PENSION FUND ASPECTS OF MERGERS AND TAKEOVERS IN SOUTH AFRICA

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Introduction

1.1 When a company merges with or takes over another company an important financial aspect that should be taken into account is the level of funding of the pension rights of employees who are taken over, that is the assets that are available to meet the pensions and other benefits that will become payable in respect of service to the date of the merger or takeover.

1.2 Another important aspect that has to be taken into account is the effect on the pension benefits of the employees of the company that is taken over. Although pension funds are theoretically outside the control of the employer, in practice this is not so, because the principal employer usually appoints the majority of the trustees of the fund and has to approve any amendments to the rules. The merger or takeover of a company can be a traumatic experience for the employees and it is vital that their accrued pension rights, which for an employee nearing retirement age is probably his greatest single asset, be protected.

1.3 The actuary has a duty to see that the parties affected by a transfer of assets and liabilities from one pension fund to another are treated fairly and equitably. The parties concerned are:
(a) the members (and possibly pensioners) transferred from the first fund to the second fund;
(b) the other members and pensioners of the first and second funds;
(c) the employers participating in the first and second funds.

Level of Funding

2.1 Until recently the level of funding in the first fund has more often than not been overlooked in the merger or takeover negotiations. Very often when the takeover becomes public the first action of the buying company is to assure employees concerned that their conditions of service (which includes pension rights) will not be affected. An assurance of this nature without knowledge of the financial implications of the possible lower level of funding in the first fund and the cost of future-service benefits is rash.

2.2 Even an examination of the latest actuarial valuation report of the first fund by a person who does not have the knowledge of an actuary will not necessarily disclose different levels of funding in the two pension funds. It is therefore imperative that the actuary of the second fund, who has a duty to advise the second fund and the employers participating in it, examines the level of funding in the first fund at an early stage — ideally this should be done before the takeover negotiations are completed.

2.3 As an example, the two funds may have very similar benefits and conditions and similar valuation bases and methods, except that the first fund makes no provision in advance for post-retirement increases in pensions while the second fund makes implicit allowance for such increases in pensions by using a lower valuation rate of interest after retirement. The level of funding in the second fund could be as much as 25% higher than the level in the first fund.

2.4 The difference in the level of funding should ideally be taken into account in the takeover price so that the buying company will be in a position to make a special contribution to the second fund to make good any shortfall in the level of funding. If this is not done and a shortfall is disclosed after negotiations have been completed, the seller considers that he has met his obligations and unless the buyer is prepared to foot the bill to maintain good staff relations, there is little option but to provide the transferred members with smaller benefits for service to the date of transfer than they expected to receive from the first fund.

2.5 Because the great majority of South African pension funds provide benefits related to service and average salary over the last few years of service and the normal method of funding is "entry age normal with a level contribution rate", I have confined my remarks in this paper to funds of this type.

First Fund — Accrued Rights

3.1 The rules of most South African pension funds provide that, in the case of a merger or takeover, the employer has the option of:
(i) continuing the fund for its present members and pensioners, or
(ii) terminating the fund, or
(iii) transferring the interest or accrued rights of each member and pensioner to another fund for his benefit.

Options (i) and (ii) are rarely elected and it is the third option with which we are mainly concerned.

3.2 At the outset we should determine what is the member's "share", "interest" or "accrued rights" in the fund. There are different opinions as to what these terms mean, the most common being:
(a) the value of the member's accrued benefits with allowance for future increases in salary and an adjustment for the surplus or shortfall in the fund at the date of transfer with assets taken at market value (this is effectively the cash amount that the member would have received if the fund had been terminated on the date of transfer);
(b) the value of the member's accrued benefits with allowance for future increases in salary; or
(c) the value of the member's accrued benefits without allowance for future increases in salary.

3.3 Under (a) the member will receive the benefit of the share of the assets that has been built up in the fund on his behalf, but the assets built up may not be a reasonable value of his accrued rights to benefits in respect of service to the date of transfer. If the whole fund is being transferred (a) must be used.

3.4 Under (b) the transfer value could be a disproportionate share of the assets if the past-service liabilities of the fund are significantly different from the market value of the assets. Under (c) the transfer value will be considerably less than a reasonable value of the member's accrued rights in the fund in respect of service to the date of transfer and in the majority of cases will be less than an equitable share of the fund unless the method of funding is on a similar basis.

3.5 Ideally (a) should be used for all cases. However, the reasons for any past-service shortfall should be determined. If the past-service shortfall is as a result of an improvement in benefits for both past and future service that is being met by an increase in future-service contributions only, the periods of service in the first fund of the members transferred, the period since the increased rate of contribution was effected and the period for which it is anticipated the increased rate of contribution will be payable, are relevant to the adjustment that should be made in respect of the past-service shortfall.

3.6 With the transfer of a relatively small number of members (a) is unpractical and (b) (possibly with an approximate adjustment for the past-service surplus or shortfall) can be justified.

3.7 There is no justification for using (c) unless the total assets of the first fund are only sufficient to cover the total past-service liabilities calculated on this basis.

Second Fund — Past-service Liability

4.1 If the past-service liabilities of the second fund are matched by the assets of that fund, the liabilities undertaken by that fund for the past service of the transferred members should be equal to the value of the assets transferred. If, however, the second fund has a substantial surplus or shortfall in respect of past-service, consideration has to be given to the liabilities that should be undertaken in respect of the assets transferred.

4.2 If all the employers in the second fund are wholly-owned subsidiaries of the principal employer, it is not necessary for the assets and liabilities taken over to contribute a proportionate share to the past-service surplus or shortfall, as the case may be. The main consideration can therefore be that the value of the benefits of the transferred members in the second fund is equal to the value of the benefits that they would have received in the first fund for service to the date of transfer. The problem of any consequent shortfall can be met by all the employers over a future period.

4.3 If the second fund is a group fund and all the employers are not wholly-owned subsidiaries of the principal employer, any existing shortfall should be met by the existing employers and any shortfall as a result of the transfer should be met by the new employer alone. If the second fund has a past-service surplus, it may be considered that the new employer should contribute a proportionate share of the assets transferred towards the surplus, but this should not be done if it causes the transferred members to be granted benefits in the second fund lower in value than those that they would have received in the first fund.

Future-Service Liability

5.1 A pension fund can have a substantial future-service liability (that is, an excess of the value of benefits for future service over the value of future contributions at the current rate) and yet be in a sound financial condition because it has a corresponding past-service surplus. This can arise in a mature fund where the rate of contribution payable is correct for the average age at which new entrants join the fund and the average age of existing members is naturally greater than that age. The reason can also be that a fund has made substantial profits for one reason or another and either the rate of contribution has been reduced or the benefits for both past and future service have been improved without a consequent adjustment in the rate of contribution.

5.2 If the age distribution of members who are transferred out of a fund is the same as the age distribution of the other members of the fund and the transfer value is based on past-service liabilities, with an adjustment for the surplus or shortfall on a past-service basis, the members receive an equitable share of the assets that have been built up in respect of them, irrespective of whether the total future-service liability of the first fund is positive, nil or negative.

5.3 If the average age of the members who are transferred out of the first fund is less than the average age of the other members of that fund, the transfer value based on past-service liabilites is likely to appear small in relation to the contributions paid by that group of members and their employer less the benefits paid to employees who were employed by that employer plus interest. This reflects the fact that those members and that employer were effectively subsidizing the other members and employers of the first fund. Because the fund was a joint operation for all the members and employers up to the date of the transfer this is fair and equitable.

5.4 It is true that if the members concerned had remained in the first fund, they and/or their employer would effectively have continued to subsidize the other members and employers in that fund. There is, however, no reason why the remaining members and employers in the first fund should effectively continue to be subsidized by the transferred members by the actuary making allowance for the negative future-service liability in calculating the transfer value.

5.5 The converse obtains if the age distribution of the members transferred from the first fund is greater than the average age of the other members of that fund.

5.6 If the admission of the transferred members to the second fund creates a future-service liability in that fund that is not covered by the transfer value from the first fund, it can be met:
(a) by an increase in the rate of contribution by all employers in the second fund or from the surplus (if any) in that fund, or
(b) by a special contribution to the second fund by the employer taken over.

5.7 If all the employers in the second fund are wholly-owned subsidiaries of the principal employer, either method can be adopted. If, however, the second fund is a group fund and not all the employers are wholly-owned subsidiaries of the principal employer method (a) may not be suitable.

Options

6.1 When the benefits in the second fund differ from those in the first fund (either in type or in total value) it may be considered necessary to give each transferring member an option to elect his existing benefits in terms of the rules of the first fund. The option can be given for service to the date of transfer only or for all service. In the case of a benefit which is not based on length of service (such as a lump sum death benefit that is a multiple of annual salary) the option cannot be given for past service only.

6.2 The option can be given to a member to elect the old or new benefits *in toto* at the date of transfer or the option can be given to a member (or his dependants) to elect the old or new benefits when the benefits become payable. If the option is left open until the benefit becomes payable, the cost is, of course, likely to be greater.

6.3 A point to be considered when granting options is that invariably some members make the incorrect election, either because they are not given the best advice or because they do not heed the advice given. Those members will in due course become dissatisfied and pressure may be brought for the option to be reopened.

6.4 A further complication arises if an option has been given to members who have transferred from the first fund and the benefits in the second fund are subsequently improved. Had the improved benefits been in force when the option was given, the members who elected their existing benefits in the first fund might have elected otherwise. Should they be given a further option? Should their benefits be improved to give a corresponding increase in the value of benefits?

6.5 In the long run the fewer the options that are granted, the fewer are the problems that will arise in the future. If it is nevertheless decided that options are to be given, every effort should be made to ensure that members are fully aware of the implications of their decisions.

Guarantees

7.1 As an alternative to giving each transferring member an option to elect his existing benefits, a guarantee can be given to each member that the value of his benefits in the second fund when they become payable will not be less than the value of the benefits that would have been payable in terms of the rules of the first fund.

7.2 The guarantee can apply to:
(a) the total benefit in respect of service before and after the date of transfer based on salary when the benefit becomes payable,
(b) the benefit in respect of service to the date of transfer based on salary when the benefit becomes payable,

(c) the benefit in respect of service before and after the date of transfer, or
(d) the benefit in respect of service to the date of transfer based on salary at the date of transfer.

The effects of inflation can make guarantees of types (c) and (d) practically valueless and types (a) and (b) are generally much more suitable.

7.3 Where the benefit is not based on length of service the guarantee can be based on salary when the benefit becomes payable or on salary at the date of transfer. A guarantee based on salary at the date of transfer may be suitable if the first fund has a large lump sum death benefit that is much greater than the benefit in the second fund.

7.4 The main advantage of guarantees over options is that it is not necessary to ask a member to make an election which requires him to assess not only his future salary progression, but also his probability of dying before attaining the retirement age, possibly his marital status at the time of his retirement and his expectation of life thereafter.

Pensioners

8.1 The rights of pensioners may also need to be protected if:
(a) the whole of the first fund is amalgamated with the second fund and the interests of pensioners are transferred to the second fund, or
(b) a portion of the first fund is transferred to the second fund and the pensioners who were formerly employed by the employer that has been taken over also transferred to the second fund, or
(c) a large proportion of the members of the first fund are transferred to the second fund and all the pensioners are left in the first fund with a relatively small number of members and a relatively small employer with a limited ability to meet any shortfall in the fund that may arise in future.

8.2 With the current high rates of interest it is most unlikely that any pensioner's basic pension will be reduced as a result of a takeover or merger, but his expectation of future increases in pension could be vitally affected because in many pension funds the power to increase pensions in the course of payment vests in the trustees, acting upon the advice of the actuary and with the consent of the principal employer.

8.3 If pensioners are transferred, the principal employer in the second fund will have little connection with the former employees of the employer that has been taken over and there is no legal obligation on its part to ensure that any profits made on the assets taken over in respect of pensioners are used to increase pensions in the course of payment. At a time when the rate of inflation in South Africa is in double figures and many pension funds are increasing pensions at rates of between 5% and 10% a year, it can be seen that for a recently retired pensioner the potential increases in pension could be almost as valuable as the actual pension that he is receiving.