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Pension Fund Surpluses in South Africa

by Marius du Toit

Introduction

During the course of many years up to December 2001, substantial surpluses accumulated in defined benefit (DB) funds in South Africa. It was estimated that in 1998 the amount of surplus in pension funds was approximately R80 billion. This figure included the surpluses in defined contribution (DC) funds, much of which was transferred from previous DB funds that converted to DC funds. To put this amount in perspective, the total assets in pension funds in 1998 was approximately R605 billion, which implies that the average funding level was in the order of 115 percent.

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How Did this Surplus Arise?

Surpluses arose for a number of reasons, the most important of which are the following:

- Favorable experience of funds compared to the conservative approach generally followed by actuaries in setting assumptions. The most significant of these is the very high investment returns earned by funds during most of the 80s and 90s.
- Generally low level of withdrawal and retrenchment benefits in comparison with the accrued liability. In addition, there were significant movements of members from DB funds to DC funds or other arrangements. In 2001 it was estimated that as much as 80 percent of DB members had moved from DB to DC funds over the period from 1980 to 2000. Also, some industries contracted significantly, resulting in a large number of retrenchments.
- Pension increases had often not been as much as could be afforded given the excellent investment returns achieved.

Ownership of Surplus

The ownership of surpluses in pension funds had been a topic of debate since the late 1980s. Many people believed that all surpluses in a pension fund belonged to the employer, and could be utilised at will. The FSB Appeal Board determined in 1994 (the Lintas case) that surplus could be repatriated to the employer.

However, this view was being challenged increasingly. Following the determination in the Lintas case, the Pensions Advisory Committee investigated the payment of surplus assets to employers. They drafted a Bill that allowed payment of surplus to employers, after giving proper pension increases, increasing withdrawal benefits and obtaining the consent of 2/3 of members. Labour strongly opposed the Bill, and it was withdrawn from Parliament in 1999.

In another landmark case, the Supreme Court confirmed in a 1999 case (TEK vs. Lorentz) that:

- Neither the employer nor the members had any rights in law to the surplus and
- Any rights could only be established in the rules of a fund.

The rules hardly ever conferred any rights to any stakeholder, but merely a reasonable expectation to be considered. Rules of funds generally provided that:

- On liquidation, assets (including surplus), are distributed between members, including those who left the fund in the previous 12 months,
- Trustees had the right to improve benefits (subject to consent by the employer) and
- The employer could take a contribution holiday, since it was (normally) responsible to pay the balance of the cost of benefits in a DB scheme (in excess of the contributions made by members).

Discussions and Negotiations Leading up to the Surplus Legislation

In light of the substantial amount of surplus that had accumulated, it became necessary to create legislation that resulted in some certainty. Furthermore, former members had in many cases contributed to the surplus, and without specific legislation it would not have been able to confer any rights on them.

The matter was taken to National Economic Development & Labour Council (NEDLAC). NEDLAC is a representative and consensus-seeking body acting to reach agreement on issues of social and economic policy through negotiation and discussion. The parties involved are Government, organized labour, organized business, and organized community groupings. The retirement fund industry and service providers to that industry are not represented, and would have to channel inputs through one of the mentioned parties. Needless to say, both labour and business had strong opposing views on surplus.

Labour believed that assets were in funds for the sole purpose of providing benefits to members and their dependants, and that the employer had no right to repatriation of any surplus. Interestingly, from an actuarial point of view, they drew a strong distinction between paying money out of the fund through repatriation and not paying more money into the fund (i.e., taking a contribution holiday) if the fund was in surplus. Furthermore, they believed that past transfers were inadequate and did not reflect margins held to protect transferring members against market value volatility. As a result of keeping this margin, surpluses had been inflated at the expense of the transferring members. Funds should be forced to review those transfers. They wanted all past transfers, conversion and retrenchment benefits to be increased in proportion to the market value of assets over the actuarial value of assets, even if it meant that the fund would go into deficit. Furthermore, no surplus should be apportioned to the employer and any past use of surplus by the employer should be repaid.

Business, on the other hand, believed that the conservatism of actuaries led to the employers paying too much in the past, and that these over-contributions had been the major reason why surpluses existed. They supported repatriation of surplus to the employer. Furthermore, they felt that past transfers had been based on arms-length negotiations, and that they should not be revisited.

The discussions took place over a period of 18 months and by August 2000, it was clear that no agreement would be possible. Organized labour then demanded that Government should introduce legislation.

Principles Followed in Surplus Legislation

In drafting the new legislation, Government in essence followed a middle road, balancing the views of the opposing parties. The principles followed were:

- There should be a sharing of reward commensurate with the risk each stakeholder experienced.
- If the employer got a right to surplus, there should be a commensurate duty to fund any deficits.
- The surplus apportionment exercise should not cause a fund to go into deficit.
- A fair minimum benefit should apply when a member left a fund for any reason. This should take account of prevailing market conditions at date of exit.
- The employer should make good any inappropriate benefit it had enjoyed in the past.

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Pension Funds Second Amendment Act, 2001 (Surplus Act)

The Bill was enacted on Dec. 7, 2001. The main elements contained in the Act were the correction of the past and introducing a minimum benefit regime, in order to prevent future surplus from accruing as a result of inappropriately low benefits.

The "sins" of the past were corrected through the following:

- The surplus must be determined at the surplus apportionment date, being the first statutory valuation following Dec. 7,

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2001. The surplus apportionment dates would therefore fall between Jan. 1, 2002 and Dec.1, 2004, as statutory actuarial valuations are required at least once every three years.

- "Improper" use of surplus by employers must be investigated, repaid by employers and added to the surplus to be apportioned. These include usage of surplus by employers where it was not properly negotiated with all stakeholders, as well as use of surplus by employers to benefit certain selected individuals (executives). It covered the period from Jan. 1, 1980 (or inception of the fund if later) to the surplus apportionment date.
- If there was surplus to apportion, all historic benefit payments since 1980 must be evaluated against a minimum benefit as now defined, and where members had received too little, the benefit must be enhanced.
- Pensions must be increased up to the level of increases in inflation—given that they can be afforded.
- If former member benefit shortfalls and pension increases can be fully met, and there was surplus remaining, such surplus must be apportioned between all stakeholders, on a fair and equitable basis.
- It was recognized that there may be conflicts of interest in the surplus apportionment process, and hence a number of checks and balances had been built into this process.

It was also necessary to consider the future, in order to prevent an unacceptable build up of surplus. For this reason a minimum benefit regime was introduced in legislation. This provided that

- Minimum benefits must apply on exit from a pension fund. These are defined separately for DB and DC funds. In DB funds it is the present value of a deferred pension, based on prescribed assumptions, with a minimum of a member's contributions plus fund return. There was a commitment to negotiate the assumptions with the intention that they should reflect current market conditions and make provision for reasonable increases in earnings up to retirement age, and pension increases thereafter at levels in accordance with the fund's pension increase policy. In DC funds it is the accumulated member and net employer contributions, plus fund return.
- All DB funds (and DC funds with pensioners) must establish a pension increase policy. Pension increases must be linked to some measure of inflation. Every three years, pensions must be increased to compensate for inflation if this can be afforded based on the investment return earned on the assets backing the pensions in payment (irrespective of the pension increase policy).

It was accepted and anticipated that the cost of DB funds might increase substantially, so much so that employers might not be prepared (or be in a position to) continue with a DB fund. Hence a time period of one year after surplus apportionment date was allowed during which pension arrangements could be renegotiated without taking account of minimum benefit levels.

On termination of participation in a fund by the employer, if the market value of the assets is less than the minimum benefit level for all members and pensioners, the difference becomes a debt payable to the fund by the employer.

Conclusion

There had been a significant number of challenges in the surplus apportionment process. Whilst the intention of the Act was clear, there had been problems in interpreting the law. It resulted in a number of amendments to the Act, as well as pension fund circulars issued by the Regulator to clarify various aspects. This resulted in long delays, and even in 2008 there are still a large number of surplus apportionment schemes outstanding. In addition, the amount of surplus that will eventually be apportioned will be significantly lower than what was originally estimated. There are a number of reasons, the most important being the poor investment returns over the period to 2003, and strengthening of valuation bases due to decreases in interest rates and concerns over improvement in longevity at older ages.

Nevertheless, a large number of members and former members benefited from direct surplus payouts, and members and pensioners can be assured of a reasonable benefit in future. ☐