(DRAFT) PF NOTICE … OF 2015

FINANCIAL SERVICES BOARD

PENSION FUNDS ACT, NO. 24 OF 1956

FINANCIAL SOUNDNESS

Section 18(1) of the Pension Funds Act, 1956 ('the Act') was amended by the Financial Services Laws General Amendment Act, 2013 and came into operation with effect from 28 August 2014.

In terms of section 18(1) of the Act, read with the definition of "actuarial surplus" in section 1(1), for funds that are not valuation exempt:

- a valuation basis; and
- conditions for financial soundness,

may be prescribed by the registrar by notice on the web site of the Financial Services Board (www.fsb.co.za). Furthermore and in terms of this section, the registrar may also prescribe criteria for financial soundness for funds that are valuation exempt.

In terms of section 18(1), the registrar may also direct a fund that is not in a sound financial condition to submit a scheme setting out the arrangements that have been made, or which it intends to make, to bring the fund into a financially sound condition within such period, and subject to such conditions, as determined by the registrar.

I, **Dube Phineas Tshidi**, registrar of pension funds, by this notice and for any statutory submission made by a fund in terms of the Act, with an effective date after the publication of this notice in the *Government Gazette*, prescribe the criteria for financial soundness and the valuation basis in terms of which financial soundness is determined as well as particulars relevant to a scheme of arrangement, as set out in the Schedule.

DP TSHIDI

REGISTRAR OF PENSION FUNDS

SCHEDULE

1. **Definitions** – In this Schedule –

'fair value' has the meaning assigned to it in financial reporting standards and includes any other conditions as may be prescribed;

'funding level' means the ratio, expressed as a percentage, calculated in terms of the following formula:

$$\frac{(\mathrm{A} - \mathrm{ESA} - \mathrm{MSA})}{(\mathrm{L} + \mathrm{CRA})}$$

where:

A means the value that the valuator has placed on the assets;
ESA means the credit balance in the employer surplus account;
MSA means the credit balance in the member surplus account;
L means the value that the valuator has placed on the liabilities; and
CRA means the amounts standing to the credit of those contingency reserve accounts which are established or which the board deems prudent to establish on the advice of the valuator;

'scheme of arrangement', in relation to a fund, means the remedies employed by the board of a fund to bring the fund into a financially sound condition, subject to the conditions and periods prescribed in this notice; and

'the Act' means the Pension Funds Act, 1956 (Act No. 24 of 1956), as amended, and any word or expression to which a meaning is assigned in the Act has the same meaning in this notice.

2. Application

2.1 This notice has application for every fund that is registered under the Act, except for sections 3, 4 and 5 of this notice, which have application only for defined benefit categories of a fund.

3. Prescribed valuation basis

3.1 The financial assumptions used in a statutory actuarial valuation to calculate the value of liabilities must be consistent with those used to calculate the value of the assets and these assumptions must reflect market conditions prevailing as at the valuation date.

3.2 Any assumption used, or statistical evidence that may be used to substantiate any assumption, must not amount to unfair discrimination or result in outcomes that are unconstitutional.

3.3 The prescribed basis for the determination of the value of assets and the value of liabilities is as follows:

Assets

3.4 The value of the assets of a fund at the valuation date must be stated at its fair value.

3.5 Where the fair value of an asset cannot be determined, or where the fair value of an asset is not available, the valuator should determine the value of such asset by using a reasonable approximation based on accepted market valuation techniques, or rely on the value placed on such asset by a suitably qualified and experienced professional. Appropriate disclosure must be made by the valuator in the relevant report on the statutory actuarial valuation.

Liabilities

3.6 In the determination of the value of a fund's liabilities, any actuarial assumption must:

3.6.1 be realistic;

3.6.2 have regard to the nature of the fund concerned; and

3.6.3 be guided by past experience, as modified by knowledge or reasonable expectation of changes in the future, including events such as expected changes in taxation regimes or other legislation, which may impact the expected experience of the fund.

3.7 A valuator must motivate the choice and relevance of the assumptions. The motivation may include a reference to any of the following:

3.7.1 the experience of the fund, taking into account the size of the fund and underlying trends in that experience where the actuary deems it appropriate to do so;

3.7.2 statistical evidence emanating from:

- other funds in general (if applicable), or
- relevant published information, including information about annuitant or in-service mortality or morbidity rates, and the effect of HIV/AIDS, or
- an investigation performed within a firm of valuators in respect of funds advised by that firm,

where that evidence may relate to demographic or economic items.

3.8 Demographic assumptions must be determined in a manner that is relevant to the membership of the fund for whom the liabilities are calculated.

3.9 There must be consistency in the methodology adopted to determine the financial assumptions used to value liabilities related to in-service members and those used to value liabilities related to pensioners and deferred pensioners.

Determination of the discount rate

3.10 In order to arrive at a discount rate, two generally accepted approaches are recognised, namely a risk-free approach and a risk premium approach.

3.11 In terms of a risk-free approach, the valuator must select a proxy for risk-free rates available in the market, i.e. the discount rate must reflect market yields on government bonds commensurate with the duration, nature and currency of the liabilities at the valuation date.

3.12 In terms of a risk premium approach, the valuator may add a risk premium to the risk-free rate to reflect the net investment returns expected to be earned based on the investment strategy of the fund. When using this approach, the risk premium must be equal to or greater than 0%, but may not exceed 3% per annum.

Determination of the assumption for general price inflation

3.13 The assumption for general price inflation must be based on information about market expectations at the valuation date commensurate with the duration, nature and currency of the liabilities. An inflation risk premium not exceeding 0,5% per annum may be used in the determination of this assumption.

Determination of the assumption regarding future pension increases

3.14 In order to arrive at an assumption regarding expected future pension increases, the valuator must ensure consistency between the pension increase assumption, the discount rate in paragraphs 3.10 to 3.12 and the assumption regarding future price inflation in paragraph 3.13, subject to the fund's pension increase policy in terms of section 14B(3) of the Act.

Contingency reserve accounts

3.15 In terms of regulation 35(2)(a), made in terms of section 36 of the Act, the establishment and magnitude of any contingency reserve account by a fund must be motivated by the valuator in the relevant report on the statutory actuarial valuation.

3.16 Any margins of conservatism must be separately identifiable in the contingency reserves that are established.

3.17 The fund and valuator must bear in mind that the establishment, magnitude and operation of contingency reserve accounts must be properly motivated.

4. Valuation results

4.1 At the date of valuation, the valuator must report on the financial condition of a fund in terms of the following three bases, as outlined below, in the relevant report on the statutory actuarial valuation:

4.1.1 Risk-free basis;
4.1.2 Funding basis; and
4.1.3 Contingency reserving basis.

Risk-free basis

4.2 The financial condition must be reported on, and the contribution rate must be determined in terms of the risk-free basis as outlined in paragraph 3.11. For the purposes of determining the funding level, the value of a solvency contingency reserve account must equal zero.

Funding basis

4.3 If a fund uses a basis different than a risk-free basis to determine its funding objectives, the financial condition must be reported on, and the contribution rate determined in terms of the risk premium approach as outlined in paragraph 3.12. For the purposes of determining the funding level, the value of solvency contingency reserve account must equal zero.

Contingency reserving basis

4.4 For the purposes of determining the funding level on a contingency reserving basis, it must include the value of the amounts standing to the credit of those contingency reserve accounts (including a solvency reserve account, if appropriate) which are established or which the board deems prudent to establish on the advice of the valuator.

4.5 In addition to more conservative financial assumptions than the funding basis when determining the required level of a solvency reserve, it is also desirable to allow for more conservatism in demographic assumptions, such as improvements in mortality.

5. Requirements emanating from the valuation results

5.1 The funding basis in paragraph 4.3 must be used to:

5.1.1 determine whether or not a fund is financially sound;
5.1.2 determine the contribution rates and benefit payments of the fund; and
5.1.3 fund the minimum individual reserves on a per member basis.

Distribution of surplus

5.2 The greater of the value of the liabilities determined on the risk-free basis in paragraph 4.2 and the value of the liabilities and contingency reserve accounts determined on the contingency reserving basis in paragraph 4.4 must be used to quantify actuarial surplus in terms of section 15C of the Act. Pension increases granted to pensions in payment and deferred pensions are not considered as a distribution of actuarial surplus.

6. Financial Soundness Criteria

6.1 The registrar may prescribe criteria for financial soundness in terms of section 18(1) of the Act.

Defined benefit categories of a fund

6.2 A valuator is required to certify the financial condition of a fund in the relevant report on the statutory actuarial valuation on the funding basis set out in paragraph 4.3.

6.3 In the case of a deficit, taking into account the provisions of section 15H of the Act, the valuator must state the measures taken or recommended to eliminate such deficit and the expected period within which it is anticipated that the deficit will be eliminated, with the consent of the board of the fund and / or the sponsor where this is considered to be appropriate.

6.4 The funding level determined in terms of the funding basis in paragraph 4.3 must be equal to or exceed 100% for a fund to be financially sound, failing which the board must take steps to bring the fund into a financially sound condition and a scheme of arrangement must be submitted to the registrar.

Defined contribution categories of a fund

6.5 By design, the financial position of defined contribution categories of a fund should at all times be such that the fund is financially sound. Financial unsoundness may, however, arise for several reasons.

6.6 The funding level must be equal to or exceed 100% for a fund to be financially sound, failing which the board must take steps to bring the fund into a financially sound condition and a scheme of arrangement setting out these steps must be submitted to the registrar.

7. Scheme of arrangement

7.1 Any deficit in a fund, which cannot be dealt with in the manner prescribed in this notice, must be dealt with by the fund in terms of a scheme of arrangement, in consultation with the registrar.

7.2 In terms of section 18(1) of the Act, when any return under the Act indicates that a registered fund is not in a sound financial condition, the registrar may, save as provided in section 29 of the Act, direct the fund to submit a scheme setting out the arrangements which have been made, or which it intends to make, to bring the fund into a financially sound condition within such period, and subject to such conditions, as determined by the registrar.

7.3 In terms of section 18(1A) of the Act, when any return under the Act indicates a deficiency in a registered fund, the fund shall, within three months from the date of such return, submit a scheme to the registrar setting out the arrangements which have been made or which it is intended to make to eliminate the deficiency, together with a report thereon by a valuator.

7.4 Within the context of section 18 of the Act, the deficiency contemplated by sub-section (1A) should be restricted to a financial deficiency, i.e. a deficiency which will or may impact the financial condition of a fund. As such, a deficiency may be identified by the board of a fund which may not have caused, or not yet have caused the fund to be in an unsound financial condition. Therefore, where the board of a fund identifies a financial deficiency in the fund, the provisions of section 18(1A) will apply.

7.5 A fund that is not financially sound must submit a scheme of arrangement that must aim to restore financial soundness within 3 years from the due date of the statutory actuarial valuation report in which it was confirmed that the fund is not financially sound.

7.6 If a statutory actuarial valuation report is submitted after its due date, this 3-year period may be reduced. Therefore funds and valuators should ensure that statutory actuarial valuation reports are prepared in time and submitted to the registrar.

7.7 A scheme of arrangement must:

7.7.1 contain the particulars of the remedies which the board of the fund intend to employ to bring the fund into a financially sound condition;

7.7.2 include a projection of the financial condition of the fund, setting out all the relevant assumptions, taking into account the effect of the remedies once implemented; and

7.7.3 indicate the timeframe within which financial soundness is anticipated to be restored.

7.8 Notwithstanding the provisions of paragraph 7.5, in the cases where:

7.8.1 a new fund is established and prior service is recognised as being pensionable; or

7.8.2 retirement or other benefits are augmented with retrospective effect,

funds are reminded of their obligations in terms of the provisions of section 12(3) of the Act. These obligations require the board of a fund to obtain a certificate from a valuator which confirms the financial soundness of these provisions and the scheme of arrangement submitted to the registrar must include reference to the remedies that will be made to bring the fund into a financially sound position with a maximum period of 9 years from the date of establishment of a new fund or from the effective date that retirement or other benefits are augmented, as appropriate.

7.9 The registrar will approve the scheme if it is not inconsistent with the provisions of the Act and is satisfied that the arrangements suffice to meet the objects of section 18 of the Act.

8. Format and submission of a scheme of arrangement

8.1 There must be a resolution by the board of the fund confirming the adoption of the scheme of arrangement and the scheme must be duly signed by the chairperson, a member of the board, the principal officer and be certified by the valuator prior to submission to the registrar.

8.2 Where the scheme of arrangement requires the consent or commitment of the employer or any third party to the fund, confirmation of such consent or commitment must be included in the submission.

8.3 The submission to the registrar must be made through the official web site (www.fsb.co.za) in portable document format (PDF).

8.4 The provisions set out in paragraphs 8.1 to 8.3 apply *mutatis mutandis* to any scheme of arrangement formulated by a board to eliminate any deficiency in terms of section 18(1A) of the Act.

9. **Short title** – This notice is called the Notice on Financial Soundness, 2015.