUTORY APPORTIONMENT OF THE RESULTING ACTUARIAL SURPLUS

By JP Andrew

ABSTRACT

This paper reviews and discusses the history of the conversion of members' rights in South African retirement funds from defined benefits to defined contributions. It explains the development of the law in this regard, including legislation governing the apportionment of surplus on conversion. It draws lessons from the process and discusses its ongoing effects.

KEYWORDS

Retirement funds; defined benefits; defined contributions; conversion; apportionment of surplus

CONTACT DETAILS

Jeremy Andrew, P O Box 54, Morningside, 2057; Tel: (0)11 884-9770; Fax: (0)11 884-9770;
E-mail: jpandrew@telkomsa.net

1. INTRODUCTION

1.1 A combination of factors lead to the widespread conversion of South African retirement-fund rights from a defined-benefit (DB) to a defined-contribution (DC) basis across the 1980s and 1990s, releasing substantial amounts of actuarial surplus.

1.2 Coincident attempts to transfer actuarial surplus to the employer, challenges to certain past conversion terms, attempts to pass legislation governing the transfer of surplus to the employer, the resulting reaction by the trade-union movement, and court cases which clarified the ownership and rights to dispose of actuarial surplus, culminated in legislation which introduced minimum benefits on transfer or conversion, minimum pension increases, and a statutory apportionment of actuarial surplus, priority being given to the enhancement of past transfers and conversions and pension increases to minimum levels. The legislation also requires retrospective review of certain past actions that may have benefited the employer.

1.3 The reputation of the actuarial profession has been damaged in the process.

1.4 The paper puts the development of this legislation into its historical and legal context and questions the actions of boards of trustees, the actuarial profession and the

regulator in the conversion process, which the author believes to be the cause of the subsequent statutory intervention. The author concludes that insufficient attention was given to the duties of care of the boards of trustees and their professional advisors towards converting members, to conflicting interests between the employer, the fund, members who remained on a DB basis and members who converted to a DC basis, to disclosure and communication, and to ensuring that stakeholders all had access to expert advice. One of the biggest dangers identified is working within a paradigm and not recognising outcomes that challenge the paradigm. Fortunately for the actuaries concerned, the conservatism in their actuarial assumptions may minimise the volume of enhancements to minimum benefits, in practice.

1.5 The lesson for other jurisdictions is that, unless there is adequate disclosure, management of conflicts of interest, and access to independent professional advice by all classes of stakeholder, during a conversion, either the courts or the legislature may intervene retrospectively.

1.6 Broad generalisations inevitably obscure the nuances of each individual conversion. This runs a danger in that issues that have nothing to do with the technicalities of the conversion are omitted, despite perhaps having been very relevant to the decisions taken by the employer, by trustees and by members. These could, for example, relate to conditions in the workplace and to other negotiations between stakeholders. Such issues will affect the long-term prognosis of this large-scale conversion.

1.7 Section 2 reviews the history of the conversion process. Section 3 discusses themes emerging from that history. Section 4 describes the criticism directed at the regulator, the boards of trustees, and the actuarial profession in South Africa for their role in determining or approving conversion values. Section 5 discusses the issues that should have been considered during the conversions. Section 6 describes best practice as identified by Gluckman & Kamionsky (1997). Section 7 draws conclusions with lessons to be learned from the process.

2. A HISTORY OF THE CONVERSION PROCESS

2.1 THE SITUATION BEFORE 1980

2.1.1 South Africa has minimal social security: a means-tested social old-age pension provides poverty relief after the age of 65 for men, and 60 for women. The replacement ratio of this pension is satisfactory for low-paid workers, such as those in agriculture or domestic service, but is inadequate for workers in commerce or industry. If it were effectively applied, the means test would deny most people who retire after a career in the formal sector any state pension benefit.

2.1.2 Tax incentives encouraged occupational retirement provision from a relatively early stage, essentially on an EET basis. (Contributions were exempt from tax within limits, investment return was exempt from tax, and benefits—less an amount

which was tax free—were taxed on receipt.) A formal structure was given to the retirement-fund industry by the Pension Funds Act, passed in 1956.¹ Pension fund organisations are not trusts but acquire their legal identity through registration of a set of rules under the Pension Funds Act. The trustees, or board of management, and other office bearers such as the actuary have duties, a subset of which are set out under the Act, and which are amplified in the rules of the fund.

2.1.3 The Mouton Commission, which investigated retirement provision in South Africa, estimated that as many as 80% of employees in formal employment belong to an occupational retirement fund. The balance of employees in this sector are thought either to earn too little to make it attractive as a competitor for the social old-age pension, or to be temporary or part-time workers.

2.1.4 South Africa permits a retirement fund to offer either a pension on retirement, in which case at most one third can be commuted for a cash lump sum on retirement, or a lump sum on retirement (the so-called provident fund). Pension and provident funds may provide either defined benefits or benefits based on defined contributions.

2.1.5 Resignation and retrenchment benefits are available in cash or may be preserved through transfer to another fund. As there is minimal unemployment insurance, such cash benefits are necessary to support former employees during gaps in employment.

2.1.6 Before 1980, most large retirement funds in South Africa were DB pension funds. Some small DC funds existed, but these were largely concentrated in the 'underwritten fund' sector, meaning that they were administered and invested by an insurer.

2.1.7 In the late 1970s the Wiehahn Commission created an environment suitable for the establishment of black trade unions. There followed a rapid growth of black trade unions, which looked for issues that would encourage black employees to join the unions. At that time most DB funds returned members' own contributions on withdrawal, with a very modest rate of interest. The unions seized on these poor withdrawal benefits, cross subsidy, and payment of pensions rather than lump sums, to attack employer-sponsored DB funds.

2.1.8 In response, rates of interest used to accumulate member contributions were increased from very low numbers to ones that were conservative but better in relation to competing savings instruments. Vesting provisions were introduced, which gave members either a multiple of their own contributions with interest depending upon service, or a proportion of the employer contributions. In the case of DB funds, the latter was usually expressed as the difference between the accrued liability at date of exit and the total refund of the member's own contributions with interest.

2.2 THE DRAFT BILL ON PENSION PRESERVATION

2.2.1 In 1980 a draft bill on pension preservation attempted to stop leakage, which had been recognised by the Mouton Commission as one of the primary reasons why many people retired with inadequate benefits. There was widespread industrial unrest. Workers demanded their money out of employer-sponsored retirement funds

1 Pension Funds Act, Act No. 24 of 1956

before preservation could be enforced. Black trade unions used the draft bill as an opportunity to promote transfer to union-sponsored DC provident funds as an alternative retirement vehicle. (See paragraph 3.3 dealing with the conversion terms). Kerrigan (1991) notes that:

Although such refunds resulted in workers losing substantial accrued retirement benefits, it did not influence them to remain on pension funds.

2.2.2 Reasons given by Kerrigan were:

- Workers' priorities lay with housing, education and funeral benefits, none of which were catered for in existing DB schemes.
- Lump-sum benefits were preferred over income benefits because of a lack of confidence that an ongoing income would be received in rural areas after retirement. [Such lump sums could be invested on retirement in such a way that the means test could be avoided, which was not the case for pension benefits. Some commentators have guessed that this was one of the reasons for a preference for lump sums.]
- Most employees at unskilled levels expected to resign or to be retrenched rather than to retire, and wanted good early-leaver benefits. Most existing DB schemes favoured retirement benefits rather than resignation benefits: few gave any portion of the employers' contributions on exit and the rate of interest paid was significantly less than commercially competitive rates. Members were aware that many schemes had made substantial profits on the withdrawal from service of low-income employees.
- Low-income employees believed that they had a higher mortality than higher-income employees and therefore that they would subsidise the pensions of higher-income employees.
- There was little understanding amongst members of DB schemes, whereas the alternative DC provident funds were simple, easily understood and easily communicated to all levels of member.
- Members had no share in the management of schemes. Workers distrusted the paternalistic attitude of employers who were perceived to dominate existing schemes.
- This process gave a strong black trade-union movement, which had emerged after the changes in legislation brought about by the Wiehahn Commission, an issue that was important to workers and could be used to consolidate existing union membership and recruit new members.

2.2.3 The trade-union movement was therefore strongly in favour of conversion to defined contributions.

2.2.4 Kerrigan notes that, as they became more involved, the largest of the trade-union movements, the Congress of South African Trade Unions (COSATU) became aware of the important role that benefit programmes play in the life of the average worker and wished to be involved in the management of the asset base associated with retirement funds. They recognised that this could become an important tool in improving the conditions of the workers that COSATU represented. It could be used for job creation.

2.2.5 COSATU-affiliated unions motivated the establishment of negotiated provident funds. This was repeated by unions affiliated to other union federations.

Kerrigan notes the following effects of this process:

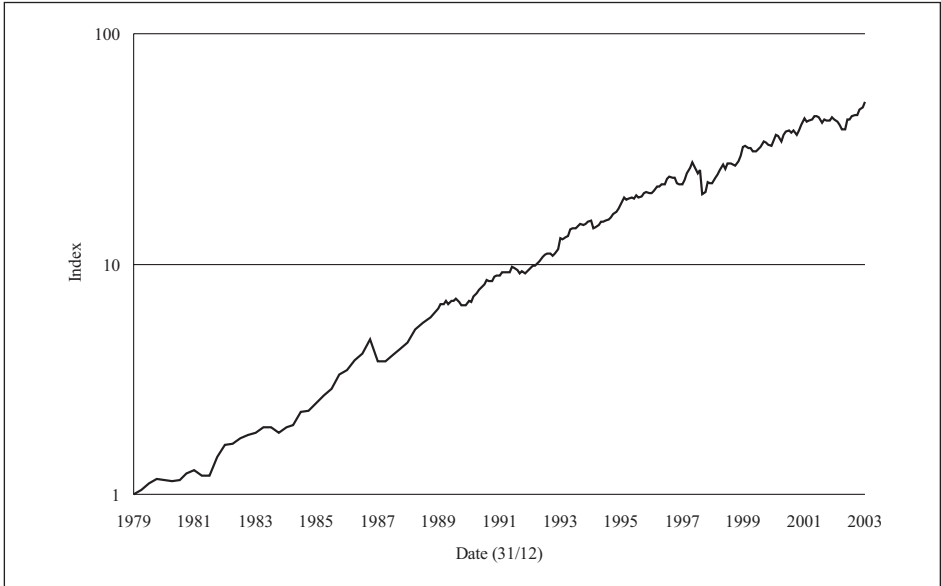
- Workers participated in retirement funds at a higher level. This relieved pressure for a national retirement fund.
- Membership converted substantially from the old DB pension funds to the new DC funds negotiated by workers and trade unions. Most of the new funds were provident funds (i.e. they paid a lump sum on retirement rather than a pension) in which the premiums required for death, disability and funeral benefits were deducted from a defined employer contribution before the balance of the contribution by member and employer was invested on a money accumulation basis. On retirement, the full accumulated member and net employer contributions, with full fund yield, was paid out as a lump sum. On death or disability, lump sum benefits were paid. Comprehensive funeral policies were included. Often these funds stretched across industries.
- Membership of the union-sponsored funds was often confined to employees belonging to particular bargaining units. The publicity around union-sponsored conversions caused many non-unionised employees, who were attracted by membership of a DC fund, to put pressure on employers to sponsor a DC alternative.
- Resignation benefits commonly included a refund of the member's own contributions accumulated with the full fund yield plus a percentage of the employer's net contributions with interest, for each year of service, subject to a maximum of the full member and employer contributions, net of expenses, with the full fund yield.
- There was equal representation on the board of management of employer-sponsored funds from employer-appointed and member-elected trustees. In union-sponsored funds, all trustees were usually appointed by the unions.
- The contribution rate was usually set equal to the rate paid under the previous DB fund, inclusive of any insured benefits and administration fees. Kerrigan (*op. cit.*) noted that most employers were reluctant to pay more than 12% of pensionable payroll, while the unions would be reluctant to accept less than 9%.
- This was helped by high real returns relative to the values assumed by actuaries. The JSE Securities Exchange had entered an extended bull run.
- When combined with the perceived flexibility of provident funds, the rules of which could be written to optimise the tax incentives for individuals, even high-income employees demanded conversion to DC provident funds. Many of these were hybrids between DB and DC in that they offered the executives the better of the DC accumulation of transfer value plus subsequent net contributions and the old defined benefit.

2.3 THE TRANSFER OF EMPLOYEES TO DC PROVIDENT FUNDS

2.3.1 From 1981 to the early 1990s the transfer of blue-collar employees to DC provident funds was widespread. This movement was largely but not wholly union-sponsored: some employers established DC funds in competition with the unions, thereby offering their employees a choice.

2.3.2 The bull run on the JSE Securities Exchange continued, apparently associated with a re-rating of the future growth expected from equities. Figure 1 shows an index of retirement-fund performance compiled by AssetBase, an independent investment

Figure 1. Index of retirement-fund performance



performance monitoring service. Andrew (1994) showed real returns earned of the order of 4,25% a year over extended periods of time. Defined contributions gave the benefit of these returns to the members rather than the employer. The risk of poor investment returns in DC funds seemed remote.

2.3.3 Actuarial surplus developed in many DB funds (and some DC funds where the trustees had determined overly conservative investment returns to accrue to member accounts). This was partly because real returns were considerably higher than expected, and partly because many actuaries changed their approach towards the actuarial valuation of assets, causing the release of further actuarial surplus in DB funds.

2.3.4 The Registrar of Pension Funds opposed any payment of actuarial surplus to the employer on the grounds that were stated in the *Lintas*² case and repeated in PF99, viz. that:

- the assets of the pension fund are owned by the pension fund, a separate juristic person, to the exclusion of all others;
- the object for which those funds are held is the benefit of the members of the fund and their dependants by way of lump-sum benefits and annuities (pensions) on retirement or death (and a fund is prohibited from doing any business other than the business of a fund);
- the funds so held are held to the complete exclusion of the employer; and

2 Unpublished determination of the board of appeal established in terms of the Financial Services Board Act and dated June 1994 in the matter of *Lintas South Africa Pension Fund v The Registrar of Pension Funds*. Per Adv SA Celliers, SC.

- (with reference to the attempt in the *Lintas* case, and others, to permit the payment of residual surplus to the employer on the liquidation of a pension fund) there is nothing in the Act that makes these principles subject to an exception that, on liquidation of the fund, if there is a surplus of assets over and above that which is necessary to secure to all beneficiaries the benefits to which they are entitled under the rules, the employer does, or can, acquire an interest in that surplus.

2.3.5 Noting that actuarial surplus was developing in funds, the Pensions Institute (the forerunner of the Institute of Retirement Funds) established a working party to investigate the ownership and control of actuarial surplus. Debate around the use of actuarial surplus culminated in the report of the working party, which was published as a paper by Milburn-Pyle & Lennox (1990). This paper argued that, in a DB fund, any surplus represents over-payment by the employer and the employer must approve any use of the surplus.

2.3.6 The working party established two points of principle:

- (a) the surplus belongs to the fund, not to the members or the employer or any other party; and
- (b) while it is one of the duties of the trustees to formulate proposals for the application of the distributable surplus,
 - (i) in a DB fund this must be done in consultation with the employer and must be subject to the approval of the employer (who if necessary may exercise a casting vote); and
 - (ii) in a DC fund the decision on how the distributable surplus is to be applied lies with the trustees in the absence of any clear provision to the contrary in the rules of the fund.

2.3.7 The principle in (b)(i) above arose from their view that, in a DB fund: the emergence of a surplus effectively means that with the benefit of hindsight the employer has overpaid in the past; the surplus represents the accumulation of monies that he has (deliberately or inadvertently) paid over and above his legal obligations, and it is therefore only equitable that he should have the prerogative of approving (and if necessary amending) proposals by the trustees as to how the surplus is to be used.

2.3.8 The working party proposed that the Registrar's objections to the payment of actuarial surplus in a DB fund to the employer should be relaxed, particularly on termination of the fund.

2.3.9 As far as transfers were concerned, the working party recommended that

- (a) where company A takes over company B:
 - (i) the full assets of the company B pension fund should be merged with the assets of the company A pension fund; and
 - (ii) if the company B pension fund was in surplus, company A would then be entitled if it so wished to take a contribution holiday; but
- (b) where company A sells a division to company B:
 - (i) if the rules are specific as to the determination of the transfer value, the rules should be followed;

(ii) otherwise, only the accrued liabilities corresponding to the members to be transferred from the company A pension fund to the company B pension fund should be transferred.

2.3.10 The full text of the point made in recommendation (a)(ii) above was:

It is quite possible that the existence of a surplus may have been taken into account when setting the price paid by Company A for Company B; Company A could then be entitled if it so wished to take a contribution holiday until such time as the additional price paid had been recovered, and the surplus would in the process disappear. If however the surplus is not in fact absorbed in this way then it simply becomes a surplus existing in Company A's defined benefit Pension Fund, to be dealt with according to the principles discussed earlier.

2.3.11 Recommendation (b)(ii) was explained as follows:

The surplus built up in the original fund will have arisen *inter alia* from the contributions paid by the continuing employer, and there would therefore be no grounds for expecting him to pay any part of that surplus to the new employer (who would not have contributed to the accumulation of the surplus).

2.3.12 The report did recommend that the protection given to transferring members in terms of section 14 of the Pension Funds Act should be reviewed.

2.4 A NEW SOUTH AFRICA

2.4.1 In February 1990 the African National Congress (ANC) was unbanned and in 1992 Codesa mapped out an interim constitution. In April 1994 the first democratic elections resulted in a government comprising an alliance of the ANC, COSATU and the SA Communist Party.

2.4.2 Employers had recognised that there would be a change of government, but they were uncertain as to the economic policies of that government. In particular there was a concern that it might lack fiscal and monetary restraint, which could lead to hyperinflation. In addition, South Africa faced a serious AIDS risk, which was expected to increase insurance premiums for death and disability risks significantly. This would directly impact employers paying the balance of cost of the benefits in excess of a defined contribution by members. In the discussions with Business South Africa surrounding the Pension Funds Second Amendment Bill,³ it was apparent to the author that employers in the emerging economy of South Africa were not prepared to bear the risk implicit in a DB fund without a considerable cushion of actuarial surplus in the fund. Indeed the benefit levels that had been supported in the past because of very high real returns (i.e. the difference between the investment return earned and salary increases) would not be affordable at the then current contribution rates if the economy were to move into low inflation and low investment returns. As the National Treasury had a stated goal of reducing inflation (excluding interest rates and fuel) to between 3% and 6% a year by 2002 and were experiencing considerable success in achieving this target, such risks were real.

3 *Government Gazette*, 24 January 2001

2.4.3 Employers therefore wanted to pass the economic risks in retirement funds to the members and therefore encouraged the transfer of unionised and non-unionised employees from DB to DC funds. The old DB funds were closed to new entrants.

2.4.4 It was at this time that the transfers in the Tek⁴ and Pepkor⁵ cases took place. These transfers were to be the subject of subsequent litigation, as discussed below.

2.4.5 As some residual DB funds became overweight in pensioners, pensioner liabilities were outsourced through the purchase of annuity policies from insurers. (See ¶3.3.5) At this time long-term bonds were offering high real returns over the then current inflation rates. This left many DB funds with relatively few members but large amounts of surplus.

2.5 LINTAS

2.5.1 In 1994 there had been widespread publicity in the industry about the Lintas case. Practitioners had been informing employers and boards of trustees about its progress. On 2 June the Appeal Board had ruled that residual actuarial surplus might be paid out on liquidation of a fund once members' rights and reasonable expectations had been satisfied.

2.5.2 The Registrar then developed a practice note that would permit the transfer of actuarial surplus to the employer in circumstances similar to the Lintas case.

2.5.3 There was common knowledge in the industry that some residual DB funds with actuarial surplus were being prepared for liquidation along the lines set out in the Lintas case. This included application to the Registrar for approval of rule amendments permitting the transfer of residual surplus on termination to the employer.

2.5.4 For example, the Pepkor Pension Fund, whose membership had shrunk to 14 relatively low-income pensioners, and which had approximately R100 million of surplus, applied to register such a rule amendment.

2.5.5 The issue of the Registrar's practice note was held up because the Registrar became concerned that abuse might occur and that legislative change was desirable (either to prevent altogether the transfer of surplus to employers or to permit it in circumstances which would discourage abuse). The Registrar therefore referred the matter of the transfer of surplus to employers to the Pensions Advisory Committee.

2.6 MEMBER-ELECTED TRUSTEES

In terms of an amending act, which became law in April 1996, every fund was required to have a management board, and members would have the right to elect at least 50% of the board. Funds were given a deadline of 15 December 1998 for the implementation of this requirement.

4 *Lorentz v TEK Corporation Provident Fund & Others*, (1997) 18 ILJ 1253 (W)

5 *Financial Services Board and Another v Pepkor Pension Fund and Another*, [1998] 4 All SA 129 (C)

2.7 DRAFT BILL ON THE TRANSFER OF SURPLUS TO EMPLOYERS

2.7.1 In 1997 a workgroup established by the Pensions Advisory Committee from stakeholder representatives recommended that the transfer of actuarial surplus to employers be permitted under controlled circumstances. This was put into a Draft Bill on Surplus Repatriation and tabled in Parliament. (Here the ‘repatriation’ of surplus meant the transfer of surplus to employers.)

2.7.2 The controlled circumstances were as follows:

- (a) The actuarial surplus was to be determined using strong actuarial assumptions, which would need the approval of the Registrar.
- (b) The rules must be changed to give members their full accrued actuarial liability on resignation.
- (c) Pensions were to be increased by the full change in the Consumer Price Index from date of retirement.
- (d) At least two thirds of members must consent to the terms of the transfer. Effectively this meant that there would need to be a deal struck between the members (including the pensioners) and the employer.
- (e) The employer was obliged to fund any deficit that occurred within the seven years after the transfer, but not to a greater extent than the amount transferred to the employer plus interest.

2.7.3 Some of the funds that wanted to transfer surplus to employers modified their proposals along lines consistent with the draft bill. Among these was the Paarl Municipal Widows and Orphans Pension Fund.⁶

2.7.4 In 1997, in the Tek case, the High Court decided that surplus utilisation depended upon the origin of the surplus, and the employer’s entitlement to use surplus was limited to proven over-contribution. The labour movement was satisfied with the decision. It would have enabled them to re-open many past transfers and argue for a better share of the surplus. But industry was thrown into disarray. Most practitioners had worked on the premise that the employer had at least a right to take a contribution holiday or to use the surplus for selective benefit improvement and were disconcerted, to say the least, to discover that the employer might not have such a right.

2.7.5 There was now nothing to be gained (in fact considerable potential loss) to the labour movement from seeing the draft bill on the transfer of surplus to employers becoming law. In February 1999, following pressure from COSATU, the draft surplus bill was withdrawn from Parliament.

2.8 KRANSDORFF

The publicity surrounding the Kransdorff case⁷ was the first public indication that the labour movement was contemplating legal action concerning past transfer terms. The

6 *Paarlse Munisipale Weduwee- en Wese-Pensioenfonds v Registrar of Pension Funds* [2000] 3 BPLR 247 (PFA)

7 *Basil Kransdorff v Sentrachim Pension Fund and Sentrachim Limited*, PFA/GA/3/98. [1999] 9 BPLR 55 (PFA) <http://www.fsb.co.za/pfa/kransdorff.htm>

Kransdorff complaint highlighted one of the significant problems with past transfers: transferring members received only their accrued liability, which seemed reasonable as the fund had declared little surplus in the previous actuarial valuation. In the subsequent actuarial valuation, considerable surplus was revealed. There was then critical review as to where the surplus had come from.

2.9 NEDLAC

In March 1999, consultation commenced between the Financial Services Board (FSB) and COSATU. Following complaints from business that they were being excluded and had a valid interest in the outcome, the matter was referred to NEDLAC. Plenary, bilateral and trilateral discussions commenced. There were limited opportunities for industry representation in the NEDLAC discussions—essentially this input would have to be channelled through business or labour. During these discussions at NEDLAC, COSATU demanded a moratorium on the transfer of surplus to employers.

2.10 CIRCULAR PF99

In the background, the Pepkor matter continued in discussions between the Registrar and the board of the fund. The Registrar sought legal advice, and concluded that the decision in *Lintas* was wrong. The Registrar then issued circular PF99. This circular effectively froze applications for the transfer of pension surplus to employers. To the best of the author's knowledge only one case was approved after *Lintas*.

2.11 THE TEK APPEAL

2.11.1 On 3 September 1999, in the *Tek* case,⁸ the Supreme Court of Appeal overturned much of the High Court decision, determining that:

- neither members nor the employer have any rights in law to the surplus;
- rights can only be conferred in the rules;
- if the rules are silent, the stakeholders should negotiate the distribution of surplus and amend the rules accordingly;
- it would be preferable for the social and policy issues involved in surplus distribution to be determined through legislation; and
- an employer may take a contribution holiday if there is actuarial surplus, without any consideration of the source of the surplus.

2.11.2 This created a potential situation in which the rules of the fund could be amended to transfer surplus to the employer after negotiation with stakeholders. In some of the residual DB funds, only the employer and relatively few members remained involved. The latter were often senior employees who would be amenable to suggestions from the employer. Alternatively, the members could be enticed to agree to a proposal by the employer with significant benefit improvements which might constitute only a part of the surplus. There was no requirement to go back and renegotiate past transfers with former members. In the *Pepkor* matter, for example, the 14 remaining pensioners were

⁸ *Tek Corporation Provident Fund v Lorentz*, 1999 (4) SA 884 (SCA)

given significant enhancements to their pensions on condition that they agree to the employer receiving the residual surplus.

2.12 IBM

In the IBM case⁹, the Pension Funds Adjudicator found that the employer could validly refuse its consent where required in terms of the rules, in order to negotiate favourable terms in the distribution of the surplus. The rules of this fund required the consent of the employer to any pension increase. The employer refused its consent to the discretionary topping up of the pension increase to match the change in the consumer price index, as proposed by the board of trustees, until such time as the pensioners agreed to a distribution of the actuarial surplus as proposed by the employer. This distribution favoured the employer.

2.13 PAARL WIDOWS

2.13.1 On 6 December 1999, in the matter of the Paarl Municipal Widows and Orphans Pension Fund, the Appeal Board confirmed the Lintas decision: once a retirement fund was liquidated, after members' rights and reasonable expectations had been satisfied, any residual assets could be paid to the employer.

2.13.2 As mentioned above, COSATU had demanded that Government impose a moratorium on all surplus payments. But no moratorium was possible without changing the law. However, the Registrar was reluctant to approve transfers of surplus to employers when the NEDLAC discussions were expected to give rise to new law. In December 1999 the Registrar issued circular PF105, which confined the situations in which actuarial surplus could be transferred to employers to the circumstances of the Paarl Widows case.

2.14 NEDLAC DEADLOCK

2.14.1 If the NEDLAC discussions had not been taking place, this would have resulted in a number of applications to the Registrar to approve the required rule amendments to permit the transfer of surplus to employers. However, the industry was concerned to see what emerged from these discussions. Most boards of trustees adopted a cautious attitude and did not want to be seen to be taking advantage of old law before new law came into being. There were also now member-elected trustees who were questioning some of the events of the past. These trustees were not anxious to take steps which could be perceived by their constituency as favouring the employer.

2.14.2 In August 2000 the positions of business and labour in the NEDLAC discussions crystallised in deadlock. Labour's position was that:

- former members who had transferred to a DC fund should have received at least their accrued liability multiplied by the ratio of the fair value of assets to the actuarial value of assets, and past transfers should be amended to reflect this; and

⁹ *IBM Pensioners' Action Group v IBM South Africa (Pty) Ltd and another*, PFA/GA/121/98/JM, [2000] BPLR 268 (PFA) <http://www.fsb.co.za/pfa/ibm.htm>

- actuarial surplus belonged to the retirement fund and should be used for the benefit of the members of that fund unless it could be shown to have resulted from deliberate over-contribution by the employer (i.e. payment by the employer of more than the amount recommended by the actuary).

2.14.3 Business's position was that:

- any actuarial surplus had arisen because of overly conservative assumptions relative to the experience of the fund; and therefore had resulted, in effect, from the payment by the employer of more contributions than had actually been required;
- the members had no rights to the surplus; and
- the employer had the right to use any actuarial surplus to fund a contribution holiday.

2.14.4 The stakeholders told government to govern.

2.15 THE PENSION FUNDS SECOND AMENDMENT ACT

2.15.1 A government team drafted the Pension Funds Second Amendment Bill, 2001, which was published for comment on 26 January 2001. During the period to mid-2001, stakeholders commented on the draft bill.

2.15.2 During the period from 21 August to 15 November 2001 the legislature made considerable changes to the draft bill, insisting that matters that the government team had proposed be handled by regulation should instead be included in statute.

2.15.3 On 7 December 2001 the Pension Funds Second Amendment Act, 2001,¹⁰ became law. Stakeholders were now concerned about surplus distributions that had been negotiated over the previous year or two, many of which were somewhere between completion of the negotiation and approval by the Registrar.

2.15.4 In October 2002 the Registrar issued circular PF109, which clarified that complete applications received by the Registrar before 7 December 2001 would be considered in terms of 'old' law.

3. THEMES EMERGING

3.1 CONVERSION METHODOLOGY

3.1.1 CONVERSION THROUGH TRANSFER

3.1.1.1 It is a condition of approval of a retirement fund by the South African Revenue Services that eligible employees who join a company after establishment of a fund must become members of the fund. This is commonly written into each employee's contract of employment. Without this approval, contributions would not be tax deductible and investment build-up might be taxed at a higher rate.

3.1.1.2 At the start of the conversion process, therefore, most employees were contractually members of DB pension funds. Often their contract of employment stipulated their defined retirement benefit and their contribution rate to such fund.

3.1.1.3 Acting on legal advice that the contract of employment can only be changed by agreement, many employers were reluctant to change their retirement fund

10 Pension Funds Second Amendment Act, Act No. 39 of 2001

without the approval of employees. Employees could give such approval by accepting transfer to another retirement fund on defined terms. Most employer-sponsored conversions were achieved by establishing a new DC fund separate from the existing DB fund. Employees were then offered the right to elect to move to the alternative scheme with a defined transfer value. Such an election effectively amended the contract of employment.

3.1.1.4 Where the conversion represented a move from a DB employer-sponsored fund to a union-sponsored DC fund, the transfer terms were frequently negotiated between the union and the employer, the fund sometimes being a party to the resulting agreement, or the board of trustees of that fund sometimes being obliged to amend the rules to enable the union–employer agreement to be effected.

3.1.1.5 Conversion therefore normally required the determination of a transfer value.

3.1.1.6 Sometimes a DB fund was converted by rule amendment. In this case it would be necessary similarly to secure the employee’s agreement to the initial credit, which would start his or her individual account under a new DC section. This type of conversion shares all the issues of transfer from DB to DC. However, in order to avoid confusion between the terms ‘transfer’ and ‘conversion’, it is not further discussed in this paper.

3.1.2 TRANSFER VALUES

3.1.2.1 Kerrigan (*op. cit.*) notes that, in some of the initial transfers to union-sponsored schemes, the transfer value was nothing more than a cash resignation benefit, which constituted a refund of the member’s own contributions with a relatively low rate of interest. The employer contributions and any surplus were left behind.

3.1.2.2 Later it became accepted practice to transfer the member’s accrued liability, determined using the ongoing fund assumptions from the most recent valuation tabled with the regulatory authority in terms of section 16 of the Pension Funds Act, 1956. That section requires that every retirement fund have an actuarial valuation, a report on which must lodged with the regulator, at least once every three years. Any report so lodged must include ‘the particulars prescribed by regulation’. Regulation 15 prescribes these particulars as follows:

‘accrued liabilities’ is defined to mean:

(aa) the actuarial liabilities in respect of past service benefits (including accrued bonus service) of active members, with due allowance for future salary increases where these affect the benefits in respect of past service, and with due allowance for increases in pensions and deferred pensions at rates consistent with past practice, the current policy and the reasonable benefit expectations of members;

(bb) the actuarial liabilities in respect of pensions in course of payment and deferred pensions, with due allowance for increases at rates consistent with past practice, the current policy and the reasonable benefit expectations of pensioners; and

(cc) any other accrued actuarial liability.

3.1.2.3 In communication to members this accrued liability was often described as their ‘interest’ in the fund or their ‘actuarial reserve values’. Both these terms are causing problems today.

3.1.2.4 The transfer value was usually augmented by a ‘sweetener’, namely an arbitrary addition (usually between 15% and 40% of the accrued liability) to encourage transfer, usually paid for out of surplus. This sweetener was offered because it was perceived to be in the interests of both members and the employer for conversion to take place (see ¶¶4.1–4.3).

3.1.2.5 The accrued liability was seldom adjusted by the difference between the fair value of the assets and the actuarial value of the assets, nor by any share of any actuarial surplus. In 2000, while working for the regulator, the author came across a conversion, for the first time, in which members of the DB fund were given an option each year to transfer to the DC scheme sponsored by the employer or to the corresponding scheme sponsored by the majority union, and the transfer values included the difference between the fair value of the assets and the actuarial value of the assets as determined in a valuation at the end of each financial year for the fund, adjusted arbitrarily for a contingency reserve. But such arrangements were not generally made.

3.1.2.6 This is consistent with the approach in Milburn-Pyle & Lennox (1990), which effectively views the actuarial surplus in a DB fund as being under the control of the employer.

3.1.2.7 As Kerrigan (*op. cit.*) notes, later in the conversion process, unions demanded a share of the fair value of the assets in the proportion that the accrued liability of transferring members bore to the accrued liability in respect of all members before the transfer.

3.1.3 CLOSURE TO NEW ENTRANTS

3.1.3.1 The employer was normally only too keen to close the residual DB fund to new entrants. The author is aware of very few occasions in which, once transfer had been offered to a DC fund, a subsequent new employee had a choice of joining either the DB or the DC fund.

3.1.3.2 This was not a problem from an employment perspective, because new contracts of employment specified membership of the DC scheme. The contract might even have offered choice between more than one DC scheme, commonly one sponsored by the employer and another by one or other trade union.

3.1.4 ALTERNATIVES WHEN THERE WAS NO CHOICE

3.1.4.1 When membership is small, it is not cost effective to run a DB fund. Small employers who wished to offer their employees a DC alternative had no choice but to amend the employment contract.

3.1.4.2 If the alternative scheme was expected to replace the defined benefit on a realistic set of assumptions, or if the alternative scheme incorporated a DB underpin for employees in employment at the date of conversion, employers were advised that they could unilaterally amend the scheme.

3.1.4.3 Alternatively, employers compelled all to convert if more than a significant majority wished to convert.

3.1.4.4 Any of these approaches, other than the DB underpin, has a potential

legal problem. Gluckman & Kamionsky (1997) have noted the statement in a leading textbook on the law of trusts (Honoré, 1985), that:

It is a defence to an action of breach of trust that the beneficiaries, being of full age and capacity, consented to it, or confirmed it. This is because of the rule that a trust may be varied or discharged with the consent of the beneficiaries, if of full capacity. When, however, only some of the beneficiaries consent to the breach of trust the remainder may nevertheless sue.

3.1.4.5 While pension funds in South Africa are not trusts, the courts are known to look towards the law on trusts to determine rights of members and beneficiaries and duties of the board of management, who are loosely called trustees.

3.1.5 OUTSOURCING OF PENSIONS

3.1.5.1 Future retirees from DC provident and pension funds usually have only the right to purchase annuity policies from the insurers of their choice. They do not usually have the right to elect pensions paid from the funds. On the other hand, before the mass conversion of DB funds to DC funds, most members retiring from large DB pension funds received pensions paid from the fund. Pension increases were usually not prescribed in the rules but left to the discretion of the trustees, sometimes with a provision that the employer must approve the increase for it to be effective.

3.1.5.2 Once the active members had exercised their choice in the conversion exercise, many DB schemes were left heavily overweight in pensioners. Because new retirees would automatically purchase annuities from insurers after the conversion, the existing pensioner group at date of conversion became closed to new retirees. Experience in developed economies had shown improvement in pensioner mortality with improved medical diagnostic and treatment tools. The residual DB funds had therefore a significant longevity risk. Fluctuations in the experience would increase.

3.1.5.3 A fund is a single entity on liquidation. Most rules provide that the assets of the fund will be applied first to purchase annuity policies for the pensioners and the contributory members get only as much as is left. Even though the investment philosophy might differentiate the investments of the pools of assets applicable to the pensioners and the contributory members, this division would be ignored on liquidation. In relatively recent times, rules have been amended to create 'pensioner accounts' in which the assets corresponding to the pensioner liabilities are set aside and invested differently from the other assets with the pensioners enjoying the corresponding returns. This was not common at the time much of the outsourcing took place.

3.1.5.4 Fearing that fluctuations in experience would adversely affect the investment strategy appropriate to the remaining active members if assets were to be matched to the liabilities, many funds (or their employers) advocated the outsourcing of existing pensioners by the purchase of annuity policies from insurers. The insurers commonly paid the consultants commission at a statutory rate, initially 0,5% and then increased to 1,5%, of the purchase price of the annuity policies. The rationale accepted by the Registrar before the statutory change was that 0,5% was insufficient to enable an

intermediary to do a proper job of establishing the type of annuity most appropriate to the retiring member, obtain quotes from different insurers, compare them, present the results and obtain a decision from the individual retiree. No consideration was given to differentiating the rate in the case of bulk outsourcing where a single set of such activities was performed for all the pensioners on behalf of the trustees of the fund. When a significant body of pensioners were outsourced, this earned the consultants significant commission for relatively little work. Disclosure was limited to statements such as: "Commission will be paid at the statutory rate."

3.1.5.5 Pensioners usually had their existing pensions purchased, with a once-off special increase if they agreed to the purchase of a policy in their own name. Such policies might be with-profit annuities or so-called 'living annuities'. A with-profit annuity is purchased at a stated discount rate, and the pension increase equals the difference between the bonus declared by the insurer on its with-profit portfolio and the stated discount rate. The insurer may, or may not, carry the mortality risk. In a 'living annuity' the reserve backing the pension is transferred to the insurer and invested in an account for the benefit of the pensioner. The pensioner has choice over the investment medium into which the account is invested and can change this from time to time. Investment returns accrue to this account, net of expenses. The pensioner can draw an income from this account each year, which the pensioner can vary between limits agreed with the tax authorities, currently a minimum of 5% and a maximum of 20% of the capital value at the beginning of the year. Any balance in the account will be available to the pensioner's dependants or his estate on death. Terms and conditions of the annuity policy might match the pension paid by the fund, particularly if with-profit annuity policies were purchased. They might differ, particularly if the pensioner was allowed to purchase a so-called 'living annuity'.

3.1.5.6 Apart from any sweetener given to enhance the pension purchased, surplus was not usually transferred on the purchase of the annuity policy, nor was the margin between the fair value of the assets and the actuarial value of the assets in the fund included in the purchase price if the purchase price approximated the reserve held in the fund. The purchase of the annuities was essentially treated as a benefit payment.

3.1.5.7 The purchase of the annuity policies transferred the mortality risk to insurers (or to the pensioner in the case of some with-profit annuities and all 'living annuities'). If with-profit annuities were bought, the insurer would now determine future pension increases. Over the period prior to purchase while the major outsourcing exercises were being conducted, because of the bull run being experienced on the stock exchange, the rate of increase previously awarded by the insurer to holders of with-profit annuity policies commonly exceeded increases that had been paid by the fund. It seemed advantageous to the pensioner if past experience was to be repeated.

3.1.6 RESULT

3.1.6.1 More than 80% of active members elected to move to DC funds.

3.1.6.2 Kerrigan (*op. cit.*) was positive about the longer-term impact on retirement funds. Overall the process of conversion gave rise to:

- much better communication to members through annual reports, benefit statements, simplified booklets, videos, etc.; use was made of regional and local committees and this spilt over into DB funds;
- better fund governance; the board of management was not an extension of the employer, and member-elected trustees could better establish the needs of a member's dependants following the death of the member; and
- better resignation and retrenchment benefits in DB funds.

3.1.6.3 Kerrigan (*op. cit.*) notes that:

In ten years, we have moved from a position where employees felt that the retirement fund was the province of the employer to the current position where members of alternative benefit programmes consider that they have ownership of the fund's assets.

3.1.6.4 Very substantial proportions of pensioners moved out to various forms of annuity policies.

3.1.6.5 This concentrated and released surplus in the residual DB fund. A simple example, shown in Table 1, illustrates the effect: a retirement fund has an actuarial value of assets prior to transfer which is 80% of the fair value of the assets, and a ratio of actuarial value of assets to accrued liabilities of 125%; 80% of the members leave with only their accrued liabilities. The table shows that R13 million of what was previously in the margin between the fair value and the actuarial value of assets has now been released into actuarial surplus. This extraordinary surplus release was not considered in the analysis of Milburn-Pyle & Lennox (1990), nor was any difference between the fair value and the actuarial value of assets.

Table 1. Illustrative example of a transfer (R millions)

	Before transfer	Transfer	After transfer
Fair value of assets	125	64	61
Actuarial value of assets	100	64	49
Accrued liabilities	80	64	16
Surplus on actuarial value of assets	20	0	33
Surplus on fair value of assets	45	0	45

3.2 WHY IT HAPPENED

3.2.1 MEMBER PERSPECTIVE

Kerrigan (1991) has noted many of the reasons above. Andrew¹¹ noted that members received:

- better resignation and retrenchment benefits;

11 *The Actuary*, January 2001

- a funding structure which they found easier to understand (which was important in an environment of relative low education);
- the possibility of managing contributions more flexibly within a package approach to remuneration;
- a share in the management of the funds (which only became mandatory from 15 December 1998);
- the reward of high real returns which were being earned in the South African economy (where ‘real return’ is the degree to which investment returns earned exceeded salary and price inflation), and
- (if the transfer was from a pension fund to a provident fund) a lump sum on retirement, which eased lower paid workers’ fears of dying soon after retirement and losing the value of a pension, and which could be invested in such a way that the member could circumvent the means test applicable to the state pension paid to the indigent above retirement age.

3.2.2 UNION PERSPECTIVE

Where the transfer took place to a union-sponsored fund, the union gained effective control over the investments of the assets of the fund, and the provision of important benefits to their members. This empowered the trade union economically, because their nominees determined the investment strategy of the fund, and reinforced the union as the provider of benefits to members.

3.2.3 EMPLOYER PERSPECTIVE

3.2.3.1 The employer enjoyed:

- the capping of employee-benefit costs; and
- the transfer of the investment and expense risks from the employer to members.

3.2.3.2 The capping of employer costs and the transfer of risk to members was particularly important in an environment in which AIDS was expected to result in significant increases in death- and disability-insurance premiums, and in which there was considerable uncertainty over the future management of the economy by a democratically elected government, following the regime change which was known would be likely after February 1990. The new government was likely to have a different relationship with business than its predecessor.

3.2.3.3 In the later years of the process, members who were offered transfer to a DC fund were often granted a higher sweetener on condition that they waived any claim against the employer for the subsidy of medical-aid contributions after retirement. Actuarial surplus was used to enhance benefits for contributory members and pensioners in lieu of the employer’s obligation to subsidise medical-aid contributions during the member’s retirement. This relieved employers of a requirement to reveal their contingent liability in respect of this subsidy on their balance sheets in terms of revised international accounting standards, which were adopted in South Africa as accounting standard AC116. Very substantial amounts of actuarial surplus were used in this way.

3.3 THE LEGISLATIVE AND REGULATORY SITUATION

3.3.1 THE SILENCE OF THE LAW ON THE OWNERSHIP OF ACTUARIAL SURPLUS

The Pension Funds Act does not prescribe conversion terms, nor does it clarify the ownership of surplus. This was confirmed in the Tek case. In this case, Lorentz and a very substantial majority of the members of the fund had transferred to another fund on the sale of the major operating division of the employer without receiving any share of the surplus in the retirement fund. Their transfer value was limited to their accrued liability. They challenged this in the courts, winning in the High Court, and subsequently losing on appeal in the Supreme Court of Appeal. The latter court decided as follows:

- Neither members nor the employer have rights to surplus in law.
- Any rights can only be conferred in the rules of the fund. (Commonly any such rights had previously only been given on termination of the fund where the fund was not replaced by another fund to which the assets and liabilities were transferred: in terms of practice approved by the Registrar, all the surplus was applied for the benefit of the members of the fund and the former members who had left in the twelve months preceding termination.)
- In a DB fund in which the employer is obliged to pay only the balance of the cost of the defined benefit, when there is a surplus, the actuary may recommend a future employer contribution rate that is less than the standard cost of future service in terms of the funding method being used by the actuary (and may even be nil). This so-called ‘contribution holiday’ has been a right of employers in most DB funds if there is a surplus.
- If the rules are silent, the stakeholders (including the employer) should negotiate the distribution of the surplus and amend the rules accordingly.

3.3.2 FUND RULES

3.3.2.1 The rules of a fund seldom contained any statement governing the application of actuarial surplus, except on liquidation of the fund.

3.3.2.2 The Registrar of Pension Funds had opposed any payment of actuarial surplus to the employer on the grounds that were stated in PF99 (¶2.3.4).

3.3.2.3 Milburn-Pyle & Lennox (*op. cit.*) had advocated that these standards be relaxed.

3.3.2.4 In the Lintas case, the Appeal Board established under the Financial Services Board Act, 1990, to hear any disputes concerning the Registrar, had determined that, once the rights and reasonable expectations of members had been satisfied on liquidation of a fund, the objects of a fund were no longer relevant and it was possible to amend the rules to provide for the employer to be paid any residual assets. That amendment would not be inconsistent with the Pension Funds Act.

3.3.2.5 In August 2001 the Registrar of Pension Funds issued circular PF99 to clarify its continued opposition to any payment to the employer.

3.3.2.6 The Tek appeal decision was used by the Appeal Board to decide in the Paarl Widows case that residual surplus on liquidation of a fund, once members’ reasonable benefit expectations had been satisfied and a distribution of residual surplus

had been negotiated with the members, could be transferred to the employer. This was further extended by the Appeal Board, in the *Reckitt & Colman* case¹² to permit the board of a fund to amend the rules to permit the transfer of actuarial surplus to the employer if the fund was ongoing, provided the amendment had been negotiated with members. The latter was overtaken by events, as it was determined just after the Pension Funds Second Amendment Act had become law.

3.3.3 APPROVAL OF TRANSFERS BY THE REGULATOR

3.3.3.1 On a transfer of business between funds, section 14 of the Pension Funds Act, 1956, requires that the Registrar may approve the transfer only if he is satisfied that the scheme of transfer “is reasonable and equitable and accords full recognition to the rights and reasonable benefit expectations of the members transferring in terms of the rules of (the) fund”.

3.3.3.2 Before 1992, this did not apply to transfers between funds both of which were underwritten. Section 2(3)(a) of the Pension Funds Act was amended to remove the right of the Registrar of Pension Funds to exempt underwritten funds from section 14, as had previously been the case. As was reported in the *Pepkor* matter, because of constraints within the Registrar’s office, full implementation of this section to underwritten funds took place only from mid-1994.

3.3.3.3 This excluded very many transfers from what could have been a valuable check on the reasonability of the process, as, certainly in the initial stages, many of the union-sponsored funds were underwritten funds. At the end of 2001, there were 3 198 ‘self-administered’ funds (i.e. funds administered by the sponsor, directly, or placed with specialist administrators who are not insurers) compared with 11 808 underwritten funds.¹³

3.3.3.4 Before the Pension Funds Second Amendment Act, 2001, became law, the regulatory authorities did not require the transfer of more than the accrued liability. They interpreted the term ‘reasonable benefit expectations’ to relate to discretionary benefits such as pension increases rather than to an asset that would give a long-term value equivalent to the accrued liability. The regulatory authorities sought to encourage the transfer of more than the accrued liability but did not believe that they had a legal right to demand that any share of the actuarial surplus, or any excess of fair value of assets over the actuarial value of the assets, be included in the transfer value.

3.3.3.5 This view is supported by the decision of the Supreme Court of Appeal in the *Tek* matter, as most bulk transfers occurred in terms of the rules of the fund in which the transfer terms were stipulated.

3.3.3.6 On the other hand, the failure to disclose the extent to which actuarial surplus was concentrated in the residual fund following bulk transfers was found to be good grounds to overturn approvals given previously by the Registrar in the *Pepkor* matter.

12 Unpublished determination of the board of appeal established in terms of the Financial Services Board Act and dated December 2001 in the matter of *Reckitt & Colman South Africa Pension Fund v Registrar of Pension Funds*. Per Friedman J.

13 Forty-third Annual Report of the Registrar of Pension Funds

3.3.3.7 The Registrar's primary concern in the early 1990s was to prevent 'cherry picking', namely the use of actuarial surplus to benefit particular parties (usually decision makers and the employer) to the exclusion of the generality of members, and the asset-stripping of funds by predatory takeover companies. The latter is cited in Milburn-Pyle & Lennox (*op. cit.*): company A takes over company B, the assets of the company B pension fund are then merged into the company A pension fund, after which all the employees of company B are retrenched, generating a substantial amount of surplus in the company A pension fund.

3.3.4 DELAYS IN COURTS' DECISIONS

3.3.4.1 Kerrigan (*op. cit.*) noted that a decision was expected shortly from the courts:

The amount that is transferred from a traditional pension fund to the alternative benefit programme is a sensitive and contentious issue. In the early alternative programmes that were established, employers offered a transfer of the member's cash withdrawal benefit or, as an alternative, a paid-up pension in the pension fund. Once the trade unions understood the issues involved, this basis was quickly superseded by a transfer of a member's actuarial reserve in the pension fund. Currently, the COSATU position is that a pro-rata share of the market value of the assets should be transferred, where a fund is in surplus and where the assets have been taken into account by the actuary at substantially less than the current market value. There are strong arguments both in favour of transferring surplus and against transferring surplus, but any employer who negotiates an alternative benefit programme should not simply assume that [it] will be able to remove this issue from the negotiation by stating the obvious position that the surplus legally belongs to the pension fund. While the employer can claim that [it] needs the surplus as a protection against the remaining open-ended liability in the defined benefit pension fund, the transferring members can equally claim that they require the surplus as they are taking over the employer's benefit obligation and moving to an uncertain defined contribution provident fund benefit. There is no simple solution to this issue and it is likely to be tested before long either in the Industrial Court or in the Supreme Court.

3.3.4.2 In fact the first time this was tested in the courts was the Tek matter, including the appeal which was handed down by the Supreme Court of Appeal only in September 1999, many years after most of the transfers had taken place.

3.3.5 THE LACK OF GUIDANCE BY THE ACTUARIAL PROFESSION

3.3.5.1 No professional guidance notes in South Africa specifically cover conversions or transfer values. Gluckman & Kamionsky (*op. cit.*) pointed out this omission, years after most of the conversions had happened.

3.3.5.2 Milburn-Pyle & Lennox (*op. cit.*) set out the prevailing views of the actuarial profession at the time the transfers were taking place. Fundamental to this is the view that, in a DB fund, the actuarial surplus results from previous over-contribution by the employer, and the employer should have the right to approve or veto any application

of that surplus, including any share payable to transferring members. However, the difference between the fair value of the assets and the actuarial value of the assets was not considered by Milburn-Pyle & Lennox (*op. cit.*).

3.4 TRANSFER OF ACTUARIAL SURPLUS TO EMPLOYERS

3.4.1 RESIDUAL FUNDS

3.4.1.1 The process set out in section 2 had given rise to a number of residual DB funds within which much of the actuarial surplus was concentrated, but which had relatively few remaining members.

3.4.1.2 As noted in ¶2.5.1, it was decided in the Lintas matter¹⁴ that residual assets could be paid to the employer on the liquidation of a fund once the rights and reasonable expectations of members have been satisfied, with the agreement of the members. In the absence of any legislative action, once the Tek appeal and the Lintas decisions had been handed down, the stage was set for employers to obtain transfer of much of the surplus left in these residual DB funds.

3.4.1.3 As noted in ¶3.3.1, regulatory practice required only those members who were in the fund in the twelve months prior to termination to participate in the distribution of assets. Regulation 30 requires the rules to set out the circumstances under which the pension fund may be terminated with specific reference to “the position of persons whose membership ceased during at least the twelve-month period immediately prior to the date of liquidation”. The Registrar has interpreted this to require these people to be included in the liquidation distribution. Where a residual fund had been in its current state for some years, this meant that only a small minority of the original members qualified to participate in the distribution of the assets and the negotiation of the distribution of surplus. This created an opportunity to buy off the residual members with a much more generous settlement than any of the former members who transferred out to DC funds had received, and to pay the balance of the surplus to the employer.

3.4.1.4 Funds such as the Pepkor Pension Fund sought to use this approach: the remaining members were offered significant increases to their pensions by the employer on condition that they waived any claim against the actuarial surplus on liquidation of the fund, while thousands of former members, who had previously participated in the fund and who were now in separate funds established for each company within the Pepkor Group, would not share in the surplus at all.

3.4.2 THE 1997 BILL

3.4.2.1 Milburn-Pyle & Lennox (*op. cit.*) had already pleaded for the Government to relax its prohibition on the payment of actuarial surplus to the employer under certain circumstances:

- the funding level (i.e. the ratio of the value of the assets to that of the accrued liabilities) must be at least 110% after the proposed payment;

14 *Lintas South Africa Pension Fund v Registrar of Pension Funds*

- the basis of valuation of the assets and liabilities should be agreed between the Registrar and the Actuarial Society of South Africa (ASSA);
- pension increases should be allowed at levels consistent with past practice;
- the rate of member contribution may not increase over the three years following the payment unless benefits are improved or employer contributions increase proportionately;
- the accrued benefit rights of members may not be reduced; and
- the cash payment should be taxed in the hands of the employer.

3.4.2.2 Immediately after the decision in the Lintas matter, the Registrar referred the problem of the transfer of surplus to the employer to the Pensions Advisory Committee, a committee established in terms of the Pension Funds Act to advise the Registrar and the Minister of Finance on matters pertaining to retirement funds. That committee established a representative subcommittee to review the issues. The Registrar's brief was to determine the desirability of such transfer. If desirable, under certain conditions, the appropriate legislation should be drafted; if undesirable, legislation should be drafted to stop it. This would address what the Registrar saw as potential abuse.

3.4.2.3 As recorded in section 2.7, the subcommittee recommended legislation to permit the transfer of surplus to the employer under controlled circumstances to prevent abuse. The Bill was drafted accordingly and the parliamentary process commenced.

3.4.3 TEK

3.4.3.1 In the early 1990s, the main operating division of the Tek Corporation was sold to another group, and the vast majority of the members still in employment of the Tek Corporation, who belonged to the Tek Corporation Provident Fund, were transferred to another fund. The most senior of the members transferred was a Mr Lorentz. On behalf of himself and his transferring colleagues, Mr Lorentz challenged the terms of transfer, initially from the Tek Corporation Pension Fund to the Tek Corporation Provident Fund and then to the new organisation's fund, on the grounds that there was an actuarial surplus and the transferring members were entitled to a reasonable share of it.

3.4.3.2 The High Court found in Mr Lorentz's favour. The Tek Corporation Pension Fund had been administered on a balance-of-cost basis (that is, the employer paid the balance of the cost of the defined benefits once any fixed contribution paid by the member had been taken into account). Judge Navsa found that the employer was only entitled to benefit from actuarial surplus that had arisen from deliberate employer over-contribution, and, therefore, *inter alia*:

- the actuary was not entitled to permit the employer to pay less than the standard future-service contribution unless past over-contribution had created sufficient surplus to fund the shortfall; and
- the trustees should consider what share of the actuarial surplus should be paid to the fund to which the Tek employees had transferred.

3.4.3.3 The Supreme Court of Appeal overturned this judgment. Its findings are set out in ¶2.11.1.

3.4.3.4 The Supreme Court of Appeal then went on to note that the complex social and policy issues surrounding surplus apportionment should be dealt with by legislation. This was one of the motivators of what ultimately became the Pension Funds Second Amendment Act, 2001.

3.4.4 PAARL WIDOWS AND RECKITT & COLMAN

3.4.4.1 The Paarl Municipal Widows and Orphans Pension Fund was one of a number of funds that were preparing to apply for the transfer of actuarial surplus to employers after having met the conditions set in the draft 1997 bill. The fund submitted a rule amendment that would put into effect a distribution of the surplus on liquidation of the fund, including payment of the employer's share to the employer.

3.4.4.2 The Registrar refused approval to the enabling rule amendment, having taken legal advice which suggested that the Lintas decision was not well founded in law.

3.4.4.3 The Appeal Board found that the object for which a fund is established is irrelevant on liquidation once the fund has satisfied the rights and reasonable expectations of the members and there is no inconsistency with the Act if the rules then make provision for any residual actuarial surplus to be transferred to the employer.

3.4.4.4 The Appeal Board had waited, before issuing its determination, to hear the decision of the Supreme Court of Appeal in the Tek matter. Its determination (cf. ¶2.13.1) is consistent with the latter decision.

3.4.4.5 This established comprehensively that the rules of a fund could be amended to permit the payment of surplus to the employer.

3.4.4.6 In *Reckitt & Colman*¹⁵, the Appeal Board was asked to extend the circumstances in which the board of the fund could amend the rules to permit payment of actuarial surplus to the employer in circumstances other than liquidation. The *Reckitt & Colman* Pension Fund wanted payment of actuarial surplus to the employer, after negotiating a distribution of the surplus amongst existing members and the employer, while the fund continued its normal operations.

3.4.4.7 While the determination of the Appeal Board went against the fund (because the rule amendment as drafted was not financially sound), the Appeal Board affirmed the principle (cf. ¶3.3.2.6) that the board of a fund could amend the rules to permit payment of surplus moneys to the employer, even in an ongoing fund.

3.5 APPORTIONMENT OF ACTUARIAL SURPLUS AND MINIMUM BENEFITS

3.5.1 THE NEDLAC NEGOTIATIONS

3.5.1.1 As noted in section 2.7, following strong pressure from COSATU, the Government withdrew the draft Pensions Surplus Bill in February 1999. The Minister of Finance then facilitated discussions between the FSB, the National Treasury and COSATU to determine the stumbling blocks and a way forward. These discussions revealed the link between past transfers from employer-sponsored to union-sponsored

15 *Reckitt & Colman Pension Fund v Registrar of Pension Funds*

funds (and retrenchments before and after this process on similar terms to those transfers) and the apportionment of surplus.

3.5.1.2 The union federations believed that much of the actuarial surplus that was now revealed in DB funds had arisen because the transferring members had received less than their fair share of the assets of funds during the extraordinary transfers that had taken place over the previous twenty-odd years during the mass conversions. The union movement was determined to renegotiate the terms of these transfers, with assistance from the courts or the legislature, if required. The federations were very anxious to prevent any transfer of actuarial surplus to the employer until such time as this process had worked its way through the system.

3.5.1.3 Once business became aware of these discussions, it demanded that its voice be heard, and the discussions were moved into the formal forum for such discussions, namely NEDLAC. The parties to the negotiations in NEDLAC were the three major trade-union federations (COSATU, NACTU and FEDUSA), Business South Africa and the Government team.

3.5.2 THE EFFECT OF KRANSDORFF AND THE IBM PENSIONERS' COMPLAINTS

3.5.2.1 There were two significant complaints to the Pension Funds Adjudicator which were occurring at the same time as the NEDLAC process. Both complainants involved actuaries close to the labour representatives in the NEDLAC discussions. One complainant was actively supported by the South African Chemical Workers Union (SACWU).

3.5.2.2 A significant number of employees of Sentrachem who were members of SACWU chose to transfer from the Sentrachem Pension Fund (a DB fund) to the union-sponsored DC provident fund. At much the same time, some senior employees, including Mr Kransdorff, were retrenched. The transferring members and the retrenched members received their accrued liabilities as transfer values using the basis applicable at the previous statutory actuarial valuation of the Sentrachem Pension Fund. No actuarial surplus was included in the transfer values or retrenchment payments, and there was no adjustment for the difference between the actuarial value of assets and the fair value (or market value) of the assets.

3.5.2.3 As noted in ¶2.8, the Sentrachem Pension Fund had reported a marginal surplus in its actuarial valuation immediately preceding the transfers and retrenchments; the ratio of actuarial value of assets to the value of accrued liabilities was 101%. The actuarial valuation of the Sentrachem Pension Fund after the transfers and the retrenchments revealed a significant surplus. Analysis of the origin of this surplus showed that it had come from two sources.

3.5.2.4 The first was a change in the method of determining an actuarial value of assets. In the valuation prior to the transfers, the ratio of the fair value of assets to the actuarial value of the assets was approximately 140%. A new actuary performed the valuation following the transfer, used a different approach to determine the actuarial value of the assets, and derived a much smaller ratio of fair value of assets to actuarial value of assets, releasing substantial surplus.

3.5.2.5 The second was the release of the margin between the fair value and the actuarial value of assets on the transfers and retrenchments.

3.5.2.6 Mr Kransdorff complained to the Pension Funds Adjudicator in respect of his retrenchment benefit. SACWU launched an action against the Sentrachem Pension Fund in respect of the transfer values.

3.5.2.7 While Mr Kransdorff was not successful in his complaint, and the SACWU action has, to the best of the author's knowledge, not been heard as yet in the courts, the issue was very much in the minds of the union negotiators in NEDLAC. It was largely responsible for the development of the argument subsequently used by the labour federations in the hearings before the Portfolio Committee on Finance that an appropriate transfer value was:

$$L \frac{A_F}{A_A} ; \quad (1)$$

where L is the value of the accrued liability;

A_F is the fair value of assets; and

A_A is the actuarial value of the assets.

3.5.2.8 Employees who belonged to the IBM SA Pension Fund (a DB fund) were offered the right to transfer to an employer-sponsored DC fund in the early 1990s. A share of the fair value of the assets was transferred broadly in proportion to the accrued liabilities transferred. Most employees who were members of the fund accepted the offer, leaving the residual DB fund with some 50 members still in employment, and a large group of pensioners. The accrued liabilities of the residual fund were very heavily weighted towards the pensioners. Investment returns earned in the residual fund were good. A considerable actuarial surplus emerged.

3.5.2.9 The pension increase policy adopted by the fund comprised an annual increase of approximately two thirds of the change in the consumer price index over each past year and an irregular increase, determined by the trustees and dependent on investment performance and affordability, up to a maximum of the full change in the consumer price index from date of retirement. Each pension increase could only be implemented, in terms of the rules, if the employer consented to the increase.

3.5.2.10 The board of trustees proposed an increase to fully inflation-proof the pensions. This increase could easily be afforded by the fund on the strength of its investment performance.

3.5.2.11 The employer proposed an apportionment of the actuarial surplus that favoured the employer. This apportionment was rejected by the pensioners, who had formed a 'Pensioner Action Group' to represent their interests, as they felt that the residual share of the assets that had been left in the fund should be used for their benefit.

3.5.2.12 The employer thereupon refused its consent to the inflationary pension increase proposed by the board of trustees until such time as the pensioners approved the apportionment proposal.

3.5.2.13 The Pensioner Action Group complained to the Pension Funds Adjudicator. As noted in ¶2.12, the Pension Funds Adjudicator rejected the complaint on

the grounds that the employer could legitimately refuse its consent in circumstances in which it was involved in negotiations with the fund.

3.5.2.14 This seemed unreasonable to the Government team who were involved in the NEDLAC discussions. Pensioners are the most vulnerable of all the stakeholders involved in a fund and should benefit from the investment return earned on the assets backing their liabilities, at least to the extent required to make their pensions inflation-proof.

3.5.3 THE DRAFT BILL

3.5.3.1 By August 2000, it was apparent that the positions of organised labour and business had crystallised (cf. section 2.14).

3.5.3.2 Labour wanted all past transfers, conversions and retrenchments to be increased to the value determined by equation (1), even if this caused the fund to go into deficit. In their opinion, the extraordinary surplus released in the transfers and retrenchments should now be used to enhance the benefits paid previously.

3.5.3.3 Pension increases should preserve the purchasing power of pensions if the fund could afford this out of the investment return earned on the assets backing the pensioner liabilities.

3.5.3.4 No actuarial surplus should be used for the benefit of the employer.

3.5.3.5 Any past use of actuarial surplus for the benefit of the employer (except contribution holidays) should be paid back to the fund.

3.5.3.6 Business wanted to retain the right of the employer to have any actuarial surplus taken into account by the actuary when determining the future employer contribution rate; i.e. the first application of any actuarial surplus would be to fund future-service benefits, thereby reducing the employer contribution due.

3.5.3.7 Business was prepared to consider a minimum benefits regime for the future, but was not prepared to support any retrospective adjustments of past transfers, conversions and retrenchments.

3.5.3.8 The stakeholders asked Government to govern, namely to make up its mind as to possible legislation and place this before Parliament.

3.5.3.9 The Government team had concluded by this time that:

- the members had a reasonable expectation that actuarial surplus would be used to improve benefits; and
- the employer had a reasonable expectation that the presence of actuarial surplus would be taken into account in determining the future contribution rate;
- and these two reasonable expectations could only be resolved by having stakeholders negotiate the distribution of the actuarial surplus.

3.5.3.10 Former members (and the trade unions that represented them) had had unequal access to expert advice when negotiating their previous transfers and retrenchments, and the stakeholders in funds, as well as the boards of those funds, had been misdirected that actuarial surplus was effectively at the disposition of the employer, and should have considered including a share of the difference between the actuarial value and the fair value of assets. Similarly, pension increases had not always been fairly considered.

Therefore, the earlier transfers and retrenchments that had taken place, and pension increases that had been granted, needed to be revisited if there was actuarial surplus, and such actuarial surplus should be applied first to increase these to reasonable levels.

3.5.3.11 This is what the Government team proceeded to draft into a bill:

(a) Minimum benefits on exit

All members who left funds, for any reason, after an initial window period, must receive their minimum individual reserve. The latter would represent:

- (i) in the case of a DC fund: the member plus the employer contributions applied to retirement funding (i.e. less any administrative expenses and insurance premiums for death and disability benefits) plus net investment returns earned; and
- (ii) in the case of a DB fund, an amount of money, which, if invested prudently under prevailing market circumstances, could reasonably be expected to grow to an amount sufficient to enable the former member to replace the benefit lost at the member's normal retirement age (the assumptions to be used to calculate this benefit would be prescribed by the regulator).

The window period would expire twelve months after the surplus apportionment date. If stakeholders could not afford the additional costs associated with the implementation of minimum benefits, they should be able to change the rules with regard to benefits within the window period, in which case the minimum-benefit regime would not apply.

(b) Minimum pension increases

A pension increase policy should be established by the board of every fund, targeting a proportion of price inflation.

The net investment returns earned on the assets backing pensioner liabilities should be applied for the benefit of the pensioners, up to a maximum of full inflation proofing from date of retirement (or death in the case of pensions arising from the death of a member in service), and the employer should not be able to veto the resulting increase.

(c) Actuarial surplus must be apportioned at the surplus apportionment date.

There was to be a once-off apportionment, governed by statute, of actuarial surplus at the surplus apportionment date. Normally this date would be the effective date of the first actuarial valuation after the Act became law, but would be advanced if the fund was liquidated or converted or if the board elected to apportion actuarial surplus earlier.

- (i) Prior enhancement up to minimum benefit levels to past transfers, conversions and retrenchments

Actuarial surplus was to be applied first:

- (aa) to enhance former members who had transferred out of the fund, or who had experienced conversion from defined benefits to defined contributions, or who had been retrenched, in any of these cases over the period from 1 January 1980 to the surplus apportionment date, up to the minimum levels; and

- (bb) to enhance pensions up to minimum levels;

with proportionate reduction of both if there was insufficient actuarial surplus to permit both to be done, in full.

(ii) Equitable apportionment of the balance of actuarial surplus

The residual actuarial surplus would then be equitably apportioned between stakeholders, defined as the existing members (including pensioners), the former members, and the employer, after taking account of the financial history of the fund in a manner to be prescribed by regulation.

This draft regulation¹⁶ was published at the same time as discussion commenced in parliament. It set out how the former members should be identified and taken into account, and how the financial history of the fund would be explored:

(aa) The financial history of the fund would be analysed from 1 January 1980 onwards, identifying:

- the contribution history split between employer and employee;
- any sources or applications of actuarial surplus and the stakeholder group who benefited from such applications; and
- certain specific events as having benefited the employer, which would need to be taken into account, as such.

(bb) The history would include the enhancement in (a) and (b).

(cc) The board of the fund must take this history into account in determining the apportionment.

It was expected that any extraordinary surplus released historically would be absorbed in the enhancement in (i). This would leave normal surplus, most of which was expected to have arisen from excess investment return earned, to be split between stakeholders on a negotiated basis.

(d) Employer to have a duty to fund any deficit

In return for giving the employer a right to actuarial surplus apportioned to it, either in the once-off exercise in (c) or thereafter in terms of the rules or a decision of the trustees, the employer would be required to fund any shortfall of the value of the assets in excess of the total minimum benefits payable to members.

3.5.4 CHANGES INTRODUCED IN THE PARLIAMENTARY PROCESS

3.5.4.1 After four weeks of hearings before the Portfolio Committee on Finance and deliberation of the clauses of the Bill, members of all political parties expressed satisfaction to the author for the job that they had done. The principle changes introduced into the Bill during this process are discussed in this section.

3.5.4.2 The class of former member to be included in the apportionment of actuarial surplus was widened to include people who had resigned or who had been dismissed. There were two reasons for this (both advocated by the Pension Funds Adjudicator in his presentation to the Portfolio Committee on Finance during the hearings into the Bill):

¹⁶ Draft Regulations for the Apportionment of Actuarial Surplus in terms of the Pension Funds Second Amendment Bill, submitted to Parliament and the parties that commented on the draft Bill prior to the commencement of hearings into the draft Bill in August 2001

(a) Many of the early transfers to union-sponsored funds had been treated as far as the rules were concerned as resignations, because in those early days few rules made provision for such a transfer between funds. The exclusion of resignations from the scope of enhancement of former members would deny these members their rights.

(b) The Labour Relations Act made provision for dismissal as a result of disability. If the Bill was intended to include those who left the fund involuntarily, then they needed to be included.

3.5.4.3 It was a short step from this, in argument, to including everyone who had left the fund.

3.5.4.4 The Association of Retired Persons and Pensioners pleaded for acceleration of the first application of the provisions regarding minimum pension increases. This was introduced into the Bill, but created a pecking order with regard to the distribution of surplus that might not have been anticipated: if the minimum pension increase provisions were implemented before the surplus apportionment date, the pensioners might get their full minimum increase and leave too little actuarial surplus to enable the enhancement of the benefits of former members, whereas the Bill, elsewhere, looked for these two actions to enjoy equal priority and for both results to be proportioned downwards if there was insufficient surplus to fund both.

3.5.4.5 Secondly, the determination of an affordable pension increase subject to a maximum of full inflation-proofing increase was written into the Bill. But the provisions did not allow for a situation in which the actuarial surplus allocated to the pensioners was insufficient to set up the reserves that would be required to provide for future minimum pension increases at these levels.

3.5.4.6 Most of the stakeholders and practitioner organisations that made presentations to the Portfolio Committee in the hearings on the Bill argued that the scope of the draft regulation was too broad and the matters were too important to be imposed by regulation. This resulted in a substantial rewrite of section 15B of the Bill, which was done during the Parliamentary process and was not, therefore, subject to analysis and comment by practitioners. Various problems were introduced as a result:

(a) The employer must pay into the fund any excess of:

(i) the value of the specified uses of surplus in the past for the benefit of the employer over:

(ii) the amount of actuarial surplus allocated to the employer.

However, there is a lack of clarity as to whether the surplus apportionment exercise (including identification of the uses of surplus for the benefit of the employer) is to be conducted only if there is actuarial surplus; or if the sum of the actuarial surplus and the amount resulting from the defined uses of actuarial surplus for the benefit of the employer is sufficient to enable an apportionment, even if, for example, the fund is in deficit. There is also a lack of clarity as to whether this exercise should only start from 1 January 1980 or whether earlier uses for the benefit of the employer should also be taken into account. In addition, it is desirable that it is made clear that if the employer committed to pay additional contributions in future to fund any such uses, the corresponding value should be deducted from any amount the employer is required to pay.

(b) In practice there is limited ability to address problems that occur in the surplus-apportionment exercise through fine-tuning the regulation. One example relates to umbrella funds. These are funds in which many employers participate, and commonly, each sub-fund (or set of member records and accounts corresponding to a particular participating employer) has its financial situation determined separately. In umbrella funds it is desirable to do the surplus apportionment for each sub-fund separately. However, the legislation talks of the fund as a whole. Another example arises where the valuation at the surplus apportionment date reveals no actuarial surplus. As actuarial surplus is the product of a number of decisions on method, assumptions and the establishment of reserves, this should be communicated to stakeholders to give them a chance to challenge any such decisions.

3.5.4.7 The legislation introduced a high level of detail into the legislation. It has subsequently been established that some of the wording is flawed, from an actuarial perspective, or can be interpreted by a lawyer differently from the manner in which it would be interpreted by an actuary. For example, the ‘cost’ of an event is interpreted by a lawyer as the amount actually expended, whereas in relation to the application of actuarial surplus, actuaries are more likely to interpret it as the difference between the actuarial liabilities before and after the event.

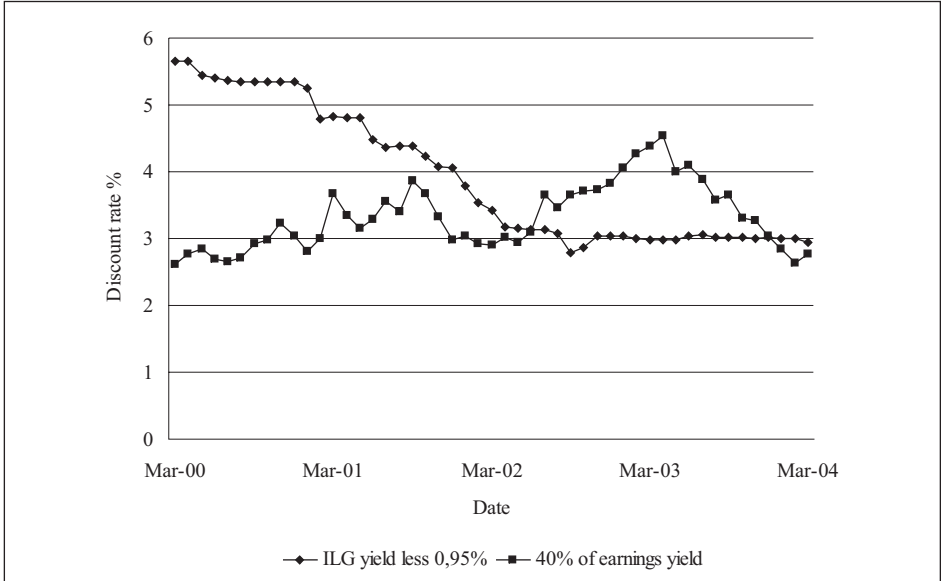
3.5.5 THE MINIMUM BENEFIT BASIS DETERMINED AFTER THE ACT BECAME LAW

3.5.5.1 For the purposes of the determination of the value contemplated in item (a)(ii) in ¶3.5.4.6, the Government team adopted a principle of establishing fair value for defined benefits foregone. The corresponding section of the Act, section 14B(2)(a)(i)(bb), empowered the Registrar of Pension Funds to prescribe the basis. A Board notice of 2003¹⁷ set out the prescribed minimum benefit basis, determined by the Registrar after consultation with a technical committee, for implementation once the Pension Funds Second Amendment Act, 2001, became law.

3.5.5.2 The Registrar adopted the principle that a fair price should be put on the retirement-benefit rights of a member, which price must take account of prevailing market conditions. The market yield on long-dated index-linked government bonds was taken as the basis on the grounds that this represented the market’s best view of future risk-free investment returns, net of price inflation. This yield was then adjusted for an equity or risk premium, salary increases in excess of price inflation, retirement-fund tax and investment management fees to get a discount rate to apply to the deferred pension payable from normal retirement age for the period from date of calculation to attainment of normal retirement age. The adjusted rate was the yield on long-dated index-linked government bonds less 0,95%. The assumptions used by the actuary were adopted for the period after retirement: these assumptions would include provision for increases in terms of the fund’s pension increase policy and should satisfy the reasonable expectations of pensioners.

¹⁷ Assumptions for the determination of minimum individual reserves of members of defined benefit categories of pension funds, *Government Gazette* no. 24809, Board Notice 35 of 2003

Figure 2. Minimum benefit basis



3.5.5.3 After representations by the ASSA that the market in index-linked government stock was limited, and most funds did, in practice, invest in equities, and at the suggestion of the Society, an alternative approach was permitted, namely to use 40% of the earnings yield on the all-share index instead of the yield on index-linked government bonds less 0,95%. The decision of which basis to use is taken by the board of each fund after consulting their actuary. Changes to the basis, however, may be viewed critically by the Registrar who is anxious to avoid a situation in which the approach is selected that gives the lowest minimum benefits from time to time. The resulting discount rates on the two approaches may be compared as shown in Figure 2.

3.6 SUBSEQUENT DEBATE

3.6.1 In a DB fund, the Act defines actuarial surplus as the difference between:

- the value that the actuary has placed on the assets of the fund less any credit balances in the member and employer surplus accounts; and
- the value that the actuary has placed on the liabilities of the fund in respect of pensionable service accrued by members before the valuation date, together with the value of those contingency reserve accounts which are established or which the board deems prudent to establish on the advice of the actuary.

3.6.2 The Act requires apportionment of the actuarial surplus determined by the actuary. The actuary has considerable freedom in selecting the method and assumptions

to be used to value the assets and the liabilities. The board of the fund has the option, acting on the advice of the actuary, to establish contingency reserve accounts, whose balances are deducted before the actuarial surplus is determined.

3.6.3 A conflict of interest has been introduced through the Pension Funds Second Amendment Act, 2001, as at the surplus apportionment date: current members and the employer have an interest to minimise actuarial surplus in order to protect their interests as much as possible, while former members have an interest to maximise actuarial surplus in order to ensure that their enhancement to minimum benefit levels is possible, although any weakening of actuarial assumptions after retirement may reduce the size of the minimum benefit and therefore the degree of enhancement. The resolution of this conflict is presenting actuaries and the boards of funds with problems in the selection of assumptions, methods of valuation, and the establishment of contingency reserves.

3.6.4 This has given rise to a recent regulatory debate: namely, whether the freedom that the actuary has to select the method and assumptions and that the board and actuary have to establish contingency reserve accounts should not be curtailed in order to prevent manipulation of the actuarial surplus to the detriment of the claims of former members. It is clear that some stakeholders fear that the actuary will favour the employer and the existing members at the expense of former members.

3.6.5 The Registrar of Pension Funds has contributed to resolution of the debate by publishing a number of circulars which set out the standard that the Registrar will normally accept, in particular circulars PF116 and PF117:

(a) PF116 clarifies various issues connected with the minimum pension increase. In particular:

(i) The actuary must value the pensioner liabilities after giving a normal increase in terms of the pension increase policy, taking account of the intentions of the board with regard to future pension increases, but not the statutory minimum pension increase which is required at the surplus apportionment date as part of the apportionment of the actuarial surplus.

(ii) The statutory minimum pension increase, which forms part of the statutory surplus apportionment exercise, is to rank equally with the enhancement to former members. Both must be proportioned downwards to the same extent if there is insufficient actuarial surplus to permit both to occur in full.

(iii) As part of the determination of the minimum pension increase, the actuary must roll up the liabilities in respect of pensioners at date of retirement, adjusted to an equivalent fair value, less any amounts commuted, pension payments and expenses, with the net investment return earned on the assets backing the pensioner liabilities, to get what may be called the 'notional pensioner accumulation balance'. This is then converted into the pension increase that can be granted by dividing it by the present value of existing pensions to give one aspect of the maximum increase required in terms of statute.

This notional pensioner accumulation balance may exceed the pensioner liability. Ideally this amount should be set aside, as it may be required in subsequent determinations of statutory minimum pension increases. However, there may not be sufficient actuarial surplus to enable the full amount to be set aside.

The circular sets out the Registrar's view that the board of the fund and the actuary may not set aside the difference between the notional pensioner accumulation balance and the pensioner liabilities in a contingency reserve account before the surplus apportionment is carried out. Such difference may only be set aside in a contingency reserve account balance out of the surplus apportioned for the benefit of the pensioners. Otherwise the pensioners would get an unfair allocation of surplus before the former members had even been considered for enhancement.

(b) PF117 sets standards that will normally be accepted by the Registrar in valuations at the surplus apportionment date:

(i) The fund must be valued at the surplus apportionment date using best-estimate assumptions. These are realistic assumptions based on the past experience of the fund, modified by the actuary's expectations of future changes in that experience. No deliberate margins of conservatism may be included in the assumptions.

(ii) The actuary may set up a solvency reserve account. Any one of three methods may be used:

- the difference between the accrued liabilities using the best-estimate assumptions in (i) and the accrued liabilities using a discontinuance-matched approach. The discontinuance-matched approach requires the use of a discount rate equal to the yield on long-dated government stock less not more than 0,5%, future price inflation equal to the difference between the yields on long-dated government bonds and long-dated index-linked government bonds, the excess of salary increases over price inflation used in the previous statutory valuation, and mortality and morbidity rates equivalent to those that would be applied by an insurer for non-profit business;
- stochastic modelling; or
- a risk-resilience reserve similar to that applicable when determining the capital-adequacy requirement of a long-term insurer in terms of ASSA's guidance note PGN104.

Any difference between the actuarial value and the fair value of assets is to be deducted from the solvency reserve.

(iii) The actuary must review any other contingency reserve accounts that the actuary might consider establishing or that the board has previously established in the light of this solvency reserve, questioning whether the additional reserves are necessary.

(iv) The actuary may establish contingency reserve accounts:

- for the expenses of surplus apportionment;
- for data errors;

- where the fund self-insures some or all of the death and disability benefits, for fluctuations in death and disability experience in line with the margins required of an insurer when determining its capital requirements;
 - for processing errors; and
 - for the difference between the cost of future benefits and the value of future contributions payable in terms of the funding method, where a prospective-benefits funding method has been used to determine the actuarial surplus.
- (v) The actuary must explain the financial effect of each change of assumptions, methods, and quantum in each contingency reserve account on the financial position of the fund, starting with what the valuation result would have been if the method and assumptions applied in the previous statutory actuarial valuation had been used.

3.6.6 It has been clear from the discussions surrounding these circulars that actuaries are vulnerable to further damage to their reputations. Some stakeholders believe that actuaries will collude with the existing members and employers to minimise actuarial surplus.

4. CRITICISM OF VARIOUS PARTIES INVOLVED IN THE CONVERSION PROCESS

In the process leading up to the legislation, and in some cases thereafter, the regulator, the boards of trustees, and the actuarial profession in South Africa have come in for strong criticism for their role in determining or approving conversion values.

4.1 CRITICISM OF THE REGULATOR

Conversions achieved by transfer from a DB fund to a DC fund and conversions achieved within a fund by rule amendment, both required the Registrar's approval.

4.1.1 TRANSFERS

4.1.1.1 In respect of any transfer, in terms of section 14 of the Act, before he gave his approval the Registrar needed to be satisfied that the transfer was "reasonable and equitable and [accorded] full recognition to the rights and reasonable benefit expectations of the members transferring in terms of the rules ... and that the proposed transactions would not render any fund which [was] a party thereto and which [would] continue to exist if the proposed transaction [were] completed, unable to ... remain in a sound financial condition".

4.1.1.2 The alarm bells did not ring in the Registrar's office that those transfers might not have been fair and might not have been financially sound.

4.1.1.3 If, for example, those transfers had taken place from one DB fund to another, and the receiving fund had invested the transfer value in the same way as it had been invested in the originating fund, with the same approach to the determination of an actuarial value of assets, only if the receiving fund obtained the amount determined by equation (1) would the receiving fund have an actuarial value of assets, after the transfer, equal to the accrued liabilities that it was assuming. Only this would satisfy the condition

for a fund to be declared financially sound in South Africa, and therefore the condition that needs to be satisfied for approval in terms of section 14.

4.1.1.4 If the transferor fund felt that the margin between the fair value of assets and the actuarial value of assets was overly conservative as a measure of investment risk, an alternative method should have been insisted on to determine an appropriate number.

4.1.1.5 Most transfers did not receive this margin.

4.1.1.6 In defence of the Registrar's office:

- The Registrar insisted that the transfer value was at least the accrued liability. If this was paid in cash, the receiving fund would have sufficient in assets to match the accrued liabilities that it was taking on board at the moment of transfer.
- As the receiving fund was a DC fund, subsequent changes in value as the moneys were invested in different asset classes were for the account of the members.
- At least in the initial stages of the conversion movement in South Africa, many of the receiving funds invested the moneys in the smoothed-bonus portfolios offered by some of the large insurers. Few actuaries assumed an actuarial value of assets for such portfolios that was lower than the portfolio value (i.e. amounts invested plus declared bonuses less claim payments).
- In the context of a bull market for investments, the transferring members seemed able to replace the benefits lost.
- The author believes that most practitioners at the time felt that what was left behind in the DB fund was a margin of conservatism made by the actuary, which had, in any event, been funded by the employer and was there to protect the employer (who bore the investment risk).

4.1.1.7 In the late 1990s, investment markets displayed considerable volatility. Members became aware of the extent of the investment risk that they had assumed and questioned their transfer values:

- With the receipt of only the accrued liability value in cash, the members in the receiving DC funds were being required to take on any investment risk implicit in market conditions at the time.
- They were leaving behind the protection built up in the DB fund, which was represented by the difference between the fair value and the actuarial value of assets. Where the members contributed, frequently an equal amount to the employer, they could argue that they had contributed to this difference.

4.1.1.8 They questioned whether it was appropriate that the actuary's margin between the fair value and the actuarial value of assets should have been left in the transferor fund.

4.1.1.9 The author believes that an argument can be put that the failure to include compensation for transfer of the investment risk in the transfer value did not result in a reasonable and equitable transfer value.

4.1.1.10 As noted in section 3, it became customary to give sweeteners to transferring members as an inducement to get members to transfer. The sweetener was a share of the actuarial surplus, or of the difference between the fair value and the actuarial value of assets. The sweetener was often explained to transferring members as

compensation for assuming the investment risk. The ratios of these sweeteners to the values of the accrued liabilities were frequently comparable to the ratios of the fair values of the assets to the actuarial values of the assets. In such cases, the transfer values may well have been reasonable and equitable.

4.1.1.11 Turning then to a share of surplus, those who argue that a share of surplus should have been included in the transfer value, depend upon the use of the term “accords full recognition to the member’s reasonable benefit expectations”. They argue that members have a reasonable expectation to participate in surplus because it could have been used to improve benefits in future, and therefore they should have been given a share of that surplus on transfer.

4.1.1.12 On the other hand, the Tek appeal determined (before the Pension Funds Second Amendment Act, 2001) that there were no rights to actuarial surplus in law.

4.1.1.13 From a legal perspective, therefore, the Registrar was correct to feel that he could not insist on the inclusion of a share of surplus.

4.1.2 CONVERSION BY MEANS OF RULE AMENDMENT

4.1.2.1 Any rule amendment is invalid unless approved by the Registrar. In order to give his approval, the Registrar must be satisfied that the amendment is not inconsistent with the Pension Funds Act and that the amendment is financially sound¹⁸. There is no explicit requirement for the Registrar to check that the amounts credited in the fund to a member’s individual account on a DC basis are reasonable and equitable. However, the tests for inconsistency with the Pension Funds Act are interpreted by the Registrar to include questioning whether the amendment is in the public interest. This is drawn from section 4(4) of the Act. If the Registrar felt that the amounts credited to members’ individual accounts were unfair, then the Registrar could surely have used the public-interest test to reject the amendment.

4.1.2.2 The practice while the author worked for the regulator was to require that members received at least their accrued liability as an initial credit into their individual accounts and to ensure that the regulator was informed of what happened to the difference between the fair value and the actuarial value of assets, and to the actuarial surplus. Where the difference between the fair value and the actuarial value of assets was to be used in future to smooth the investment return credited to individual member accounts or to provide a cushion against adverse investment performance, the Registrar would accept only the accrued liabilities’ being credited to individual member accounts.

4.1.2.3 The Registrar, during the author’s tenure, was cautious of agreeing to moneys’ being credited to an employer reserve account unless there was a fully negotiated distribution of the actuarial surplus between stakeholders. Indeed this motivated section 15F, which was introduced in the Pension Funds Second Amendment Act, 2001. That section provides for the contents of any reserve account to fall into surplus and be apportioned in terms of the Act unless it can be demonstrated that the amount originally credited to the account had been negotiated between stakeholders in a

18 Section 12(4) of the Pension Funds Act, 1956

manner consistent with the principles behind the Act. If the board of the fund satisfies the Registrar that the balance in the employer reserve account was the result of a negotiated distribution of actuarial surplus, then it may be transferred to an employer surplus account and be excluded from any apportionment of actuarial surplus in terms of the Act.

4.1.2.4 The financial soundness test was used to reject distributions of actuarial surplus and any difference between the fair value and the actuarial value of assets which deprived one or other stakeholder group of the degree of protection that it had enjoyed previously.

4.2 CRITICISM OF BOARDS OF TRUSTEES

4.2.1 The Registrar has a right to assume that trustees have properly performed their duties before applying for his approval¹⁹. In terms of the principle in Roman–Dutch law of *functus officio*, an administrative official has no power to review a decision once made, unless the official can be shown not to have given the matter proper consideration. This caveat will seldom if ever apply to transfers of business, because the Registrar demands reports of the scheme, the transfer value determination by the transferor fund and details of how the transfer value will be applied in the transferee fund, supported by certification that the actuaries to both funds are happy that the transfer meets the requirement that it is reasonable and equitable and satisfies members' reasonable benefit expectations. The Registrar then considers these reports before making a decision. If, however, the trustees did not exercise their fiduciary duties, despite the principle of *functus officio*, the transfer may be reviewed even after it has been approved by the Registrar.

4.2.2 If the board of trustees has a fiduciary responsibility to former members, the same criticism can be levelled at boards of trustees as can be levelled at the Registrar for failing to make provision for the transfer of investment risk in many of the transfers.

4.2.3 However, until sections 7A to 7D were introduced into the Act, the duties of trustees were not spelt out in the Act. Those sections applied immediately to a fund registered on or after 19 April 1997, but only from 15 December 1998 for a fund registered before this date. Most transfers will have occurred from funds registered before 19 April 1997, and therefore sections 7A to 7D would not have applied at the date of transfer.

4.2.4 Before the applicability of sections 7A to 7D most legal commentators seem to agree that, under common law, the board of a fund had a fiduciary duty to the fund. There is then disagreement over whether there was a fiduciary duty to all members (including those transferring out of the fund) or only a duty of good faith.

4.2.5 If there was a fiduciary duty towards members, the board should have treated remaining and transferring members impartially. The author questions how a transfer value could have excluded the difference between the fair value of assets and the actuarial value of assets (or some other measure to compensate them for assumption of the investment risk), when this was deemed appropriate for the remaining members.

4.2.6 If there was only a duty of good faith, this may have been satisfied by disclosure of the financial situation of the fund and the negotiation of transfer terms. The

19 *Registrar of Pension Funds v Pepkor Pension Fund*

board of the fund was not obliged to do any more than ensure that the former members received what was due to them in terms of the rules. If this is correct, the board of trustees could accept a deal negotiated between the employer and the union that resulted in an inequitable transfer value to former members, provided the board had disclosed the financial situation of the fund and the rules. As the statutory actuarial valuation and the rules are public documents, and any member could get sight of a copy from the principal officer (in terms of section 35 of the Pension Funds Act, 1956) or obtain a copy from the Registrar (in terms of section 22 of that act), and the statutory actuarial valuation contains sufficient information to reveal both the actuarial surplus and the difference between the fair value of the assets and the actuarial value of the assets, it would arguably be surprising if the board of trustees could be held liable for a failure to disclose such information.

4.2.7 Once section 7C is applicable to a fund, subsection (2) requires the board to protect the interests of members who transfer out of the fund and to act with impartiality towards members and beneficiaries. Arguably this means that the board of a fund cannot give preference to the remaining members of the fund over the interests of former members of the fund. Transfers after 15 December 1998, therefore, would be treated differently and trustees could be held liable for a breach of their fiduciary duties towards former members. Most of the transfers that are in contention occurred before these sections were applicable.

4.2.8 It is therefore a moot point whether former members could succeed in challenging past transfers on the grounds that the board of the fund (until 15 December 1998 in most cases appointed solely by the employer) had not exercised their fiduciary duties towards the former members in the determination of the transfer values.

4.3 CRITICISM OF ACTUARIES

4.3.1 EMPLOYER ORIENTATION

4.3.1.1 Before 15 December 1998, when all funds became subject to sections 7A to 7D (introducing member-elected trustees), many funds had their boards of trustees appointed solely by the employer. Often the members of the board were senior executives of the employer.

4.3.1.2 The actuary would advise the board of a fund concerning the values to be credited to members' individual accounts on conversion within the same fund or concerning transfer values where the conversion was achieved by transfer to a DC fund.

4.3.1.3 Arguably, there was no consideration of any conflict of interest between the employer and the fund: many funds were run as if they were divisions of the employer. Advice was given interchangeably by the same actuary to the board of the fund and the employer. Sometimes it was not clear which was the actuary's principal as he or she could have been advising both simultaneously through the same representatives.

4.3.1.4 Many actuaries found a natural affinity with the employer in this process and saw their competitive advantage being strengthened by fostering this relationship. For example, one of the major employee-benefit consultancies in South Africa had a strategy to foster close relationships with the employer.

4.3.1.5 In the early negotiated transfers, actuaries often found themselves supporting the DB fund, and indirectly the employer, in a robust negotiation with the trade union. The author was personally involved in a situation, in which he represented the board of the fund and was arguing that the transfer would not be to the benefit of the members transferring, only to be told that the transfer to the union fund was not a matter of benefits and contribution rates but one of the transfer of economic power.

4.3.1.6 Combine all these experiences with the natural conservatism and prudence which cause the actuary to want to maximise benefits for the residual DB fund (Sharp & Thomas, 1998; Thomas & Sharp, 1998; Bellis, 1998), and it is not difficult to see why the union movement regards actuaries as biased in favour of the employer.

4.3.2 UK BIAS

4.3.2.1 Another influence is the training of actuaries. Most South African actuaries are fellows of either the Institute or the Faculty of Actuaries. Their studies are therefore UK-based. They are influenced by UK principles, including a perception (current at least when many of them were studying) that surplus in a DB fund is synonymous with over-contribution by the employer and should therefore be at the employer's disposition. The UK requirement while many of these transfers were happening, to transfer surplus to the employer if it exceeded a prescribed level unless the employer took a contribution holiday, reinforced this view.

4.3.2.2 To a South African actuary, bearing in mind the development of South African commercial law and corporate structures and the similarities between the design of retirement funds in the UK and South Africa, this reliance on UK precedent seemed reasonable. Indeed, the retirement-fund ombudsman, the Pension Funds Adjudicator, has frequently looked to UK practice as a guide when there is no precedent in South Africa.

4.3.3 BELIEF THAT SURPLUS WAS AT THE DISPOSITION OF THE EMPLOYER

4.3.3.1 Most actuaries seemed to regard actuarial surplus in a DB fund as being at the disposition of the employer. The employer had a right to have that surplus taken into account when the contribution rate was established. This approach was endorsed by Milburn-Pyle & Lennox (1990).

4.3.3.2 Judge Navsa in the Tek High Court judgment noted that the actuary to the fund had so advised the board of trustees.

4.3.3.3 While there was no direct evidence presented to this effect in the Pepkor matter, the concentration of actuarial surplus in the residual DB fund suggests that the actuaries involved may have had similar views.

4.3.3.4 Most practising actuaries seemed to the author to favour the employer in the disposition of actuarial surplus. Certainly this seemed to be true while the actuarial surplus remained within the fund. Until the first Tek judgment was handed down, there was nothing in law to contradict this.

4.3.3.5 The transfer of actuarial surplus to the employer was limited because of the regulator's views. Attempts to find ways around the regulator's views were not regarded as unprofessional conduct.

4.3.3.6 Such an approach ignored the legal reality, namely that South African funds are subject to South African law, which differed in significant areas from UK law, as became clear after the Tek appeal.

4.3.3.7 The actuaries seemed to the author to be oblivious of any conflict of interest between the fund and the employer, much less between the interests of the fund and the interests of former members. This position was apparently reinforced by the attitude of the labour lawyers who were advising the employer and the fund on their legal rights in negotiations with the trade unions: the lawyers represented the interests of their clients (usually jointly the employer and the DB pension fund). Few actuaries considered whether the former members (or the trade union representing them) were properly informed or advised, or even understood the likely consequences of the actions that they were taking, and, if this was the case, whether the actuary had a duty to remedy the deficiency. It appeared that many of the actuaries that the author came across adopted the view that, if former members negotiated a poor deal on transfer, it was their problem. The actuaries did not see that they had a professional duty to inform and advise the transferring members.

4.3.3.8 It is questionable whether they always complied with the Guide to Professional Conduct, which stated (in paragraph 1.6):

A member will bear in mind that as a matter of law his duty of care can extend to persons or organisations whom he can reasonably expect to rely on the advice or the information that he gives.

4.4 THE UNEQUAL BARGAINING POSITION OF THE EMERGING TRADE UNIONS AND PENSIONERS

4.4.1 As would be true of any emerging market, South Africa has wide educational and income differentials. Differences in financial sophistication amongst different income levels are marked. Members involved in a negotiation with their employer do not usually have the same access to professional advice, whether legal or actuarial, if only because the employer has deeper pockets. Inevitably, even member-elected trustees have a concern to retain their job and therefore to avoid antagonising the employer. This was particularly true with the emerging black trade unions of the early 1980s.

4.4.2 Kerrigan (*op. cit.*) noted that trade unions became more sophisticated in their approach to conversions once they had more practice in their negotiation. This was true of the author's experience in dealing with unions on conversions shortly before he joined the FSB in 1998: major unions now brought their lawyers and their actuary into the discussion at an early stage.

4.4.3 Until 15 December 1998, when it was mandatory for a fund to have a board of management and for the rules to give members the right to elect at least 50% of the board of management, there was no-one independent of the employer to look after the interest of the transferring members other than the negotiators representing the fund.

4.4.4 If these negotiations had taken place at arm's length, with equal access to information and advice, there would have been no call to review past conversions. As it

happened, such a demand emerged as one of the primary requirements of the labour federations before they would support any distribution of surplus. The labour movement felt their members had been cheated.

4.4.5 The Government team involved in the development of the Pension Funds Second Amendment Bill concluded that many of the past transfers and conversions merited review if only because some of the stakeholder groups had an unequal bargaining position. Legislation would be the only means to address the problem.

4.4.6 An unequal bargaining position applies particularly to pensioners. At least active members can withdraw their labour and can rely on trade unions to defend them in any dispute with the employer. Pensioners can do nothing except make a nuisance of themselves. They usually have very limited means and have difficulty in communicating with other pensioners within their constituency. Pensioners are also susceptible to being bought: any sweetener is better than nothing and, as one gets older, one's capacity to wait out extended negotiations shrinks.

4.4.7 An agreement reached in the workplace between workers and management should not be able to bind pensioners. The Government team felt that it is essential that boards of management of funds should put aside concern for the constituency that appointed them and act in the best interests of all members. Boards should therefore be tasked to review any proposals from members or the employer without undue pressure from either party. Boards, not the employer and active members working together, should take decisions that affect the interests of the fund, for the protection of pensioners and former members who are not represented in such workplace negotiation.

4.5 THE VIEWS OF ORGANISED LABOUR

4.5.1 Organised labour have fought along much the same lines as the Registrar used in the Paarl Widows case (and lost):

- all the assets of a fund belong to the fund to the exclusion of any other party;
- the fund has as its object the provision of benefits to members and their dependants;
- the employer is not a beneficiary and is in fact excluded from deriving benefit in any way from a fund;
- therefore the employer cannot get anything on liquidation of the fund or at any other time; and
- all surplus must be used to improve benefits for members, if it is not utilised to fund a contribution holiday (labour accepted that the employer may have a right to take a contribution holiday in terms of the rules of a DB fund).

4.5.2 Labour felt strongly that many of the early transfers or conversions were prejudicial to their members, and their members lacked sufficient knowledge to realise that they were not getting what was their rightful due, particularly where surplus was 'hidden' in the difference between the fair value of the assets and the actuarial value of the assets. They have subsequently argued that their members had a right to at least this difference.

5. ISSUES THAT SHOULD HAVE BEEN CONSIDERED DURING THE CONVERSIONS

5.1 THE CONCERNS OF GLUCKMAN & KAMIONSKY

5.1.1 The first actuaries to draw the profession's attention in South Africa to the problem of conversions in a paper to ASSA were Gluckman & Kamionsky (1997). They raised concerns that members could be aggrieved when they retire and, for a number of reasons, get lower benefits than they had anticipated:

- The initial transfer value may not have represented a fair trade for the DB promise that had been foregone—either in respect of past service, or in respect of a combination of past and future service—because the member would lose the cross-subsidy by age implicit in a DB fund.
- Investment returns after conversion may have been lower than anticipated. This could have been aggravated by changes in the rate of taxation of investment build-up.
- With the transfer of the expense risk to members in a context in which AIDS is likely to cause considerable increases in the premiums charged to insure death and disability risks, the portion of the future contribution available to fund the retirement benefit could have been less than expected.
- If interest rates at retirement were lower than anticipated, the retiring member might be unable to secure the expected rate of conversion of capital to income.

5.1.2 Gluckman & Kamionsky (*op. cit.*) explored the first of these in their paper, leaving the other issues to further research. They identified two other problem areas that they did not address:

- Employers could be worse off in the DC scheme than was the case in the DB scheme because, if members were offered a choice between DB and DC schemes with similar overall contribution rates, younger members could be expected to go to the DC scheme, while older members would remain in the DB scheme. Overall costs were likely to increase, at least in the short to medium term.
- Surplus distribution may have been inequitable. Sometimes this had been in favour of the members. Gluckman & Kamionsky (*op. cit.*) raise the possibility that shareholders could take action against the trustees and their advisors.

5.1.3 The profession is more aware today than it was then that some if not all of these concerns may be realised:

- Unions have challenged the fairness of the transfer values paid in the past and the equity of surplus distribution.
- A crash in share markets in the third quarter of 1998 and volatile performance thereafter indicate the possibility of lower investment returns after conversion than expected.
- Tax on part of the investment build-up was introduced in 1996, reducing the investment return enjoyed by members of DC schemes.
- HIV is rampant. Current infection rates across the country average some 11% and are rising, ante-natal clinics in some areas reporting rates of 25%. This is causing significant increases in insurance premiums for death and disability risks. For example,

in 2004 the insurance premiums for death and disability in the average DC fund have risen from 3,4% of payroll to 4,3% of payroll²⁰.

- The National Treasury have identified inflation targeting as a critical measure of performance. They target rates of increase in CPIX (the rate of inflation excluding interest on mortgage bonds) between 3% and 6% a year. They have proved successful in the implementation of this policy. If this success is maintained, investment returns and interest rates on retirement are likely to drop, which could be critical for members purchasing fixed annuity policies.

5.2 VALUATION BASIS USED TO DETERMINE THE ACCRUED LIABILITY

5.2.1 APPROPRIATENESS OF AN ONGOING FUND VALUATION BASIS

5.2.1.1 Is it appropriate to use an ongoing-fund valuation basis such as that which applied at the last valuation tabled with the regulatory authority in terms of section 16 of the Act? Such a basis will usually incorporate withdrawal and other decrements, and will make assumptions as to the valuation of assets, which may reflect long-term expectations rather than the current position of the market. Is such a basis appropriate on conversion?

5.2.1.2 Messrs Le Roux and Pillay²¹ felt that it was not: they argued that no withdrawal decrement should be assumed. This does not matter for transfer between two DB funds both of which assume decrements before retirement, because the transfer value will buy benefits in the new fund similar to the benefits foregone in the old fund. On the other hand, when transferring from a DB fund to a DC fund, the member will not derive benefit from moneys transferred in respect of other members who leave before retirement; the amount credited to the transferring member's account is crystallised. The transferring member will only have the amount transferred into his or her individual account plus future net contributions and investment returns. If the transfer value is depressed by assuming that a high proportion of members of that age will exit before retirement, the converting member will live with that reduction until retirement. The only relief might have come if future surpluses were automatically distributed amongst the DC members, but no surpluses are expected in DC funds under the minimum-benefits regime.

5.2.1.3 The choice of assumptions in the last valuation was designed to manage the contribution rate, which is the primary purpose of that valuation. These assumptions might not be appropriate for breaking up the fund, which is effectively what happens on conversion.

5.2.2 ASSUMPTIONS IN USE FOR ONGOING FUND VALUATIONS

5.2.2.1 Kendal & Franklin (1993) surveyed the bases being used by actuaries at the time. They sent out a questionnaire to valuers. 13 questionnaires were returned, representing some 43 valuers, comprising a cross-section of life offices, broker and consulting firms.

20 Sanlam Survey, 2004

21 Le Roux AM & Pillay S. Speech delivered to the AIC Conference, February 1997

5.2.2.2 This showed approximate valuation rates of interest as shown in Tables 2 and 3.

Table 2. Approximate net annual valuation rates of interest before retirement

Ages 20–65	Valuation rates of interest per cent			Number of valuers
	Ages 30–65	Ages 40–65	Ages 60–65	
1,5	1,5	1,5	1,5	7
1	1	1	1	1
2	2	2	2	6
–1,3	–1	0,7	2	10
–0,7	0,4	0,9	1,5	4
0,4	1,3	2,2	2,5	4
0,7	1,4	2,4	3	3
–1,3	–0,1	0,7	1,5	2
–1	0,2	1,6	2,5	2
–0,2	0,7	1,5	2,7	2
0,3	1,4	2,2	2,5	1
0,5	0,9	1,4	2	1
0,1	0,7	1,4	2	average

Table 3. Gross annual valuation rates of interest after retirement

Valuation rates of interest per cent	Number of valuers
4,25	2
5	22
6	6
7	13

5.2.2.3 Not all of these would have used this in combination with explicit pension increase assumptions.

5.2.2.4 The rates used for full consumer-price indexing were as shown in Table 4.

5.2.2.5 The approaches used for the valuation of assets are shown in Table 5. Most respondents made some additional comments stressing the need for judgment rather than sticking to some mechanical rule.

5.2.2.6 Valuations submitted to the regulatory authorities in 2000 reflected the distribution of interest rates in Figures 3 and 4. These are very similar to the findings of Kendal & Franklin (*op. cit.*).

Table 4. Annual valuation rates of interest per cent for full consumer-price indexing

Valuation rates of interest per cent	Number of valuers
2-3	32
4	1
6	5

Table 5. Approaches used for the valuation of assets

Based on	Approach used Details	Number of valuers
market value	market values without adjustment	2
	fixed adjustment to about 85%	6
	some form of smoothing over 1 to 3 years	16
	arbitrary adjustments	2
	Total	26
discounted cash flows	flexible in the assumptions used and in the application of the method	3
	fixed-interest securities and property taken at market values, and equities discounted at 15% assuming 10% dividend growth	10
	property at 90% of market value, fixed interest in broad classes discounted at 15% and equities at 15% assuming 11% dividend growth	4
	Total	17

5.2.2.7 Figure 3²² shows the real returns (i.e. the difference between the discount rate and salary increase rate) at age 40 assumed in valuations submitted to the FSB after September 1998.

5.2.2.8 No information is available as yet on changes to valuation bases as a result of the current macroeconomic situation and the Pension Funds Second Amendment Act, 2001. Figure 4 shows the situation after retirement.

Figure 3. Real annual return before retirement

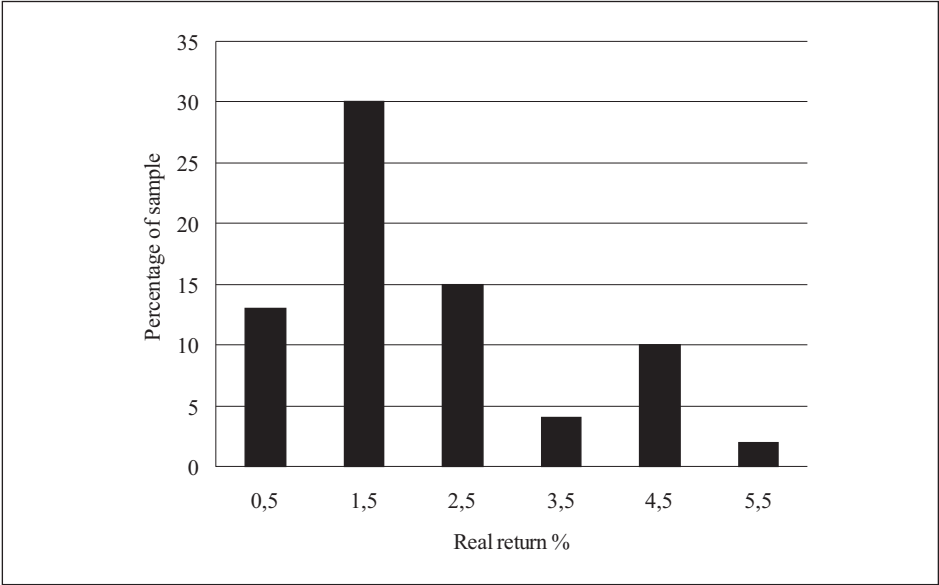


Figure 4. Real annual return after retirement

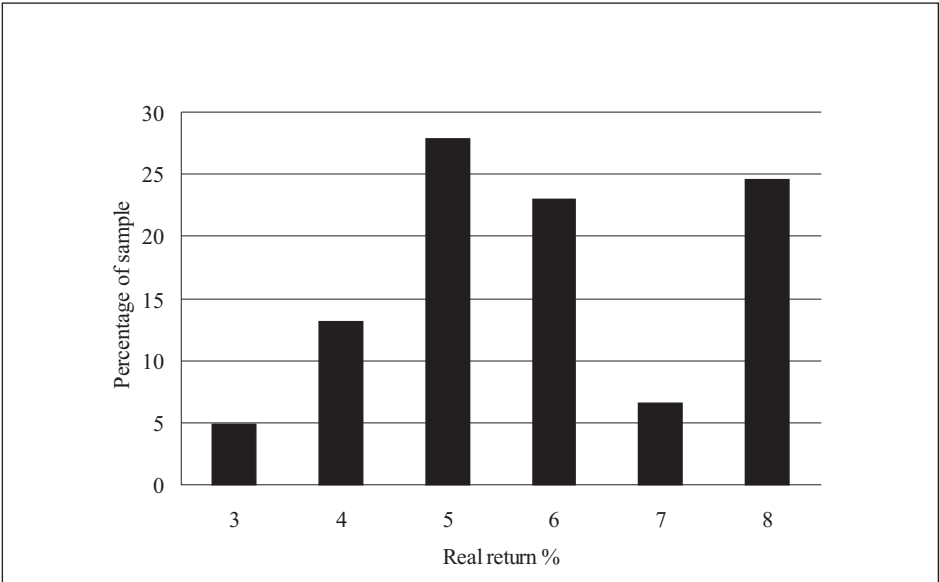


Figure 5. Annual yield, CPI and real return over a one-year period ending on 31 December of the year shown: single investment

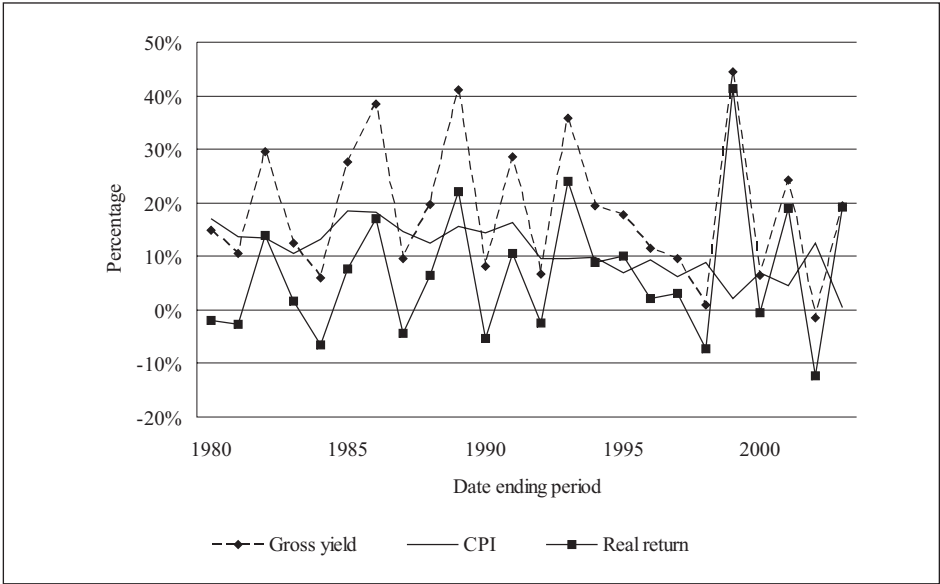


Figure 6. Annual yield, CPI and real return over a five-year period ending on 31 December of the year shown: single investment

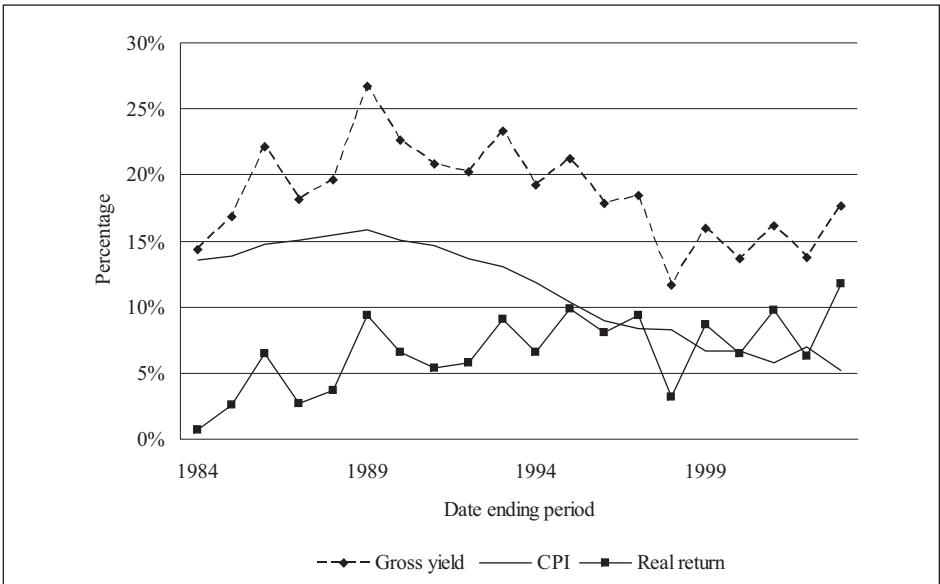


Figure 7. Annual yield, CPI and real return over a ten-year period ending on 31 December of the year shown: single investment

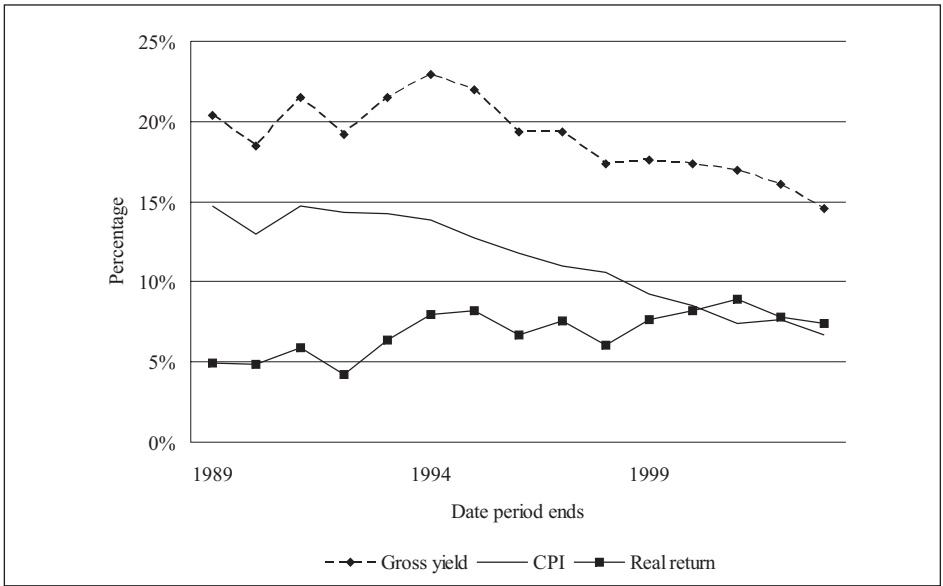
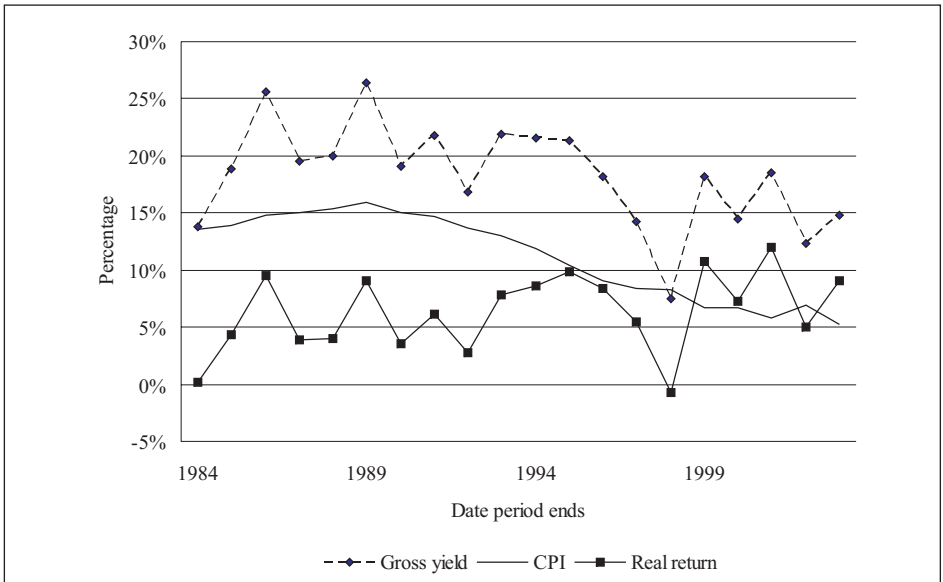


Figure 8. Annual yield, CPI and real return over a five-year period ending on 31 December of the year shown: regular investment



5.2.3 EXPERIENCE

5.2.3.1 Andrew (1994) showed that real annual returns of the order of 4,25% were achieved over an extended period. In a submission to the technical committee established while the draft bill was being discussed by NEDLAC, the author presented graphs similar to those shown in Figures 5 to 8 showing investment returns based on reported performance of a universe of retirement fund managers. The author updated these graphs for this paper. In Figures 5 to 7 the effective annual yield is shown for a single-premium investment made at the beginning of the period ending on the date shown, together with the annual increase in the CPI and the annual real return.

5.2.3.2 Figure 8 shows the corresponding results for a regular investment made over a five-year period ending on the date shown, assuming increases in contribution at the beginning of each year. The investment was assumed to have been made quarterly during the 1980s and monthly thereafter. Salary increases were assumed to take place at a rate of 1,5% more than price inflation at the beginning of each year. The yields and therefore the real returns are gross, so they need to be reduced for retirement-fund tax and investment management expenses. On the basis of investment management fees shown in the Sanlam Survey, and rates of retirement fund tax at present, an effective reduction is necessary of the order of 1,2% to 1,5%.

5.2.4 REVIEW OF THE USE OF A REALISTIC BASIS

5.2.4.1 Gluckman & Kamionsky (*op. cit.*) argue that it would be preferable to perform a fully realistic valuation, removing all margins of conservatism, to present stakeholders with the likely future costs and likely benefits of the conversion.

5.2.4.2 In discussing the issues the technical committee at NEDLAC felt under the circumstances of the time that, for a conversion benefit in mid-2000, it would be realistic to use real returns of 2,8% a year before retirement and 5,7% thereafter. No decrements should be used before retirement. Decrements after retirement should be in line with the fund's standard assumptions. There should be no market value adjustment other than an adjustment by the ratio of the current market yield on index-linked bonds to the rate of 6% a year, which underlies this set of assumptions.

5.2.4.3 The Working Group on Retirement Funds Surplus of ASSA (the ASSA working group) also considered a realistic basis for determining the present value of a deferred pension, and came up with investment returns of 3,5% a year prior to retirement age and 6,0% a year thereafter. No decrements should be used before retirement age. Mortality after retirement age should be taken at PA(90) ultimate. The proportion married at retirement age should be 80% for male members and 70% for female members. The age difference between husband and wife should be 3 years. For valuation purposes, 80% of the assets should be assumed to be invested in equities and the balance in index-linked bonds until ten years before retirement age. Thereafter, there should be a uniform monthly progression to 100% in index-linked bonds. Equities should be taken at market value multiplied by the ratio of 2,5% to the dividend yield on the JSE all-share index. Index-linked bonds should be taken at market value.

5.2.4.4 These are very different from the ongoing valuation assumptions.

5.2.4.5 The eventual decision of the Registrar in 2003 was to use an investment return prior to retirement age equal to the yield on long-dated index-linked government bonds less 0,95% or 40% of the earnings yield on the JSE all-share index. The investment return and mortality after retirement age, and the proportions married and age differences, should be as used by the actuary in the previous statutory actuarial valuation. The investment return used after retirement must take account of the fund's pension increase policy. Assets should be taken at market value.

5.2.4.6 The effect on accrued liability calculations for a member, where the assumptions and characteristics of the fund tested are shown in Appendix A, would be as shown in Table 6.

5.2.4.7 Where this ratio is less than 100%, the fund will not have to top up the accrued liability to match the minimum standard. Where it exceeds 100% because the withdrawal benefit is higher than the present value of the accrued deferred pension (the calculation according to the prescribed formula), this will also not require topping up if the transfer value was subject to a minimum of the member's resignation benefit.

5.2.4.8 In the light of the common practice to add a sweetener of the order of 15% to 40%, it seems as though the accrued liability plus sweetener will compare favourably with the minimum benefit.

5.2.4.9 The picture improves if a promotional scale is assumed, because the effective real rate of return assumed before retirement in the determination of the accrued liability drops.

5.2.4.10 Obviously, where there is a lower withdrawal benefit than in the example shown, the accrued liability drops. The withdrawal benefit is also less likely to exceed the minimum benefit on the prescribed formula. The result is difficult to predict.

5.3 INCLUSION OF AN ADJUSTMENT TO FAIR VALUE

5.3.1 Once the Pension Funds Second Amendment Bill was published (that is, before it became an act and the Registrar determined the minimum-benefit basis), much of the debate hinged around members' rights to the difference between the fair value of the assets and the actuarial value of the assets, in proportion to their accrued liabilities.

5.3.2 Protagonists of such rights argue that, if the actuary to the receiving fund were to make similar assumptions, this margin would be needed, otherwise the receiving fund could not give a benefit of matching value. They also argue (Gluckman & Kamionsky, 1997) that, if the actuary deemed it prudent when taking a long-term view of the asset valuation to take a margin, then the members merit this because they will be assuming the investment risk in the DC scheme.

5.3.3 Opponents of this approach question, not so much the need to give members a benefit that can be invested to replicate what is given up, but whether the use of this particular margin is the appropriate adjustment to the accrued liability.

5.3.4 The ASSA working group questioned what a member's reasonable benefit expectation would be on conversion or transfer. Moving from a narrow definition, namely whatever was promised in the rules of the fund, the working group determined a broad definition, namely that the member would expect to be able to invest the transfer

Table 6. Ratio of the minimum benefit on the Registrar's basis to the accrued liability determined in the fund

Real interest rate assumed in the fund after retirement (note 1) for members of different ages at date of resignation	Ratio of the minimum benefit on the Registrar's basis (note 2) to the accrued liability determined in the fund assuming rates of resignation and real return before retirement (without a promotional scale) as follows:			
	Medium rate of resignation		High rate of resignation	
	2% real return	3% real return	2% real return	3% real return
Member aged 25, 5 years service (note 3)				
8%	1,02	1,10	0,98	1,02
7%	1,00	1,09	0,97	1,02
6%	0,98	1,07	0,96	1,01
5%	0,96	1,06	0,95	1,00
4%	0,94	1,05	0,93	1,00
Member aged 30, 5 years service (note 3)				
8%	1,01	1,13	0,99	1,06
7%	0,99	1,11	0,97	1,05
6%	0,96	1,09	0,95	1,04
5%	0,93	1,07	0,93	1,02
4%	0,90	1,04	0,90	1,00
Member aged 40, 10 years service				
8%	0,91	1,07	0,90	1,04
7%	0,87	1,03	0,86	1,00
6%	0,83	0,99	0,83	0,97
5%	0,81	0,95	0,81	0,94
4%	0,82	0,96	0,83	0,95
Member aged 50, 15 years service				
8%	0,89	0,98	0,89	0,98
7%	0,89	0,99	0,90	0,99
6%	0,90	1,00	0,90	1,00
5%	0,90	1,01	0,90	1,01
4%	0,90	1,01	0,90	1,01

Note 1: In most funds pension increases are granted at the discretion of the trustees. The actuary discusses the trustees' intentions and reserves for pension payments at a real interest rate. The excess investment return earned over this rate funds the pension increases.

Note 2: The prescribed basis at time of writing (July 2004) is producing a discount rate of approximately 3% a year. That rate has therefore been used.

Note 3: For younger members, the resignation benefit at five-year duration is higher than the value of the accrued deferred pension, so overrides it, producing a higher minimum benefit.

value until retirement and then receive a pension equal to his or her past pensionable service prior to conversion multiplied by the accrual rate and by his or her pensionable earnings averaged over whatever period was defined in the rules. ASSA advocated this benefit as suitable on all forms of exit from the fund. It would cater for situations where a deliberately conservative valuation basis was being used and for any difference between the fair value and the actuarial value of assets. The Registrar accepted these views in the basis that was subsequently prescribed.

5.3.5 As is shown above, a realistically determined accrued liability based on current market yields may not be higher than the conversion value actually paid. The actuary's conservatism in his or her ongoing fund valuation assumptions for the liabilities might save the actuary embarrassment at failing to apply his or her mind properly to the need to include a market-value adjustment within the original value given on transfer or conversion within the fund.

5.4 OTHER ISSUES

5.4.1 PROSPECTIVE FAIRNESS: THE LOSS OF FUTURE CROSS-SUBSIDY

5.4.1.1 The incidence of cost by year of service, when expressed as a percentage of earnings in that year, rises sharply as the member gets closer to normal retirement age. This is a natural consequence of assuming that investment return will exceed salary increases and that not all employees of a particular age will remain until retirement but will receive benefits of a lesser value. (Some benefits on exit before retirement could have a higher value, in which case the actuary will make reasonably prudent assumptions of the proportion of members who will elect such a benefit.) There is an implicit cross-subsidy from young to old in a DB scheme. On transfer from a DB to a DC scheme in which a flat contribution rate is payable in future, members will lose this future cross-subsidy.

5.4.1.2 In such a DC scheme, if the same overall contribution rate is paid as applied in the DB scheme, the member will enjoy a higher contribution in the DC scheme when young than the effective rate under the DB scheme at that age, and a lower rate as he or she approaches normal retirement age.

5.4.1.3 The stakeholders should consider whether members should be compensated for this loss of cross-subsidy. One way of doing this would be to determine the present value of all future benefits and deduct the present value of the future net contributions under the DC scheme to get the transfer value. This would normally be subject to a minimum of the resignation benefit and the accrued liability in order not to unfairly prejudice younger members.

5.4.1.4 The ASSA working group felt that the most a member could reasonably expect was a benefit that was appropriate in relation to the member's service prior to date of transfer. It would be unreasonable to demand that the fund pay out more than it was funding. The loss of future cross-subsidy was an employer-employee issue and the employee could be compensated in a number of ways, including increased future remuneration.

5.4.1.5 However, circular PF117 acknowledges that an actuary may set up a contingency reserve account for the difference between the present value of future benefit

payments and the present value of future contributions. This contingency reserve could be transferred as it is in the DB fund, and used thereafter to subsidise the defined contribution rate to ensure that the member is not worse off.

5.4.2 TRANSFER OF RISK

5.4.2.1 In the DC scheme, members assume the investment risk. If the margin between the fair value of the assets and the actuarial value of the assets is transferred to the DC scheme and held in an investment reserve for the smoothing of investment returns to member accounts, then there is no need to adjust individual transfer values for the transfer of risk.

5.4.2.2 However, this does not always happen. Where there will be no investment reserve in the DC scheme, members should get some allowance for the investment risk that they take on.

5.4.2.3 The communication to members before making their election, and thereafter in the DC scheme, should highlight the dependence of the latter scheme on future investment returns. This could be done for example by showing the projection at more than one rate of real return.

5.4.2.4 Expense risks are important in South Africa, particularly, because AIDS is expected to increase risk premiums for death and disability benefits considerably over the course of the next ten to fifteen years. This could erode the net contribution available for investment to produce the member's retirement benefit.

5.4.2.5 The level of compensation will depend upon the particular circumstances of the conversion.

5.4.3 RETROSPECTIVE FAIRNESS

5.4.3.1 The accrued liability will reflect the cross-subsidy by age implicit in a DB scheme. If young members had been in a DC scheme in the past, their accrued liability would have been higher.

5.4.3.2 For young members, the accrued liability could be less than the cash withdrawal benefit. It is also likely to be less than the amount that they would regard as fair in relation to communication received in benefit statements and remuneration-package statements.

5.4.3.3 The trustees may want to ensure that the transfer value is at least equal to a multiple of the member's own contributions with interest, so that the member regards his or her transfer value as fair in relation to his or her past service.

5.4.3.4 The minimum benefit basis has entrenched this view by requiring the DB minimum to be not less than the accumulation of the member's own contributions with a rate of interest that is reasonable in relation to the amount earned by the fund plus any share of the employer contributions that is vested in terms of the rules. For example, if the rules say that a member will receive an extra 10% of his or her own contributions for each year of completed service by date of exit, with a maximum of twice his or her own contributions accumulated with interest, the minimum must be not less than this amount.

5.4.4 SHARE OF SURPLUS

The Pension Funds Second Amendment Act, 2001, has resolved the contentious issues: the member must receive his or her minimum benefit plus a proportionate share of any investment reserve, the member surplus account (the board can reserve surplus allocated for the benefit of members in such an account for future use; otherwise it must be used to improve benefits), and such contingency reserve accounts as the board deems appropriate. Regular apportionment of the surplus to the member surplus account and the employer surplus account should ensure that the member gets a fair share.

6. BEST PRACTICE AS IDENTIFIED BY GLUCKMAN & KAMIONSKY

6.1 Gluckman & Kamionsky (*op. cit.*) argue that best practice on conversion achieved by transfer between funds should be to offer members a choice of remaining in the existing DB arrangement or transferring to the new DC arrangement, in conjunction with a thorough communication exercise. The communication exercise should be pitched at a level that the members of the fund should reasonably be expected to understand.

6.2 They suggested standards for such communication:

- The member benefit statement should show:
 - the rand amount of the transfer value, and rand comparison of all exit benefits before and after the conversion;
 - a projection of values using a real-return assumption as a minimum (the projection should be made at more than one interest rate in order to demonstrate the sensitivity of benefits to changing investment returns);
 - the conversion of pension to lump sum (and vice versa) where conversion is from pension to provident fund; and
 - the preferred language of the member should be used.
- Written material accompanying the individual benefit statements should include:
 - an explanation of the differences between the two funds;
 - a statement of the advantages and disadvantages of each fund, with an explanation of the various risks; and
 - a clear explanation of any guarantees regarding the benefits.
- The respective funds should then determine:
 - how surplus in the existing DB fund will be used in future; and
 - the purpose of any reserve accounts in the DC fund.

6.3 They then recommended that past conversions be analysed by the trustees with the assistance of the actuary. If they did not measure up to the best practice standards the trustees should review the possibility of legal repercussions, or moral pressure at some stage in the future on the trustees or the employer. Various options would then be available to the trustees: to repeat the communication exercise, to give an option to transfer back to the DB fund, or to set aside reserves to meet shortfalls. This suggested

process has been overtaken by the surplus apportionment process required by the Pension Funds Second Amendment Act, 2001.

6.4 They recommended that

- ASSA develop a conversion guidance note;
- the regulatory authorities develop a more extensive circular setting out the expected behaviours on conversion; and
- the regulatory authorities require actuarial certification that the conversion measured up to minimum standards.

6.5 These have also largely been overtaken by the Pension Funds Second Amendment Act, 2001, because this requires an apportionment to take place as part of the conversion and members must receive at least the prescribed minimum benefits.

6.6 In the discussion, Mr D Gluckman noted that:

The first wave of comeback has already commenced – many DC funds are claiming that they did not receive a fair share of surplus on conversion. We predict that the second wave will come when significant numbers of members of these DC arrangements realise that the conversion has resulted in them being financially prejudiced.

7. CONCLUSION

7.1 SHORTCOMINGS IN THE CONVERSION PROCESS

7.1.1 This paper builds on the work done by Gluckman & Kamionsky (*op. cit.*) to show the development of surplus legislation in South Africa in the period 1999 to 2004 in its historical and legal context.

7.1.2 Former members did not believe that they had received fair value.

7.1.3 Legal and labour pressure lead to legislative review and a requirement that actuarial surplus be used to increase transfer values and benefits paid previously to minimum levels that should represent a fair benefit. The legislation itself was largely a response to shortcomings in the mass conversion of South African DB funds achieved through offering transfer to DC funds.

7.1.4 These shortcomings seem to the author to be:

- the failure to properly inform the members and the trade unions that represented them of the likely consequences of the transfer values that they were accepting, in particular the transfer of investment risk and the loss of the margin between the fair value and the actuarial value of assets; and
- the failure on the part of the boards of funds and employers to ensure that the members and the trade unions that represented them had access to sufficient information and expert advice to ensure that they took an informed decision;

and arguably, and more contentiously:

- the failure on the part of the boards of funds, and perhaps actuaries, to exercise their fiduciary duties towards members transferring out of the funds or being retrenched;

- the failure on the part of actuaries and the boards of funds to recognise and manage, impartially, conflicts of interest between employers and the existing members, on the one hand, and the former members on the other hand; and
- too close an identification by actuaries with the interests of employers to the exclusion of the interests of other stakeholders.

These failures go beyond a communication problem.

7.1.5 While Gluckman & Kamionsky (*op. cit.*) concluded that a legal challenge to the actuarial profession is unlikely to succeed, it could be damaged by adverse publicity.

7.1.6 With hindsight, these issues should have been considered much more carefully by the profession before actuaries advised trustees. If the profession had analysed the effect of the transfer values in the receiving DC fund, and had drawn this to the attention of trustees and the transferring members, even if trustees had disregarded these actions at the time, it would have come out of the process in a better position to influence trustees in future and would not be regarded as biased towards the employer.

7.1.7 The failures indicate the danger of:

- approaching a problem within a paradigm, in this case that actuarial surplus is at the disposition of the employer and that the employer has a right to retain within a fund margins that protect the employer against investment risk, when society at large may disagree with that paradigm; and
- questioning the paradigm too late, when evidence suggests a flaw in it, such as the release of substantial amounts of actuarial surplus following the first transfers and changes in the actuarial valuation of the assets.

7.2 RETROSPECTIVE LEGISLATIVE INTERFERENCE

In the event, a string of legal challenges to the actions taken by boards and their actuaries may have been deflected by legislative interference that requires review of those past actions. Provided actuaries are seen to be impartial in the surplus apportionments that follow the legislation, it will hurt actuaries' reputations much less than such legal challenges would have done.

7.3 AN ELEMENT OF CONSERVATISM

7.3.1 However, notwithstanding all the failures noted above, the actuary's conservatism in the determination of the accrued liabilities might contain sufficient margin to cover the minimum benefit without requiring a top-up. It is necessary to determine the values in each separate case before deciding whether a top-up is necessary, as the minimum will depend on the rules of the fund and the actuary's assumptions.

7.3.2 Where a sweetener was included in the transfer value, it becomes even less likely that enhancement will be required.

7.3.3 It will be interesting to look back, after the surplus apportionment exercise is over, and see the extent to which former members' benefits are enhanced where the former members received full accrued liability. It could be that the most prevalent enhancement will occur where members were paid only a resignation benefit and this did not include a generous vesting clause.

7.4 DAMAGE TO THE REPUTATION OF THE ACTUARIAL PROFESSION

7.4.1 In the conversion process, the reputation of the actuarial profession in South Africa has suffered damage. Trade-union representatives do not trust the actuary to treat members fairly; on the contrary, they expect the actuary to act in concert with the employer.

7.4.2 The actuarial profession will have to work hard to overcome these negative expectations. The Pension Funds Second Amendment Act, 2001, will produce a considerable volume of actuarial work over the next few years. The legislation has given the profession a second chance. It must do it right this time. The profession must ensure that surplus apportionment is conducted within the spirit of the Act as well as within the guidelines drawn up by ASSA.

7.4.3 Actuaries must now be seen to be impartial, to be managing the conflicts of interest, and to be communicating better.

7.5 DEMANDS FOR EXTERNAL SUPERVISION OF STANDARDS

7.5.1 There are consequences of the present distrust of the profession: one of the demands of the labour federations is that the setting of standards for actuarial work be done by an oversight body which is dominated, not by actuaries, but by stakeholders. This is still to be considered by the regulatory authorities.

7.5.2 Such independent oversight of standards is a demand that society is making of professions other than actuaries. For example, there is draft legislation in South Africa that will strengthen the independent oversight of auditors.

7.5.3 There are moves to draft new legislation to govern retirement funds. Suggestions are being made that the regulatory authority should have much greater powers to sanction any failure by trustees, or those that advise retirement funds, including actuaries, to properly exercise their duties towards funds.

7.5.4 The profession should welcome these moves, and seek to involve members of other professions who enjoy the confidence of stakeholders, into the setting of its standards and its review of professional conduct.

7.6 MANAGING THE RISKS IN DC FUNDS

Recognising the dangers pointed out by Gluckman & Kamionsky (*op. cit.*), that complaints concerning the fairness of the transfer values is likely to be only the first phase of problems associated with the conversions from DB to DC, the actuarial profession must assist the retirement-fund industry to find ways in which members' expectations can be realised in the DC fund.

ACKNOWLEDGEMENTS

This paper would not have been possible without the contributions of actuaries and consultants who have participated in the debate on pension fund surplus in South Africa, or who have raised concerns around past conversions. Many have served on the various committees involved in discussing the need for, or commenting on, the Pension Funds Second Amendment Bill, 2001, and the technical committee that followed its adoption as an act. Notable amongst these are the actuaries who served on the ASSA working group chaired first by Mr RB Gouws, and later by Mr CL Southey. They are too numerous to mention by name.

The paper represents the author's attempt to consolidate some of this comment and to add his impressions as a member of the Government team that drafted the Pension Funds Second Amendment Act, 2001.

REFERENCES

- ASSA (2001). Report of the Retirement Funds Surplus Committee, unpublished
- Andrew JP (1994). Risk management in a defined contribution fund, *Transactions of the Actuarial Society of South Africa*, **X (II)**, 348–420
- Andrew JP (2001). The South African regulatory response to problems with transfer and retrenchment values and surplus disposition, *The Actuary* website, January 2001
- Bellis CS (1998). The origins and meaning of 'professionalism' for actuaries, 26th International Congress of Actuaries 1, 33–51
- Gluckman D & Kamionsky T (1997). Retirement fund conversions: challenges and risks, *Transactions of the Actuarial Society of South Africa*, **XI (III)**, 248–308
- Honoré T (1985). *The South African Law of Trusts*, 3rd ed. Cited in Gluckman & Kamionsky (1985).
- Kendal S & Franklin MD (1993). Some pension fund topics, *Transactions of the Actuarial Society of South Africa*, **IX (III)**, 34–85
- Kerrigan GW (1991). The role of COSATU affiliated unions in retirement provisions in S.A. *Transactions of the Actuarial Society of South Africa*, **IX (I)**, 177–98
- Milburn-Pyle P & Lennox R (1990). Ownership of fund surpluses, *Transactions of the Actuarial Society of South Africa*, **VIII (I)**, 10–68
- Sharp CD & Thomas RG (1998). Actuarial values and professional conduct, 26th International Congress of Actuaries 1, 71–94
- Thomas RG & Sharp CD (1998). Actuarial values, 26th International Congress of Actuaries 1, 95–110

APPENDIX A

ASSUMPTIONS USED IN THE VALUATION OF THE ACCRUED LIABILITIES

A.1 BENEFITS AND CONTRIBUTIONS

The fund pays a pension of 2% of the average pensionable earnings over the two years prior to retirement age for each year of pensionable service. The pension carries a five-year guarantee and a 50% spouse's pension from the later of expiry of the guarantee period and death of the member. The retirement age is 65. The member contribution rate is 7,5% of pensionable earnings. The benefit on resignation is a refund of the member's own contributions with compound interest at 8% a year, increased by 10% for each completed year of pensionable service to a maximum of twice the member's own contributions with interest.

A.2 VALUATION ASSUMPTIONS

A.2.1 The pension was capitalised assuming PA(90) Ultimate mortality to give the capitalised values shown in Table A.1 for the real interest rates shown.

Table A.1. Capitalised value at age 65 of a monthly pension of R1 a year

Real annual rate of interest after retirement	Capitalised value
8%	9,540
7%	10,177
6%	10,885
5%	11,667
4%	12,557
Minimum basis	11,112

A.2.2 The accumulated contributions depended upon the real interest rate as shown in Table A.2. The same pensionable remuneration was assumed at the valuation date. Salaries were projected backwards using the absolute rate corresponding to the real return (8% for the 2% real return and 7% for the 3% real return). This had the effect of producing higher accumulated values for the higher real return assumption, because the salary the previous year (and so on) was higher, the lower the absolute rate of increase assumed.

Table A.2. Accumulated contributions

Past service (years)	Real annual interest rate	
	2%	3%
5	35 978	36 999
10	71 956	75 759
15	107 934	116 366

A.2.3 Minimum benefits were determined using the annuity rates above and a valuation rate of interest before retirement of 3% a year.

A.2.4 The annual withdrawal rates assumed were determined in terms of the Table A.3.

Table A.3. Annual withdrawal rates

Age	Medium withdrawal rate	High withdrawal rate
20–25	12,5%	18,75%
25–30	7,5%	11,25%
30–35	5,0%	7,5%
35–40	3,8%	5,7%
40–45	2,5%	3,75%
45–50	1,3%	1,95%
50–55	0,6%	0,9%
55 and over	0	0

A.2.5 The member was presumed to be paid his full accrued liability on death in service, so no decrement was assumed.