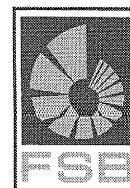


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(To all approved administrators, privately administered funds and insurers who underwrite pension funds)

INFORMATION CIRCULAR 3 of 2013

PENSION FUNDS ACT, 1956

SECTION 15C – APPORTIONMENT OF FUTURE SURPLUS

PURPOSE

1. The Registrar of Pension Funds hereby expresses his view and provides some guidance to assist boards of defined benefit funds in their efforts to comply with the provisions of section 15C of the Pension Funds Act, 1956 (“the Act”).

THE ACT

2. Section 15C of the Act was promulgated on 7 December 2001 and in terms of this section:
 - (1) *The rules may determine any apportionment of actuarial surplus arising in the fund after the surplus apportionment date between the member surplus account and the employer surplus account.*
 - (2) *If the rules are silent on the apportionment of actuarial surplus arising after the surplus apportionment date, any apportionment shall be determined by the board taking into account the interests of all the stakeholders in the fund: Provided that, notwithstanding anything to the contrary in the rules, neither the employer nor the members may veto such apportionment.*

FACTORS TO CONSIDER

3. Where future actuarial surplus arises, section 15C(2) of the Act requires that the board of a fund must take into account the interests of all stakeholders in the fund. By implication therefore, where the rules set out how surplus is dealt with (as envisaged in section 15C(1)), the rules must also take into account the interests of all the stakeholders of the fund.
4. As a general rule, the two most important criteria for a board to consider when apportioning future surplus are the reasonable benefit expectations (as set out by the rules and the pension increase policy of the fund) of the members and pensioners, and the level of risk borne by each stakeholder group.
5. The employer does not carry all the risk in a defined benefit fund, even where there is an unlimited balance of cost obligation. Where pension increases are given on an affordable basis then the pensioners carry the pension increase risk, and are thus the stakeholders who suffer first if the investments underperform relative to the assumption made in the valuation basis. The employer is at risk where the pension increases are on an affordable basis if the investment performance is so poor as not to permit level pensions to be maintained. Active members are also exposed to some degree of risk as the quantum of their minimum individual reserves is linked to the performance of the markets.
6. It is also important to appreciate that, whilst considering the issue of risk, the solvency reserve serves to protect not only the members and pensioners, but also the employer.
7. With the above as background, the Registrar is thus not supportive of an approach whereby all future actuarial surplus is automatically allocated to the employer surplus account, unless there is a corresponding enhancement of the benefit promise during the inter-valuation period. An example of this is where the pension increase promise is changed, either in the rules or in the pension increase policy (in each case with the employer's agreement) from one which is affordable to one which is guaranteed. In such a situation, where the employer bears an unlimited balance of cost obligation it is not unreasonable, in the Registrar's view, for the employer to be entitled to future surplus.

WHERE RULES ARE SILENT ABOUT FUTURE SURPLUS

8. It is prudent and desirable for a defined benefit fund to establish an adequately funded solvency reserve to protect the fund against any potential adverse future experience, following which actuarial surplus can be apportioned to the member and / or employer surplus account. Where a fund elects not to establish a solvency reserve, the board should consider maintaining a certain level of unallocated actuarial surplus as an implicit solvency reserve to protect itself and its members from such potential adverse future experience.

9. Another factor that the board should consider in determining how future actuarial surplus should be apportioned relates to the strength of the actuarial valuation basis. Even though a best-estimate is generally considered to imply a 50% chance of over-stating the liabilities and a 50% chance of understating the liabilities, a best-estimate basis may typically fall within a range of assumptions.
10. A conservative actuarial valuation basis, or a basis on the conservative end of the best-estimate range, implies that members are offered a higher level of protection against adverse future experience, and furthermore the minimum individual reserves of members would be higher than in the case of a best-estimate basis. In this instance, it would not be unreasonable for the employer to argue that it is entitled to a higher share of actuarial surplus as the stronger valuation basis would require a higher contribution rate on his part.
11. The converse would be true where a more optimistic actuarial valuation basis is used, or a basis on the optimistic end of the best-estimate range. In this instance, it would not be unreasonable for the board to consider allocating some of the future actuarial surplus to the member surplus account, because this implies that there is a higher probability that the investments may not perform as expected, with a corresponding exposure firstly to the pensioners in respect of pension increases and to members of the fund in that their minimum individual reserves would have a lower value than otherwise.

CONCLUSION

12. Whilst the Registrar is not empowered to act on complaints arising from the allocation of future actuarial surplus in terms of section 15C of the Act, when a rule amendment in respect of section 15C(1) is submitted, or when a statutory actuarial valuation is submitted in terms of section 16(1), the considerations above will be kept in mind by the Registrar when considering those submissions.

Yours faithfully



REGISTRAR OF PENSION FUNDS