(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;

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 bond based approach and a risk premium approach.

3.11 In terms of a bond based approach, the valuator must select a discount rate that reflects market yields on appropriate bonds commensurate with the duration, nature and currency of the liabilities at the valuation date. In the absence of a deep and liquid market, government bonds are often used.

3.12 In terms of a risk premium approach, the valuator may add a risk premium to the bond based 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 added must be equal to or greater than 0%, but may not exceed 3% per annum on the growth asset component, i.e. equity and property.

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 considering the difference between bond yields and inflation linked bond yields.

Determination of the assumption regarding future pension increases and salary 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 general price inflation in paragraph 3.13, subject to the fund's pension increase policy in terms of section 14B(3) of the Act.

3.15 Similarly, the assumption regarding expected future salary increases for in-service members must be consistent with the assumption regarding future general price inflation in paragraph 3.13.

Contingency reserve accounts

3.16 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.

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

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 bases (to the extent that these differ) as outlined below, in the relevant report on the statutory actuarial valuation:

4.1.1 Bond based basis; and

4.1.2 Funding basis.

4.2 Some contingency reserve accounts include the value of liabilities as opposed to a buffer against adverse experience, These may include, but are not limited to:

4.2.1 a risk reserve, where a provision is made for the funding of risk benefits if a fund carries all or part of the death and disability risks and these benefits have not been funded for as part of the liabilities of the fund;

4.2.2 a contribution reserve, where a provision is made for the future supplementing of contributions where a prospective benefits funding method has been used and the contribution rates for the employer and members are defined in the rules; and where the fund has an obligation to fund for the contributions;

4.2.3 any contingent liabilities (e.g. spouses pension), and

4.2.4 any liability relating to unclaimed benefits of a fund.

Bond based basis

4.3 The funding level and the contribution rate in terms of the bond based basis as outlined in paragraph 3.11 must be reported. For the purposes of determining the funding level, the value of contingency reserve accounts not related to liabilities (see 4.2) must equal zero.

Funding basis

4.4 If a fund uses a basis different to a bond based basis to determine its funding objectives, and/or where it chooses to set up explicit solvency contingency reserve accounts, this must be reported on in addition to the funding level in 4.3.

4.5 For purposes of the funding basis, the funding level 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.

4.6 If the basis chosen is a risk premium approach, the guidance and requirements in paragraph 3.12 should be adhered to.

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

4.8 Except for contingency reserves as described in paragraph 4.2, it is not a requirement to fully fund contingency reserve accounts, although it is desirable to do so in order to provide greater protection to members of a fund. In making this decision, the valuator and trustees must consider all relevant aspects concerning the fund and the employer (e.g. the willingness and ability of the employer to fund deficits).

5. Requirements emanating from the valuation results

5.1 The funding basis in paragraph 4.4 to 4.7 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 bond based basis in paragraph 4.3 and the value of the liabilities and contingency reserve accounts determined on the funding basis in paragraphs 4.4 to 4.7 must be used to quantify actuarial surplus in terms of section 15C of the Act.

5.3 Subject to the provisions of section 14A(1)(d) of the Act, pension increases amounting to the higher of the pension increase policy and 100 per cent of the consumer price index, granted to pensions in payment and deferred pensions are not considered a distribution of actuarial surplus. Pension increases above this would be considered 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 paragraphs 4.4 to 4.7.

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 paragraphs 4.4 to 4.7 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 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. 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.

7.4 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. The Registrar may, at his discretion, extend such three year period upon application and motivation by the Board, provided that such extension may not exceed nine years.

7.5 If a statutory actuarial valuation report is submitted after its due date, the 3-year period may be reduced.

7.6 A scheme of arrangement must:

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

7.6.2 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

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

7.7 The registrar shall approve the scheme if it is not inconsistent with the provisions of the Act and he is satisfied that the arrangements should suffice to accomplish 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).

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