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(To all approved administrators, privately administered funds and insurers who underwrite pension funds)

INTERPRETATION NOTE 2 OF 2010

PENSION FUNDS ACT, 1956

FUND RETURN AND PROCESSING MISMATCHES

1. PURPOSE

- 1.1 This Interpretation Note provides guidance on the Registrar of Pension Fund's interpretation of section 14A(1)(a) (read with the definition of "fund return" and section 14B(1)(b)) of the Pension Funds Act (the Act). This interpretation reflects the manner in which the Registrar of Pension Funds will assess compliance with the above sections of the Act for regulatory purposes.

2. BACKGROUND

- 2.1 Small surpluses or deficits may accrue in defined contribution funds during the course of the financial year of a fund due to the manner in which a fund is administered, e.g. as a result of processing errors. Arguably, a portion of this surplus or deficit forms part of the fund return of the fund, and hence such defined contribution funds that do not smooth fund return, are experiencing practical difficulties in complying with section 14A(1)(a) (read with the definition of "fund return" and section 14B(1)(b)) of the Act.
- 2.2 These practical difficulties may relate to the manner in which a fund is administered or processing mismatches that occur when there are timing differences between the time that actual transactions occur and the time when that these transactions are deemed to have occurred for purposes of calculating benefits or costs, or accruing fund return. This results in funds not being able to achieve "real-time" accuracy and is inevitable and unavoidable.

- 2.3 Examples would include funds that are administered on a basis where fund returns are allocated less frequently than on a daily basis.
- 2.4 Examples of processing mismatches include, but are not limited to –
 - 2.4.1 timing differences between fund credits and audit certificates that give rise to the over or under allocation of amounts to fund credit;
 - 2.4.2 the administration system transacts at a certain price, but the investment manager only transacts at a price that is established later; or
 - 2.4.3 timing differences between the date of a member becoming entitled to a benefit and realising of the underlying assets.
- 2.4 The exact extent of these items is only apparent when a financial review of the fund is undertaken. This has the effect that where a member ceases to be a member of a fund prior to retirement, processing mismatches may result in a difference between the fund return applied to that member's individual account and the theoretical fund return. The minimum individual reserve paid to that member in accordance with section 14A(1)(a) may therefore be less or more than the theoretical reserve to which that member is entitled to.
- 2.5 At the same time, it is recognised that not all of these amounts are necessarily related to members that exited the fund during the course of the year. It may not be possible to accurately determine how this amount is made up, and it is often merely the balancing item in an analysis of surplus, or the difference between the value of the assets and the value of the liabilities, e.g. for funds that are valuation exempt.
- 2.6 The question therefore arises how any excess or shortfall should be dealt with in terms of the Act. Specifically where the quantification of the various items that may contribute is not easily identifiable in a cost effective manner, payment or recovery of such amounts may erode fund assets and existing member benefits, because the reasonable cost associated with tracing a former member and making or recovering payments exceeds the value of the increased or reduced benefit.

3. INTERPRETATION OF SECTION 14A(1)(a)

- 3.1 On a narrow interpretation of section 14A(1)(a) (read with the definition of "fund return" and section 14B(1)(b)) of the Act, it appears that the board of a fund is not entitled to exclude former members from any increase or reduction in benefits arising from the adjustment of mismatches, and which would have affected fund return, which occurred while they were active members. The definition of "*fund return*" does not allow for any discretion in the allocation of such returns to members' individual accounts. It represents the actual returns (whether positive or negative) on the assets of the fund. It implies absolute accuracy in the determination of fund return. The amount standing to the credit or debit of a former member's individual account at the time of exit, including actual fund return must be paid or recovered, irrespective of the impact thereof on the fund, and former and existing members.

- 3.2 On a wide interpretation, of section 14A(1)(a) (read with the definition of “fund return” and section 14B(1)(b)) of the Act), it appears that the fund’s board may exclude former members and allocate any increases or reduction in benefits to address the impacts of inevitable and unavoidable processing mismatches. This is so because the legislature could not have intended obliging a fund to trace a former member, and make or recover payments, if the value of that increased or reduced benefit exceeds the reasonable cost associated with tracing a former member and making or recovering those benefits.
- 3.3 The Registrar of Pension Funds will not object to a wider interpretation of section 14A(1)(a) of the Act when assessing compliance with that section for regulatory purposes, if –
- 3.3.1 the quantum of the surplus or deficit resulting from the administrative process and processing mismatches are identified at least at each financial year end of the fund;
 - 3.3.2 the aggregate Rand value of the amount in 3.3.1 at the financial year end of the fund does not exceed 2% (positive or negative) of the value of the fund’s liabilities as at the same date¹;
 - 3.3.3 the rules of the fund authorises the board, in its discretion, to allocate such amounts to existing members and/or former members. The trustees must consider including former members, but may decide to exclude former members in order to avoid the erosion of fund assets and existing member benefits because the reasonable cost associated with tracing a former member and making or recovering payments will exceed the value of the increased or reduced benefit; and
 - 3.3.4 the board is able to demonstrate that any allocation and exclusion in terms of the rules was done to avoid the erosion of fund assets and existing member benefits because the reasonable cost associated with tracing a former member and making or recovering payments would have exceeded the value of the increased or reduced benefit.

¹ Where the aggregate Rand value of processing mismatches at any time exceeds 2% (positive or negative) of the value of the fund’s liabilities, the fund is no longer valuation exempt and must take immediate steps, including the establishment of a reserve account, to correct the variation.

4. QUERIES RELATING TO INTERPRETATION NOTE

Any queries relating to this Interpretation Note must be addressed to –

The Registrar of Pension Funds
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5. AVAILABILITY OF INTERPRETATION NOTE

This Interpretation Note is available on the website of the Financial Services Board
(www.fsb.co.za).

Yours faithfully



FOR REGISTRAR OF PENSION FUNDS