EXPLANATORY MEMORANDUM

FINANCIAL SOUNDNESS

IN TERMS OF SECTION 18 OF THE PENSION FUNDS ACT, 1956

INTRODUCTION

1. The Financial Services Laws General Amendment Act, 2013[1] ('the Act') has amended various provisions of the Pension Funds Act, 1956[2] ('the PFA'), amongst others, section 18 and the definition of "actuarial surplus" in section 1(1).

2. Section 18 of the PFA deals with a fund not in a sound financial condition. It provides that:

> *"(1) The registrar may prescribe criteria for financial soundness, and when any return under this Act indicates that a registered fund is not in a sound financial condition, the registrar may, save as provided in section 29, 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.*
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> *(1A) When any return under this 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.*
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> *(2) If a registrar finds that a scheme submitted in terms of subsection (1) or (1A) is not inconsistent with the provisions of this Act and is satisfied that the arrangements set out therein should suffice to accomplish the objects of this section, he shall approve the scheme.*

[1] Act 45 of 2013, with effect from 28 February 2014.
[2] Act 24 of 1956

(3) If the registrar is not satisfied regarding the matters referred to in subsection (2), he shall request the fund to make such amendments to the scheme, or to submit such new scheme, as will enable him to be so satisfied, and the fund shall comply with the request within a period prescribed by the registrar, not being less than 30 days from the date of the request, and shall at the same time furnish to the registrar a report on such amendments or such new scheme by the valuator or auditor mentioned in subsections (1) and (1A), and the provisions of subsection (2) shall apply to any such amended scheme or new scheme which the fund may submit.

(4) The fund shall carry out the terms of any scheme approved by the registrar under this section: Provided that -

(a) the registrar may, if he is satisfied that none of the objects of this section would be thereby prejudiced, permit the said fund to amend such scheme from time to time;

(b) if any return deposited with the registrar during the currency of such scheme in terms of this Act shows, in the opinion of the registrar, that the scheme is unlikely to accomplish the objects of this section, he may withdraw his approval of the scheme, and the fund concerned shall, within three months thereafter, prepare a further scheme, to which the provisions of this section shall apply; and

(c) if any such return shows, in the opinion of the registrar, that the financial condition of the fund is no longer unsound, he shall communicate with the principal officer of the fund to that effect and on receipt of such communication the obligations of the fund in respect of that scheme shall terminate immediately.

(5)

(a) The registrar may at any time following an inspection carried out or investigation conducted under section 25, or for any other reason which the registrar may consider necessary in the interests of the members of a fund, direct that an investigation in terms of section 16, or an audit or both an audit and such investigation be conducted into the financial position of a fund generally or with reference to any financial aspect of the fund.

(b) The costs pertaining to the audit or investigation contemplated in paragraph (a) shall constitute a first charge on the assets of the fund unless otherwise determined by the registrar.

(c) Following the audit or investigation contemplated in paragraph (a) a report must, within the time and in the format stipulated by the registrar, be furnished to the registrar and the board.

3. The definition of actuarial surplus in section 1(1), in relation to a fund subject to actuarial valuation, means the difference between –

"(i) the value, calculated in accordance with the prescribed basis, if any, that the valuator has placed on the assets of the fund, less any credit balances in the member and employer surplus accounts; and

(ii) the value that the valuator has placed on the liabilities of the fund in respect of pensionable service accrued by members prior to the valuation date plus 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, calculated in accordance with the prescribed basis, if any;"

EXPLANATION

4. As a result of the amendments to the PFA outlined above, the registrar may prescribe the following:

    4.1. the basis in terms of which actuarial surplus is determined in a fund subject to actuarial valuation, and

    4.2. criteria for financial soundness.

5. The *Notice on Financial Soundness, 2015*, addresses the issues the registrar may prescribe.

6. In this explanatory memorandum the registrar aims to explain the reasons for prescribing the matters contained in the notice, including the consideration taken of submissions received on the draft notice distributed for comment.

7. The notice will be applicable for statutory submissions made by a fund with an effective date after the publication of the notice, so that prior valuations already in progress will not be impacted. It is not expected that the provision for reporting results on an additional basis in the valuation report will impact the costs of actuarial services significantly.

TREATING CUSTOMERS FAIRLY

8. Treating Customers Fairly ('TCF') is an outcomes-based regulatory and supervisory approach designed to ensure that specific, clearly articulated fairness outcomes for financial services consumers are delivered by regulated financial firms. Firms are expected to demonstrate that they deliver the following six TCF Outcomes to their customers throughout the product life cycle, from product design and promotion, through advice and servicing, to complaints and claims handling – and throughout the product value chain:

8.1. Customers can be confident they are dealing with firms where TCF is central to the corporate culture;

8.2. Products & services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly;

8.3. Customers are provided with clear information and kept appropriately informed before, during and after point of sale;

8.4. Where advice is given, it is suitable and takes account of customer circumstances;

8.5. Products perform as firms have led customers to expect, and service is of an acceptable standard and as they have been led to expect; and

8.6. Customers do not face unreasonable post-sale barriers imposed by firms to change product, switch providers, submit a claim or make a complaint.

9. Boards of funds and their valuators must endeavour to comply with these TCF outcomes where assumptions are set to value the assets and liabilities of a fund to determine whether or not it is financially sound, in addition to any scheme of arrangement that aims to restore financial soundness in fund that is in deficit.

10. The board of a fund must have regard to the reasonable benefit expectations of its members and endeavour to fully fund any benefit promise that may result. An example of non-compliance with the TCF objectives would be the use of weaker assumptions post-retirement compared to pre-retirement on the premise that "pension increases are subject to affordability". It is a requirement that there is consistency in the assumptions used pre-and post-retirement.

SUPERVISION OF DEFINED BENEFIT PENSION FUNDS

11. Statutory actuarial valuation reports should be prepared according to prescribed criteria for financial soundness to enable the supervisory authority to objectively assess the solvency of a defined benefit (DB) pension fund.

12. A pension fund will be deemed to be financially sound where the value of the assets of the plan exceeds the value of the plan’s liabilities plus the value of any contingency reserve accounts that house liabilities. However, different valuation bases would produce different results for the same pension fund and extend to also determine the pace at which DB pension fund obligations are funded and the variability around the funding level.

13. There is no universal agreement on what an appropriate method of valuation is and practices around the world vary considerably. Whilst it is a requirement that best estimate assumptions be used, the range of what is acceptable actuarial practice varies considerably.

14. Two general approaches are being followed, namely a bond-based approach and a risk premium approach (where discount rates are based on expected returns of assets held by a fund). By its very nature, a bond-based approach is more conservative than a risk premium approach.

15. Funds can set up solvency contingency reserve accounts, but there is no requirement to fully fund these reserves. Accepting that pension funds are long term arrangements and sponsored by employers, the registrar is concerned that a risk premium approach without funded solvency contingency reserves may not adequately protect members.

16. In order to increase protection for members, a bond based approach is prescribed for valuation purposes and no surplus may be apportioned to any stakeholder unless the value of assets exceed the value of liabilities on this bond based basis. The difference between the bond basis and the funding basis can be considered an implicit buffer for the protection of members.

17. Initially it was considered to prescribe 3 different bases and to require funds to report on all 3. However, considering comments received on this approach, especially noting the potential complexity and increased costs, it was decided to prescribe only 2 bases.

18. In determining an appropriate framework, the intricacies of the Government Employees Pension Fund (GEPF) were considered. While the GEPF is not currently under the jurisdiction of the FSB and does not have to comply with the requirements of the Pension Funds Act, the expectation is that it may change in future.

19. In line with general practice around the world, it is considered reasonable that assets be valued at fair value. This is also consistent with accounting practices.

20. For the purposes of reporting the financial condition of a fund, the value of liabilities must be calculated to include known obligations that may affect the funding level of the fund, even where these obligations are housed in a contingency reserve account.

21. Whilst most liabilities are contingent upon a certain event happening, e.g. the death of a spouse, it cannot be argued that such can be provided for in a contingent reserve account and need not be funded for. All contingent liabilities, whether provided for in a contingency reserve or not, must be fully provided for.

22. Trustees have discretion to maintain contingency reserve accounts which purpose is to provide a buffer against unforeseen future events that differ from the assumptions used in the liability calculation, e.g. poor investment performance or mortality fluctuations.

SUPERVISION OF DEFINED CONTRIBUTION PENSION FUNDS

23. While the financial position of defined contribution (DC) pension funds would be expected to be such that the fund is financially sound by design, this is not always the case. The funding level and the steps required to bring the fund into a financially sound condition, if applicable, must be considered.

FINANCIAL SOUNDNESS CRITERIA

24. The notice aims to prescribe an actuarial valuation basis in terms of which valuators must prepare statutory actuarial valuation reports, to which the financial soundness criteria prescribed in the notice will be applied. If a fund is not financially sound, it will be required to present the registrar with a scheme of arrangement to restore financial soundness.

25. Financial soundness should not be defined in isolation to numbers calculated by valuators. The concept of financial soundness can be extended to include the extent to which a fund's investment policy and asset liability matching strategy, if any, as contained in the investment policy statement can be relied upon to ensure ongoing financial soundness. Furthermore, the valuator should also take into account the extent to which a sponsor of a defined benefit plan is willing and able to make good any deficit that may arise.

26. If the registrar finds that a scheme of arrangement submitted in terms of section 18(1) or 18(1A) of the PFA is not inconsistent with the provisions of the PFA, and is satisfied that the arrangements set out therein should suffice to accomplish the objects of section 18 of the PFA, he shall approve the scheme.

Yours faithfully

ROSEMARY HUNTER
DEPUTY REGISTRAR OF PENSION FUNDS