Conversion from Defined Benefit to Defined Contribution – The South African Experience.

1. Abstract.

A combination of factors lead to the widespread conversion of South African retirement funds from defined benefit to defined contribution across the 1980's and early 1990's. There were minimal legislative and regulatory constraints, particularly where the conversion was achieved by amendment to the rules of the fund rather than transfer to another fund. There were no South African professional guidance notes. Converting members received their accrued liability within the defined benefit fund using an ongoing fund valuation basis, often with a "sweetener" to encourage conversion. Any share of the actuarial surplus or of the difference between the fair value of the assets and the actuarial value of the assets was left to be negotiated between stakeholders. In practice much if not all of the actuarial surplus and the difference between the market value and actuarial value was left behind in the conversion, releasing and concentrating actuarial surplus in the residual defined benefit scheme. These residual schemes were usually closed to new entrants. With the passage of time and the outsourcing of existing pensions payable from funds to insurers through the purchase of annuity policies, the membership of the residual schemes has dwindled. Many are now ripe for liquidation, creating the possibility of repatriating the residual surplus to the employer.

This possibility is being strenuously resisted by the organised labour movement, who are seeking to challenge the conversion terms in the courts and before the Pension Funds Adjudicator, a statutory ombudsman for the retirement fund industry.

Government has drafted legislation which will introduce minimum benefits to be paid in future on conversion or transfer and which will require funds to apportion existing actuarial surplus between stakeholders, including former members as stakeholders. This is a deliberate attempt to revisit the historic transfers and correct perceived inequities.

The actuarial profession in South Africa is facing criticism over the conversion terms and the generation of surplus in the residual defined benefit funds. Some actuaries have drawn attention to the possibility that there might be a second phase to this criticism, once members come to retire from defined contribution funds and find that they would have done better if they had remained on a defined benefit basis.

The paper draws attention to issues that should have been considered in the conversion process, namely

- the conversion terms with particular reference to the responsibilities of the trustees and the employer and the actuary
- the communication to members which would have been necessary to achieve the informed consent of members.

2. Acknowledgement.

This paper would not have been possible without the contributions of actuaries and consultants, who have participated in the debate on pension fund surplus in South Africa, or who have raised concerns around past conversions. Many have served on the various committees involved in discussing the need for, or commenting on, the Pension Funds Second Amendment Bill, 2001. Notable amongst these are the actuaries who served on the working group established by the Actuarial Society of South Africa under the chairmanship first of Blignault Gouws and later of Colin Southey.

The paper represents my attempt to consolidate some of this comment. The opinions are my own.

Broad generalisations inevitably obscure the nuances of each individual conversion. This runs a danger in that issues that have nothing to do with the technicalities of the conversion are omitted, despite having been very relevant to the decisions taken by the employer, by trustees and by members. These could, for example, relate to conditions in the workplace and to other negotiations between stakeholders. Such issues will affect the long term prognosis of this large scale conversion.

3. What happened?

3.1. The situation before 1980.

South Africa has minimal social security: a means tested social old age pension provides poverty relief after the age of 65 for men, and 60 for women. The replacement ratio of this pension is satisfactory for low paid workers, such as those in agriculture or domestic service, but is inadequate for workers in commerce or industry. If effectively applied, the means test would deny most people who retire after a career in the formal sector any state pension benefit.

Tax incentives encouraged occupational retirement provision from a relatively early stage. A formal structure was given to the retirement fund industry by the Pension Funds Act, passed in 1956. Pension fund organisations are not trusts but acquire their legal identity through registration of a set of rules under the Pension Funds Act. The rules of a fund are subordinate to this Act. The trustees, or board of management, and other office bearers such as the actuary have duties, a subset of which are set out under the Act, and which are amplified in the rules of the fund.

Most employers had set up retirement funds for their employees. Prior to 1980, most large retirement funds in South Africa were defined benefit pension funds. Some defined contribution funds existed but these were largely confined to small employers, and were administered and invested by insurers. Fund management was dominated by the employer. There was no requirement on funds which were established prior to April 1996 to give members the right to elect representatives to the board of trustees until 15

December 1998. Thereafter, with the exception of umbrella funds and funds where participation was voluntary at individual member level, members have a right to elect at least 50% of the board.

The Smith Committee which investigated retirement provision in South Africa estimated that as much as 80% of employees in formal employment belong to an occupational retirement fund. The balance of employees in this sector are thought either to earn either too little to make it attractive as a competitor for the social old age pension, or to be temporary or part-time workers.

South Africa permits a retirement fund to offer either a pension on retirement, in which case at most one third can be commuted for a cash lump sum on retirement, or a lump sum on retirement (the so-called provident fund). Pension and provident funds could be either defined benefit or defined contribution.

Resignation and retrenchment benefits are available in cash or may be preserved through transfer to another fund. As there is minimal unemployment insurance, such cash benefits are often necessary to support former employees during gaps in employment.

3.2. The attempt to achieve compulsory preservation.

In 1980, the government attempted to introduce compulsory preservation. This was intended to stop the leakage on resignation before retirement which had been recognised as a major reason for inadequate retirement benefits from occupational schemes.

Considerable industrial unrest ensued. Workers demanded their money out of employer sponsored retirement funds before preservation could be enforced.

3.3. The drive towards negotiated funds.

Trade unions used the opportunity to promote an alternative retirement vehicle. Kerrigan (1991) notes that “Although such refunds resulted in workers losing substantial accrued retirement benefits, it did not influence them to remain on pension funds.” Reasons given by Kerrigan were:

- Workers’ priorities lay with housing, education and funeral benefits, none of which were catered for in existing defined benefit schemes.
- Lump sum benefits were preferred over income benefits because of a lack of confidence that an ongoing income would be received in rural areas after retirement. [Such lump sums could be invested on retirement in such a way that the means test could be avoided, which was not the case for pension benefits. Some commentators have guessed that this was one of the reasons for a lump sum preference.]
- Most employees at unskilled levels expected to resign or to be retrenched rather than to retire, and wanted good early leaver benefits. Most existing defined benefit schemes favoured retirement benefits rather than resignation benefits: few gave any portion of the employer’s contributions on exit and the rate of interest

paid was significantly less than commercially competitive rates. Members were aware that many schemes had made substantial profits on the withdrawal from service of low income employees.

- Low income employees believed that they had a higher mortality than higher income employees and therefore that they would subsidise the pensions of higher income employees.
- There was little understanding amongst members of defined benefit schemes, whereas the alternative defined contribution provident funds were simple, easily understood and easily communicated to all levels of member.
- Members had no share in the management of schemes. Workers distrusted the paternalistic attitude of employers who were perceived to dominate existing schemes.

Kerrigan notes that this process gave a strong black trade union movement, which had emerged after the changes in legislation brought about by the Wiehahn Commission, an issue which was important to workers and which could be used to consolidate existing union membership and recruit new members.

The trade union movement was therefore strongly in favour of conversion to defined contribution.

Kerrigan notes that, as they became more involved, the largest of the trade union movements, the Congress of South African Trade Unions, Cosatu, became aware of the important role that benefit programmes play in the life of the average worker and wished to be involved in the management of the asset base associated with retirement funds. They recognised that this could become an important tool in improving the conditions of the workers that Cosatu represented. It could be used for job creation.

Cosatu affiliated unions motivated the establishment of negotiated provident funds. This was repeated by unions affiliated to other union federations. Kerrigan notes that this achieved

- A higher level of participation of workers in retirement funds. This relieved pressure for a national retirement fund.
- Substantial conversion of membership from the old defined benefit pension funds to the new defined contribution funds negotiated by workers and trade unions. Most such funds were defined contribution provident funds (ie. they paid a lump sum on retirement rather than a pension) in which the premiums required for death, disability and funeral benefits were deducted from a defined employer contribution before the balance of the contribution by member and employer was invested on a money accumulation basis. On retirement, the full accumulated member and nett employer contributions, with full fund yield, was paid out as a lump sum. On death and disability, lump sum benefits were paid. Comprehensive funeral policies were included. Often these funds stretched across industries.
- Membership of the union sponsored funds was often confined to employees belonging to particular bargaining units. The publicity around union sponsored conversions caused many non-unionised employees, who were attracted by

membership of a defined contribution fund, to put pressure on employers to sponsor a defined contribution alternative.

- Resignation benefits commonly included a refund of the member's own contributions accumulated with the full fund yield plus a percentage of the employer's nett contributions with interest, for each year of service, subject to a maximum of the full member and employer contributions, nett of expenses, with the full fund yield.
- There was equal representation on the board of management of employer-sponsored funds from employer-appointed and member-elected trustees. In union sponsored funds, all trustees were usually appointed by the union.
- The contribution rate was usually set equal to the rate paid under the previous defined benefit fund, inclusive of any insured benefits and administration fees. Kerrigan noted that most employers were reluctant to pay more than 12% of pensionable payroll, while the unions would be reluctant to accept less than 9%.

The conversion to defined contribution accelerated.

This was helped by high real returns relative to the values assumed by actuaries. South Africa had entered an extended bull run on the Johannesburg Stock Exchange. Andrew (1994) showed real returns earned of the order of 4,25% over extended periods of time. Graph 4 shows more recent experience using consolidated information provided by investment managers in respect of pension funds that they manage. Defined contribution gave the benefit of these returns to the members rather than the employer. The risk of poor investment returns in defined contribution funds seemed remote.

When combined with the perceived flexibility of provident funds, the rules of which could be written to optimise the tax incentives for the individual, even high income employees demanded conversion to defined contribution provident funds. Many of these were hybrids between defined benefit and defined contribution in the sense that they offered the executives the better of the defined contribution accumulation of transfer value plus subsequent nett contributions and the old defined benefit.

3.4. Conversion methodology

3.4.1. Choice

It is a condition of approval for a retirement fund by the South African Revenue Services that eligible employees who join a company after establishment of a fund must become members of the fund. This is commonly written into each employee's contract of employment. Without this approval, member contributions would not be tax deductible, employer contributions while deductible as an expense by the employer might constitute taxable fringe benefits for employees and investment buildup may be taxed at a higher rate.

At the start of this conversion process, therefore, most employees were contractually members of defined benefit pension funds. Often their contract of employment stipulated their retirement benefit.

Acting on legal advice that the contract of employment can only be changed by agreement, many employers felt reluctant to risk changing their retirement fund without the approval of employees. Most conversions were therefore achieved by offering employees the right to elect to move to an alternative scheme. Such an election was an automatic amendment to the contract of employment.

3.4.2. Transfer values

Kerrigan notes that, in some of the initial transfers to union sponsored schemes, the transfer value was nothing more than a cash resignation benefit which constituted a refund of the members' own contributions with a relatively low rate of interest. The employer contributions and any surplus was left behind.

Later it became accepted practice to transfer the members' accrued liability using the assumptions from the most recent valuation tabled with the regulatory authority in terms of section 16 of the Pension Funds Act. In communication to members this accrued liability was often described as the members' "interest" in the fund or their "actuarial reserve values". Both these terms are causing problems today.

This transfer value was usually augmented by a "sweetener", namely an arbitrary addition (usually between 15% and 40% of the accrued liability) to encourage transfer, usually paid for out of surplus. This sweetener was offered because it was perceived to be in the interest of both members and the employer for conversion to take place (see 4.1. through 4.3).

The accrued liability was seldom adjusted by the difference between the fair value of the assets and the actuarial value of the assets, nor by any share of any actuarial surplus. (Very recently, I have for the first time come across a conversion in which members of a defined benefit fund were given an option each year to transfer across to a defined contribution scheme sponsored by the employer or to the corresponding scheme sponsored by the majority union, and the transfer values included the difference between the fair value of the assets and the actuarial value of the assets as determined in a valuation at the end of each financial year for the fund, adjusted arbitrarily for a contingency reserve.)

As Kerrigan notes, later in the conversion process, unions demanded a share of the fair value of the assets in proportion that the accrued liability of transferring members bears to the accrued liability in respect of all members prior to the transfer.

3.4.3. Closure to new entrants

As is apparent from 4.3 below, because the conversion suited the employer, the employer was only too keen to close the residual defined benefit fund to new entrants. I am aware of very few conversions in which a subsequent new entrant had a choice of either the defined benefit or the defined contribution scheme.

This was not a problem from an employment perspective, because new contracts of employment specified membership of the defined contribution scheme. The contract might even have offered choice between more than one defined contribution scheme, commonly one sponsored by the employer and another by one or other trade union.

In the discussions with Business South Africa surrounding the Pension Funds Second Amendment Bill (which is covered in 11 below), it was apparent to me that private sector employers in our emerging economy, which is seriously exposed to investment volatility depending upon foreign investment or disinvestments, to currency weakness, and to the HIV / AIDS epidemic, are no longer prepared to bear the risk implicit in a defined benefit fund. Indeed the benefit levels that have been supported in the past in South African funds because of very high real returns (ie. the difference between the investment return earned and salary increases) are not affordable at current contribution rates if we move into a low inflation / low investment return economy. As our National Treasury has a stated goal of reducing inflation (excluding interest rates and fuel) to between 3% and 6% per annum by 2002, such risks are real.

3.4.4. Alternatives when there was no choice

When membership is small, it is not cost effective to run a defined benefit fund, because of the expense of actuarial valuation. Small defined benefit funds may have high volatility in the contribution rates required which is not attractive to employers.

Small employers who wished to offer their employees a defined contribution alternative to a defined benefit fund needed to fund a way to force conversion.

If the alternative scheme was designed in such a way that it was expected to replace the defined benefit on a realistic set of assumptions, or if the alternative scheme incorporated a defined benefit underpin for employees in employment at the date of conversion, employers were advised that they could unilaterally amend the scheme.

Alternatively, employers compelled all employees to convert if more than a significant majority wished to convert.

Any of these approaches other than the defined benefit underpin has a potential legal problem. Gluckman and Kamionsky have noted the statement in a leading textbook on the law of trusts, (T. Honoré "The South African Law of Trusts", Third Edition, 1985), that "It is a defence to an action of breach of trust that the beneficiaries, being of full age and capacity, consented to it, or confirmed it. This is because of the rule that a trust may be varied or discharged with the consent of the beneficiaries, if of full capacity. When, however, only some of the beneficiaries consent to the breach of trust the remainder may nevertheless sue."

While our pension funds are not trusts because they acquire legal personality through registration, they share similar features and the courts are known to look towards trusts to determine rights of members and beneficiaries and duties of the board of management, whom we loosely call trustees.

3.4.5. Outsourcing of pensions

Future retirees from defined contribution provident or pension funds usually have only a right to purchase annuity policies from the insurer of their choice. They do not usually have a right to elect a pension paid from the fund. On the other hand, prior to the conversion trend, most members retiring from large defined benefit pension funds received pensions paid from the fund.

Once the active members had exercised their choice to transfer to defined contribution schemes, many defined benefit schemes were left heavily overweight in pensioners paid from the fund. Because new retirees would automatically purchase annuity policies from insurers after the conversion, the existing pensioner group at date of conversion would age. Experience in developed economies had shown improvement in pensioner mortality with improved medical diagnostic and treatment tools. There is therefore a significant longevity risk. Fluctuations in the experience would increase. Fearing that this would adversely impact the investment strategy appropriate to the remaining active members if assets were to be matched to the liabilities, many funds (or their employers) advocated outsourcing existing pensioners by the purchase of annuity policies from insurers.

Some commentators have questioned the motives of the consultants advocating outsourcing of the pensioners as the insurers commonly paid the consultants commission at a rate of approximately 1,5% on the purchase price of the annuity policies. This earned the consultants significant commissions for little work.

Pensioners usually had their existing pensions purchased, with a once off special increase if they agreed to the purchase of a policy in their own name. Terms and conditions of the annuity policy might match the pension paid by the fund, particularly if with profit annuity policies were purchased. They might differ, particularly if the pensioner was allowed to purchase a so-called "living annuity". In this case the reserve backing the pension was transferred to the insurer and invested in an account for the benefit of the pensioner; the pensioner had a measure of choice over the investment medium into which the account was invested and could change this from time to time; investment return accrued into this account; the pensioner could then draw a variable income from this account each year; and the balance of the account would be available to the pensioner's dependants or his estate on death.

Apart from any sweetener given to enhance the pension purchased, surplus was not usually passed across on the purchase of the annuity policy, nor was the margin between the fair value of the assets and the actuarial value of the assets in the fund included in the purchase price if the purchase price approximated the reserve held in the fund.

The purchase of the annuity policies transferred the mortality risk to insurers. If with profit annuities were bought, the insurer would now determine future pension increases. Over the period prior to purchase while the major outsourcing exercises were being conducted, the rate of increase previously awarded by the insurer to holders of with profit annuity policies commonly exceeded increases that had been paid by the fund.

It seemed like a "win win" situation for the pensioner if past experience was to be repeated.

3.4.6. Result

More than 80% of active members elected to move to defined contribution funds. Kerrigan was positive about the longer term impact on retirement funds: overall the process of conversion gave rise to

- Much better communication to members through annual reports, benefit statements, simplified booklets, videos, etc. Use was made of regional and local committees. This spilt over into defined benefit funds.
- Better fund governance: the board of management is not an extension of the employer and member-elected trustees can better establish the needs of members' dependants following the death of the member.
- Better resignation and retrenchment benefits in defined benefit funds.

Kerrigan notes that "In ten years, we have moved from a position where employees felt that the retirement fund was the province of the employer to the current position where members of alternative benefit programmes consider that they have ownership of the fund's assets."

Very substantial proportions of pensioners moved out to various forms of annuity policies.

This concentrated and released surplus in the residual defined benefit fund. Many of these now have few members and the employer is looking either to collapse these back into the defined contribution fund where the bulk of the employees are, or to liquidate them after transferring the residual members with generous compensation.

Looking at the legal situation below, there is a good chance that any residual surplus in the funds will be paid to the employer or will be transferred into the defined contribution fund for the benefit of the employer.

4. Why did it happen?

4.1. Member perspective

Kerrigan (1991) has noted many of the reasons above. Andrew (The Actuary – January 2001) noted that members received

- better resignation and retrenchment benefits
- a funding structure which they found easier to understand (which was important in an environment of relative low education),
- the possibility of managing contributions more flexibly within a package approach to remuneration,
- a share in the management of the funds (which only became mandatory from 15 December 1998),
- the reward of high real returns which were being earned in our economy (where "real return" is the degree to which investment returns earned exceeded salary and price inflation), and
- (if the transfer was from a pension fund to a provident fund) a lump sum on retirement which eased lower paid workers' fears of dying soon after retirement and losing the value of a pension and which could be invested in such a way that the member could circumvent the means test applicable to the state pension paid to the indigent above retirement age.

4.2. Union perspective

Where the transfer took place to a union sponsored fund, the union gained effective control over the investments of the assets of the fund, and the provision of important benefits to their members. This empowered them economically and socially.

4.3. Employer perspective

The employer enjoyed

- a transfer of the investment and expense risks from the employer to members and
- employee benefit costs were capped.

The capping of employer costs and the transfer of risk to members was particularly important in an environment in which HIV/AIDS was expected to result in significant increases in death and disability insurance premiums, and in which there was considerable uncertainty over the future management of the economy by a democratically elected government which was likely to have a different relationship with Business than its predecessor.

5. The legislative and regulatory situation.

5.1. The law was largely silent.

The Pension Funds Act does not prescribe conversion terms, nor does it clarify the ownership of surplus. This was confirmed in the most important legal case: *Tek Corporation Provident Fund v. Lorentz*, where the Supreme Court of Appeal handed down its judgment only in September 1999. [This would have been a good opportunity for the courts to settle some of the issues, because Lorentz and a very substantial majority of the members of the fund transferred to another fund on the sale of the major operating division of the employer without receiving any share of the surplus. Their transfer value was limited to their accrued liability. They challenged this in the courts.] The Supreme Court of Appeal decided that

- Neither members nor the employer have rights to surplus in law. Any rights could only be conferred in the rules of the fund. [Commonly any such rights are only given on termination of the fund where the fund is not replaced by another fund to which the assets and liabilities are transferred.]
- In a defined benefit fund in which the employer is obliged to pay only the balance of the cost of the defined benefit, when there is a surplus, the actuary may declare that the required employer contribution rate is less than the standard cost of future service (and may even be nil). This so-called "contribution holiday" has been a right of employers in most defined benefit funds if there is a surplus.
- If the rules are silent, the stakeholders (including the employer) should negotiate the distribution of the surplus and amend the rules accordingly.

This decision was then used by the Appeal Board, established under the Financial Services Board Act, 1990, to hear any disputes concerning decisions of the Registrar, to decide in *Paarl Municipal Widows and Orphans Pension Fund v. the Registrar of Pension Funds* that residual surplus on liquidation of a fund, once members' reasonable benefit expectations had been satisfied and a distribution of residual surplus had been negotiated with the members, could be repatriated to the employer.

We now have a legal situation in which surplus can be repatriated on liquidation provided the preceding distribution of surplus was negotiated with members.

Because most conversions were achieved by establishing a new defined contribution retirement fund and offering members of the defined benefit fund the right to transfer to the defined contribution fund, another aspect of the regulatory authorities' supervisory power came into effect: on a transfer of business between funds, the Registrar must be satisfied that the scheme of transfer "is reasonable and equitable and accords full recognition to the rights and reasonable benefit expectations of members".

Some of those who are now challenging past transfer terms are arguing that either the Registrar was wrong in approving the past transfer on the terms then available, or the trustees and / or the actuaries who supplied information to the Registrar in support of the transfer application did not perform their fiduciary duties. As the Registrar has a right to assume that trustees have properly performed their duties before making his decision, if the trustees were ultra vires, the transfer approved by the Registrar is capable of being reviewed.

Otherwise there is a principle of Roman Dutch Law (which is used in South Africa) that an administrative official has no power to review a decision once made. (This statement is not strictly correct: if the official can be shown not to have given the matter proper consideration, the official can be required to review his decision. This caveat will seldom if ever apply to transfers of business, because the Registrar demands documentation of the scheme, the transfer value determination by the transferor fund and details of how the transfer value will be applied in the transferee fund, supported by certification that the actuaries to both funds are happy that the transfer meets the requirement that it is reasonable and equitable and satisfies members' reasonable benefit expectations. The Registrar then considers these reports before making a decision.)

5.2. The regulatory authorities interpreted "reasonable benefit expectations" in a narrow sense.

Those who argue that shares of surplus or the difference between the fair value of the assets and the actuarial value of the assets should be included, by right, in the transfer value, depend upon the use of the term "accords full recognition to the member's reasonable benefit expectations". They argue that members have a right to surplus because it could be used to improve benefits or supplement costs (and therefore they have a reasonable expectation that some of it, at least, will be used for their benefit) and they depend upon the term "actuarial reserve value" to argue that the transfer value should be the amount that has a market value which will deliver an actuarial value equivalent to the accrued liability, on the basis used in the fund at the previous statutory actuarial valuation.

The regulatory authorities did not require the transfer of more than the accrued liability. They interpreted the term "reasonable benefit expectations" to relate to discretionary benefits such as pension increases at the discretion of the trustees rather than to an asset that would give a long-term value equivalent to the accrued liability.

The regulatory authorities sought to encourage the transfer of more than the accrued liability but did not believe that they had a legal right to demand such addition to be included in the transfer value.

5.3. The courts' decisions were received only years after most of the conversions had happened.

Kerrigan noted in 1991 that a decision was expected shortly from the courts. "The amount that is transferred from a traditional pension fund to the alternative benefit programme is a sensitive and contentious issue. In the early alternative programmes that were established, employers offered a transfer of the member's cash withdrawal benefit or, as an alternative, a paid-up pension in the pension fund. Once the trade unions understood the issues involved, this basis was quickly superseded by a transfer of a member's actuarial reserve in the pension fund. Currently, the Cosatu position is that a pro-rata share of the market value of the assets should be transferred, where a fund is in surplus and where the assets have been taken into account by the actuary at substantially less than the current market value. There are strong arguments both in favour of transferring surplus and against transferring surplus, but any employer who negotiates an alternative benefit programme should not simply assume that he will be able to remove this issue from the negotiation by stating the obvious position that the surplus legally belongs to the pension fund. While the employer can claim that he needs the surplus as a protection against the remaining open-ended liability in the defined benefit pension fund, the transferring members can equally claim that they require the surplus as they are taking over the employer's benefit obligation and moving to an uncertain defined contribution provident fund benefit. There is no simple solution to this issue and it is likely to be tested before long either in the Industrial Court or in the Supreme Court."

In fact, the Tek Appeal was handed down in September 1999, many years after most of the transfers had taken place.

5.4. There were no guidance notes issued by the actuarial profession in South Africa.

No professional guidance notes in South Africa specifically cover conversions or transfer values. Gluckman and Kamionsky pointed out this omission, years after most of the conversions had happened.

5.5. Residual surplus is ripe for repatriation to the employer.

In the absence of any legislative action, because of the Paarl Widows decision, the stage is set for employers to achieve repatriation of much of the surplus left in residual defined benefit funds. The law requires only those members who were in the fund in the twelve months prior to termination to participate in the distribution of assets. Where a residual fund has been in its current state for some years, this means that only a small minority of the original members will participate in the distribution. This creates an opportunity to buy off the residual members with a much more generous settlement than any of the former members who transferred out to defined contribution funds received, and pay the balance of the surplus to the employer. [In practice this is unlikely in large employers, because the Labour Relations Act requires that social benefits be negotiated with employees. Where most employees are in other funds, these employees can be expected to resist the payment of favourable terms to a select subset.]

6. Attitude of the actuary

In the conversion process, the actuary often found himself supporting the defined benefit fund, and indirectly the employer, in a robust negotiation with a trade union. As the employer mostly appointed all the trustees of the fund, there was little effective separation of the employer and the fund. Many actuaries found a natural affinity with the employer in this process. Combine this with the natural conservatism and prudence which cause the actuary to want to maximise benefits for the residual defined benefit fund (see the papers by Thomas and Sharpe and Bellis to the International Congress of Actuaries in Birmingham 1998), and it is not difficult to see why the union movement regards actuaries as biased in favour of the employer.

Another influence is their training. Most South African actuaries are fellows of either the Institute or Faculty of Actuaries. Their studies are therefore U.K. based. They are influenced by U.K. principles, including a perception (current at least when many of them were studying) that surplus in a defined benefit fund is synonymous with over-contribution by the employer and should therefore be at the employer's disposition. The requirement to repatriate surplus to the employer in the U.K. if it exceeds a prescribed level, unless the employer takes a contribution holiday or benefits are improved, reinforces this view.

This reliance on U.K. precedent is reasonable bearing in mind the development of our laws and corporate structures, and the similarities between the design of retirement funds in the U.K. and South Africa. Indeed our retirement fund ombudsman, the Pension Funds Adjudicator, frequently looks to U.K. practice as a guide when there is no precedent in South Africa.

Such an approach has ignored the legal reality, namely that South African funds are subject to South African law, which differs in significant areas from U.K. law as became clear after the Tek Appeal.

7. Unequal bargaining position

As would be true of any emerging market, South Africa has wide educational and income differentials between employees of different status. Differences in financial sophistication amongst different income levels is marked. Members involved in a negotiation with the employer do not usually have the same access to professional advice, whether legal or actuarial, if only because the employer will have deeper pockets. Inevitably, even member-elected trustees have a concern to retain their jobs and therefore to avoid antagonising the employer.

Kerrigan noted that trade unions had become more sophisticated in their approach to conversions as they had more practice in the negotiation of such conversions, as the process matured. It was certainly true of my own experience in dealing with unions on conversions shortly before I joined the Financial Services Board: major unions now brought their lawyers and their actuary into the discussion at an early stage. This was not true in the early 1980's.

From 15 December 1998 it was mandatory for a fund to have a board of management and for the rules to give members the right to elect at least 50% of the trustees. Until this time most funds were dominated by employer appointed trustees. There was little effective separation between the employer and the fund. There was no-one independent of the employer to look after the interest of the transferring members other than the negotiators from the defined contribution fund side.

An unequal bargaining position applies particularly to pensioners. At least active members can withdraw their labour and can rely on trade unions to defend them in any dispute with the employer. Pensioners can do nothing except make a nuisance of themselves. They usually have very limited means and have difficulty in communicating with other pensioners within their constituency. Pensioners are also susceptible to being "bought": any sweetener is better than nothing and, as you get older, your capacity to wait out extended negotiations shrinks.

An agreement reached in the workplace between workers and management should not be able to bind pensioners. The Government team felt that it is essential that boards of management of funds should put aside concern for the constituency that appointed them and act in the best interests of all members. Boards should therefore be tasked to review any proposals from members or the employer without undue pressure from either party. Boards, not the employer and active members working together, should take decisions that affect the interests of the fund, for the protection of pensioners and former members who are not represented in such workplace negotiation.

8. The Government reaction.

If these negotiations had taken place at arms' length, with equal access to information, and advice, there would be no call to review past conversions. As it is, this emerged as one of the primary requirements before it would be possible to distribute surplus. The Labour movement felt strongly that much of the surplus which had emerged in residual funds had done so at the expense of "fair" transfer values. They felt their members had been cheated.

The Government team involved in the development of the Pension Funds Second Amendment Bill concluded that many of the past transfers and conversions merited review if only because some of the stakeholder groups had an unequal bargaining position. Legislation would be the only means to address the problem.

9. The views of organised Labour.

Organised labour have fought along much the same lines as the Registrar used in the Paarl Widows case (and lost): all the assets of a fund belong to the fund to the exclusion of any other party; the fund has as its object the provision of benefits to members and their dependants; the employer is not a beneficiary and is in fact excluded from deriving benefit in the Income Tax Act and therefore the employer cannot get anything on liquidation of the fund or at any other time. All surplus must be used to improve benefits for members, if it is not utilised to fund a contribution holiday. [Labour accept that the employer may have a right to take a contribution holiday in terms of the rules of a defined benefit fund.]

Labour feel strongly that many of the early transfers or conversions were prejudicial to their members, and their members lacked sufficient knowledge to realise that they were not getting what was their rightful due.

Particularly where surplus was "hidden" in the difference between the fair value of the assets and the actuarial value of the assets, they are arguing that their members had a right to at least this difference.

10. The concerns of Gluckman and Kamionsky

The first actuaries to draw the profession's attention in South Africa to the problem of conversions in a paper to the Society were David Gluckman and Tony Kamionsky (1997). They raised concerns that members could be aggrieved when they retire and get lower than anticipated benefits, for a number of reasons:

- The initial transfer value may not have represented a fair trade for the defined benefit promise that had been foregone – either in respect of past service, or in respect of a combination of past and future service because the member will lose the cross subsidy by age implicit in a defined benefit fund.
- Investment returns after conversion may have been lower than anticipated. This could be aggravated by changes in the rate of taxation of investment buildup.
- With the transfer of the expense risk to members in a context in which HIV / AIDS is likely to cause considerable increases in the premiums charged to insure death and disability risks, the portion of the future contribution available to fund the retirement benefit could be less than expected.
- If interest rates at retirement are lower than anticipated, the retiring member may be unable to secure the expected rate of conversion of capital to income.

Gluckman and Kamionsky explored the first of these in their paper, leaving the other issues to further research. They identified two other problem areas that they did not address:

- Employers could be worse off in the defined contribution scheme than was the case in the defined benefit scheme because, if members are offered a choice between defined benefit and defined contribution schemes with similar overall contribution rates, younger members can be expected to go to the defined contribution scheme, while older members will remain in the defined benefit scheme. Overall costs are likely to increase at least in the short to medium term.
- Surplus distribution may have been inequitable. Sometimes this has been in favour of the members. Gluckman and Kamionsky raise the possibility that shareholders could take action against the trustees and their advisors.

We are more aware today than we were then that some if not all of these concerns may be realised:

- Unions are challenging the fairness of the transfer value and the equity of surplus distribution.

- A crash in our stock markets in the third quarter of 1998 and very volatile performance thereafter indicate a possibility of lower investment returns after conversion than anticipated. Tax rates on investment buildup were introduced in 1996 and have subsequently been increased, dropping the investment return enjoyed by members of defined contribution schemes.
- HIV / AIDS is rampant. Current infection rates across the country average some 11% and rising, with ante natal clinics in some areas reporting rates of 25%. This will increase premiums charged for death and disability risks which might then reduce the proportion of the defined contribution available for investment.
- The National Treasury has identified inflation targeting as a critical measure of performance. They aim to achieve rates between 3% and 6%, excluding interest and fuel. This could drop investment returns and interest rates on retirement which could be critical for members purchasing fixed annuity policies. The conversion into pension may therefore be unfavourable compared to the rates used when the initial conversion took place.

11. What were the issues that should have been considered?

11.1. Valuation basis used to determine the accrued liability

11.1.1. Appropriateness of an ongoing fund valuation basis

Is it appropriate to use an ongoing fund valuation basis such as that which applied at the last valuation tabled with the regulatory authority in terms of section 16 of the Act? Such a basis will usually incorporate withdrawal and other decrements, and will make assumptions as to the valuation of assets which may reflect long term expectations rather than the current position of the market.

Is such a basis appropriate on conversion? Le Roux and Pillay felt that it was not: no withdrawal decrement should be assumed. Members of a defined benefit fund who remain to retirement age will not be penalised because, some years earlier, a valuation had assumed that some proportion of them would not reach retirement age. On the other hand, when the transfer value is determined the amounts are crystallised. The converted member will only have the amount transferred into his individual account plus future nett contributions and investment return. If the transfer value is depressed by assuming that a high proportion of members of that age will exit before retirement, the converting member will live with that reduction until retirement. The only relief might come if future surpluses are automatically distributed amongst the defined contribution members and this is not true in all funds.

The choice of assumptions in the last valuation was designed to manage the contribution rate, which is the primary purpose of that valuation. These assumptions might not be appropriate to breaking up the fund, which is effectively what happens on conversion.

11.1.2. Assumptions in use for ongoing fund valuations.

Kendal and Franklin surveyed the bases being used by actuaries at the time. They sent out a questionnaire to valuators. 13 questionnaires were returned, representing some 43 valuators, comprising a cross-section of life offices, broker and consulting firms.

This showed an approximate nett valuation rate of interest as follows:

Approximate nett rate of interest as a per cent per annum used before retirement				Number of valuators
20 - 65	30 - 65	40 - 65	60 - 65	
1.5	1.5	1.5	1.5	7
1	1	1	1	1
2	2	2	2	6
-1.3	-1	0.7	2	10
-0.7	0.4	0.9	1.5	4
0.4	1.3	2.2	2.5	4
0.7	1.4	2.4	3	3
-1.3	-0.1	0.7	1.5	2
-1	0.2	1.6	2.5	2
-0.2	0.7	1.5	2.7	2
0.3	1.4	2.2	2.5	1
0.5	0.9	1.4	2	1
0.1	0.7	1.4	2	average

The gross rates of interest after retirement were:	
Rate per cent per annum	Number of valuators
4.25	2
5	22
6	6
7	13

Not all of these would have used this in combination with explicit pension increase assumptions.

The rates used for full consumer price indexing were:

Rate per cent per annum	Number of valuators
Between 2 and 3	32
4	1
6	5

On the valuation of assets, most respondents made some additional comments stressing the need for "judgment" rather than sticking to some mechanical rule.

Number of valuators	Approach used
26	Market value based: Two used market values without adjustment Six had a fixed adjustment of about 85% 16 had some form of smoothing over 1 to 3 years Two used arbitrary adjustments.
17	Discounted cash flow methods. Three of these indicated strongly that they would be flexible in the assumptions that they used and in the application of the method. The other 14 used a more structured approach: 10 took fixed interest securities and property at market values and discounted equities at 15% assuming 10% dividend growth; while the remaining four took property at 90% of market value, fixed interest in broad classes discounted at 15% and equities at 15% assuming 11% dividend growth.

Current valuations submitted to the regulatory authorities reflect the distribution of interest rates in graphs 1 and 2. These are very similar to the Kendal and Franklin figures.

11.1.3. Experience

Andrew (1994) showed real returns of the order of 4,25% being achieved over an extended period. In a submission to the technical committee established while the draft Bill was being discussed in the National Economic, Development and Labour Council (NEDLAC), Andrew presented Graphs 3 and 4 showing more recent investment returns based upon reported performance of the universe of retirement fund managers. In both graphs, the effective return is shown for a single premium investment made at the beginning of the period ending on the date in the graph. So, for example, the 5 year graph figure for the third quarter of 1997 shows the effective return for a single premium invested at the end of the third quarter of 1992. These returns are gross, so need to be reduced for retirement fund tax and investment management expenses.

11.1.4. Review of the use of a realistic basis at least for the future.

Gluckman and Kamionsky argue that it would be preferable to perform a fully realistic valuation, removing all margins of conservatism, to present stakeholders with the likely future costs and likely benefits of the conversion.

In discussing the issues the technical committee at NEDLAC felt under current circumstances that the following basis would be realistic for a conversion benefit in mid 2000:

Real return before retirement	2,8%
Real return after retirement	5,7%

No decrements before retirement
Decrements after retirement in line with the fund's standard assumptions.
No market value adjustment other than an adjustment by the ratio of the current market yield on index linked bonds to the rate of 6% which underlies this set of assumptions.

The Working Group on Retirement Funds Surplus of the Actuarial Society of South Africa also considered a realistic basis for determining the present value of a deferred pension, and came up with the following:

Investment return prior to retirement age	3,5%
Investment return after retirement age	6,0%
Decrements prior to retirement age	nil
Mortality after retirement age	PA(90) Ultimate
Proportion married at retirement age	
Male	80%
Female	70%
Age difference between husband and wife	3 years
Market value adjustment	
Equities	The ratio of 2,5% to the actual dividend yield on the JSE All Share Index
Index linked bonds:	1
Adjustment 10 or more years before retirement age	80% equity MVA, 20% index linked bond MVA.
At retirement age	index linked bond MVA
Between	uniform monthly progression between these two limits

NB. Both the NEDLAC and the ASSA recommendations covered future transfers and conversions. They were not intended to relate to past transactions. The relevance of this is particularly clear from Graphs 5 and 6 which show the dividend yield on the All Share Index and the resulting 80% of equity MVA adjustment that would apply if the ASSA approach were used retrospectively. Dividend yields have changed materially over the last twenty years. This reflects a rerating of equities by the market, changes to dividend policy such as replacing dividends with capitalisation issues of scrip in lieu of dividends and an increasing weight in the indices of companies which retain earnings rather than declare dividends.

These are very different from the ongoing valuation assumptions.

The effect on accrued liability calculations for a member, where the assumptions and characteristics of the fund tested are shown in the Appendix, would be as follows:

Ratio of • the accrued liability on the fund's set of assumptions to • the accrued liability on the NEDLAC or ASSA assumptions without adjustment to an equivalent market value, where appropriate. In all cases a 40 year old member with 10 years' prior service has been assumed.				
Basis used for minimum:	NEDLAC		ASSA	
	Fund's rate of real return before retirement (without a promotional scale)		Fund's rate of real return before retirement (without a promotional scale)	
Real interest rate assumed in the fund after retirement (note 1)	2%	3%	2%	3%
8%	95%	85%	114%	103%
7%	98%	88%	119%	106%
6%	103%	92%	124%	111%
5%	108%	96%	130%	115%
4%	113%	100%	136%	121%

Note 1: In most funds pension increases are granted at the discretion of the trustees. The actuary discusses the trustees' intentions and reserves for pension payments at a real interest rate. The excess investment return earned over this rate funds the pension increases.

Note 2: Graph 6 shows the degree to which past values would have been increased on the ASSA basis for active members at age 40, assuming no change to the basis upon which index linked gilts would have been sold had they been available.

Where this ratio exceeds 100% (after the market value adjustment if appropriate), the fund will not have to top up the accrued liability to match the minimum standard.

In the light of the common practice to add a "sweetener" of the order of 15% to 40%, it seems as though the accrued liability plus sweetener will compare favourably with a realistic accrued liability adjusted to give an equivalent market value.

These calculations can be repeated at different ages. Such calculations show a less favourable position at older ages and a more favourable one at younger ages (because the value of the resignation benefit is more important the younger you are relative to the value of the retirement benefit). The picture also improves if a promotional scale is assumed, because the effective real rate of return assumed before retirement drops.

I doubt that funds which transferred accrued liability plus a sweetener will have a material adjustment to make if the courts or the law require them to pay at least the present value of a deferred pension calculated on either the NEDLAC or ASSA basis. So, despite theoretical flaws in how the actuary determined the conversion value in the past, in practice, retrospective correction to a realistic basis including a market value adjustment is likely to have little impact on most funds.

11.2. Share of the difference between the fair value of the assets and the actuarial value of the assets.

Much of the debate today hinges around members' rights to this margin, although, as Gluckman and Kamionsky have noted, this is perhaps only the first phase of reaction to the conversion.

Protagonists of giving members a share of this margin in proportion to their accrued liabilities argue that, if the actuary to the receiving fund were to make similar assumptions, this margin would be needed otherwise the receiving fund could not give a benefit of matching (liability) value. They also argue (see Gluckman and Kamionsky) that, if the actuary deemed it prudent when taking a long term view of the asset valuation to take a margin, then the members merit this because they will be assuming the investment risk in the defined contribution scheme.

Opponents of this approach question, not so much the need to give members a benefit which can be invested to replicate what is given up, but whether the use of this particular margin is the appropriate adjustment to the accrued liability.

The Actuarial Society working group questioned what a member's reasonable benefit expectation would be on conversion or transfer. Moving from a "narrow" definition, namely whatever was promised in the rules of the fund, the working group determined a "broad" definition, namely that the member would expect to be able to invest the transfer value until retirement and then receive a pension equal to his past pensionable service prior to conversion multiplied by the accrual rate and his pensionable earnings averaged over whatever period was defined in the rules. The Actuarial Society advocated this benefit as suitable on all forms of exit from the fund.

As is shown above, a realistically determined accrued liability adjusted by a realistic market value adjustment may not be higher than the conversion value actually paid. The actuary's conservatism on his ongoing fund valuation assumptions for the liabilities might compensate for a failure to apply his mind properly to the need to include a market value adjustment in the conversion value. If a realistic liability had been adjusted by a realistic amount to get a market value equivalent, and had been communicated in this way to members, the profession might have been saved its potential embarrassment.

Berg (2001) using a 2% real return assumption before retirement and a 5% interest rate after retirement for his South African numbers, without a "sweetener", showed sample transfer values on the South African accrued liability basis and the UK transfer value basis which included market value adjustment for male members with ten years' past service, a pension of 2% of the average salary earned over the last two years of employment and an allowance for a 50% spouse's pension:

Age	UK – MFR transfer value	South Africa – past service accrued liability
30	8000	9000
40	12000	14000
50	19000	17000

With even a 10% sweetener, the South African numbers at the higher ages will compare reasonably with the UK numbers.

11.3.Other issues

11.3.1. Prospective fairness: the loss of future cross subsidy

The incidence of cost by year of service, when expressed as a percentage of earnings in that year, rises sharply as the member gets closer to normal retirement age. This is a natural consequence of assuming that investment return will exceed salary increases and that not all employees of a particular age will remain until retirement but will rather enjoy benefits of a lesser value. (Some benefits on exit before retirement could have a higher value, in which case the actuary will make reasonably prudent assumptions of the proportion of members who will elect such a benefit.) There is an implicit cross subsidy from young to old in a defined benefit scheme. On transfer from a defined benefit to a defined contribution scheme in which a flat contribution rate is payable in future, members will lose this future cross subsidy.

In such a defined contribution scheme if the same overall contribution rate is paid as applied in the defined benefit scheme, the member will enjoy a higher contribution in the defined contribution scheme when young than the effective rate under the defined benefit scheme at that age, and a lower rate as he approaches normal retirement age.

The stakeholders should consider whether members should be compensated for this loss of cross subsidy. One way of doing this would be to determine the present value of all future benefits and deduct the present value of the future net contribution under the defined contribution scheme to get the transfer value. This would normally be subject to a minimum of the resignation benefit and the accrued liability in order not to unfairly prejudice younger members.

The Actuarial Society working group felt that the most a member could reasonably expect was a benefit that was appropriate in relation to the member's service prior to date of transfer. It would be unreasonable to demand that the fund pay out more. The loss of future cross subsidy was an employer / employee issue and the employee could be compensated in a number of ways, including increased future remuneration.

11.3.2. Transfer of risk

In the defined contribution scheme, members assume the investment risk. If the margin between the fair value of the assets and the actuarial value of the assets is transferred across to the defined contribution scheme and held in an investment reserve for the smoothing of investment returns to member accounts, then there is no need to adjust individual transfer values for the transfer of risk.

However, this does not always happen. Where there will be no investment reserve in the defined contribution scheme, members should get some allowance for the investment risk that they take on.

The communication to members before making their election, and thereafter in the defined contribution scheme, should highlight the dependence of the defined contribution scheme on future investment returns. This could be done for example by showing the projection at more than one rate of real return.

Expense risks are important in South Africa, particularly, because HIV / AIDS is expected to increase risk premiums for death and disability benefits considerably over the course of the next ten to fifteen years. This could erode the net contribution available for investment to produce the member’s retirement benefit.

The level of compensation will depend upon the particular circumstances of the conversion.

11.3.3. Retrospective fairness

The accrued liability will reflect the cross subsidy by age implicit in a defined benefit scheme. If young members had been in a defined contribution scheme in the past, their accrued liability would have been higher.

For young members the accrued liability could be less than the cash withdrawal benefit. It is also likely to be less than the amount that they would regard as fair in relation to communication received in benefit statements and remuneration package statements.

The trustees may want to ensure that the transfer value is at least equal to the a multiple of the member’s own contributions with interest so that the member regards his transfer value as fair in relation to his past service.

11.3.4. Share of surplus

Kerrigan noted that a share of surplus was very contentious.

The issue has not been decided in the courts. The major decision was that in the case of Tek Corporation Provident Fund v. Lorentz, before the Supreme Court of Appeal. The judges appealed for legislation rather than a case by case consideration of the matter before the courts.

In a recent decision, RESA Pension Fund v. Pension Funds Adjudicator, the Cape High Court required that trustees consider what share of surplus would be appropriate on transfer.

12. The conclusions of the working group of the Actuarial Society of South Africa

The working group of the Actuarial Society of South Africa came to the conclusion that converting members should receive a transfer value which, if invested until normal retirement age in a similar mix of investments, would reasonably be expected to replace the benefit enjoyed in respect of past service in the defined benefit fund.

This demands realistic assumptions and a realistic adjustment to the liability value to take account of current market conditions. Withdrawal decrements should be excluded. Death decrements might be included depending on the death benefit in the defined contribution fund.

The working group discarded any adjustment for the cross subsidy by age implicit in the defined benefit scheme, arguing that this is properly an employer / employee issue rather than a fund issue. What is critical is that the communication to members before they make their election shows projections which will demonstrate whether members are likely to be worse off.

This is broadly similar to the views expressed in the technical committee during the discussions within NEDLAC of the draft Bill.

13. Best practice as identified by Gluckman and Kamionsky

Best practice should be to offer members a choice of the existing defined benefit arrangement and the new defined contribution arrangement, in conjunction with a thorough communication exercise. The communication exercise should be pitched at a level that the members of the fund should reasonably be able to understand.
They suggested standards for such communication:
In the member benefit statement, show:

- The Rand amount of the transfer value, and Rand comparison of all exit benefits before and after the conversion
- A projection of values using a real return assumption as a minimum. Best practice should project at more than one interest rate in order to demonstrate the sensitivity of benefits to changing investment returns.
- The conversion of pension to lump sum (and vice versa) where conversion is from pension to provident fund.
- Best practice should ensure that the preferred language of the member is used.

In the written material which would accompany the individual benefit statements:

- An explanation of the differences between the two funds
- The advantages and disadvantages of each fund. The various risks should be explained.
- A clear explanation should be given of any guarantees regarding the benefits.

Best practice should then determine
- How surplus in the existing defined benefit fund will be used in future
- The purpose of any reserve accounts in the defined contribution fund.

They then recommended that past conversions be analysed by the trustees with the assistance of the actuary. If they did not measure up to the best practice standards the trustees should review the possibility of a legal comeback, or moral pressure at some stage in the future on the trustees or the employer. Various options would then be available to the trustees: repeat the communication exercise, give an option to transfer back to the defined benefit fund, or set aside reserves to meet shortfalls.

They recommended that
- the Actuarial Society develop a conversion guidance note,
- the regulatory authorities develop a more extensive circular setting out the expected behaviours on conversion,
- the regulatory authorities require actuarial certification that the conversion measured up to minimum standards.

In the discussion, David Gluckman noted that “The first wave of comeback has already commenced – many defined contribution funds are claiming that they did not receive a fair share of surplus on conversion. We predict that the second wave will come when significant numbers of members of these defined contribution arrangements realise that the conversion has resulted in them being financially prejudiced.”

14. What has happened since 1997?

14.1. The first surplus bill

First we have to go back slightly in time. In June 1994, the Appeal Board established in terms of the Financial Services Board Act, 1990, found against the Registrar of Pension Funds in Lintas (South Africa) Pension Fund v. Registrar of Pension Funds. The Lintas Fund had agreed with its stakeholders to distribute surplus, and wished to register a rule amendment which would permit the employer to enjoy the residual surplus once the fund terminated.

The Registrar had used much the same arguments as Labour, and lost.

The Pensions Advisory Committee which advises the Minister of Finance and the Registrar then commissioned a committee to review whether the law should not be changed. This committee came up with a recommendation that surplus be allowed to be repatriated to the employer once a substantial majority of members and former members had given their informed consent.

This would have forced a negotiated distribution of surplus.

The recommendation was translated into a draft bill which was submitted to Parliament. The Congress of South African Trade Unions, Cosatu, threatened a national strike if the draft bill was not withdrawn. Government did this and the Minister of Finance facilitated discussions with Cosatu.

14.2. Interaction between Government and Labour to determine the problem areas, followed by inclusion of Business South Africa in the discussions.

Subsequent discussions with Cosatu revealed their deep seated concern that much of the surplus had arisen not through over-contribution by the employer but through the payment of unfair conversion and transfer values in the past wave of conversion to defined contribution and through unfairly restricting pension increases.

A Government team worked with them to identify a possible solution which was almost certainly likely to involve some retrospective review of past transfers and a regime for the future which would ensure the payment of fair benefits.

Business South Africa complained that they were being excluded from discussions, and, as they represented employers, they felt that their exclusion was unreasonable. We therefore took the matter to the formal bargaining chamber in which Government, Business and Labour interact, namely NEDLAC.

These discussions revealed wide differences between Labour and Business. When the Government team realised that consensus was not possible, we proceeded to draft what we hoped would be an acceptable compromise.

14.3.The Pension Funds Second Amendment Bill, 2001.

This Bill is the result. In summary, the Bill
- Introduces minimum benefits to be paid on future transfers, conversions and retrenchments;
- Introduces minimum pension increases;
- Requires boards of management of funds to apportion existing actuarial surplus equitably between stakeholders, including the employer and former members as potential beneficiaries of such apportionment for the first time; we are still awaiting regulation concerning how far back trustees must go in considering former members, how much they should give former members and what will happen if this retrospective correction will more than exhaust the available actuarial surplus;
- Requires the board to inform the employer, members and former members of this apportionment (where standards may be set for such communication), to give them an

opportunity to object and to address any objections that they feel it would be reasonable to address;

- Requires boards of management to write rules to govern the apportionment of future surplus or to go through a similar exercise in future;
- Specifies how the employer and members may use their shares of the surplus. In particular, the employer may only withdraw surplus from the fund on liquidation or if such withdrawal will prevent significant job losses.

The Registrar will be the guardian of the process, ensuring that boards do the apportionment within an appropriate time and address reasonable objections, or else removing the responsibility from the board and giving it to an independent tribunal which will perform the apportionment for the board.

We are still analysing comment on the Bill which is due to be heard in Parliament during the third quarter.

Effectively the Bill addresses a number of concerns:

- past conversions and transfers will be reviewed, addressing any inequity;
- ensures future conversions adhere to minimum standards, including the communication to members;

At the same time the Actuarial Society is looking at communication standards.

15. Conclusion

Analysis of the terms under which conversions have taken place show that the resulting numbers have not been unreasonable, at least by comparison to United Kingdom standards. (Berg 2001).

Early inequities combined with poor communication of these calculations have, however, lead to complaints, which have culminated in demands for retrospective legislation and for the setting of standards for future conversions.

While Gluckman and Kamionsky have concluded that a legal challenge to the actuarial profession is unlikely to succeed, our reputation could be damaged by adverse publicity.

With hindsight these issues should have been considered much more carefully by the profession before we advised trustees. Even if trustees had disregarded this advice at the time, we would have come out of the process in a better position to influence trustees in future.

The draft Bill, if passed by Parliament, will produce a considerable volume of actuarial work over the next 5 years. We need to ensure that this is conducted within the spirit of the Bill and within guidelines drawn up by the Actuarial Society. Otherwise we run a risk that the profession will be swamped by litigation.

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Appendix: Assumptions used when calculating the accrued liabilities

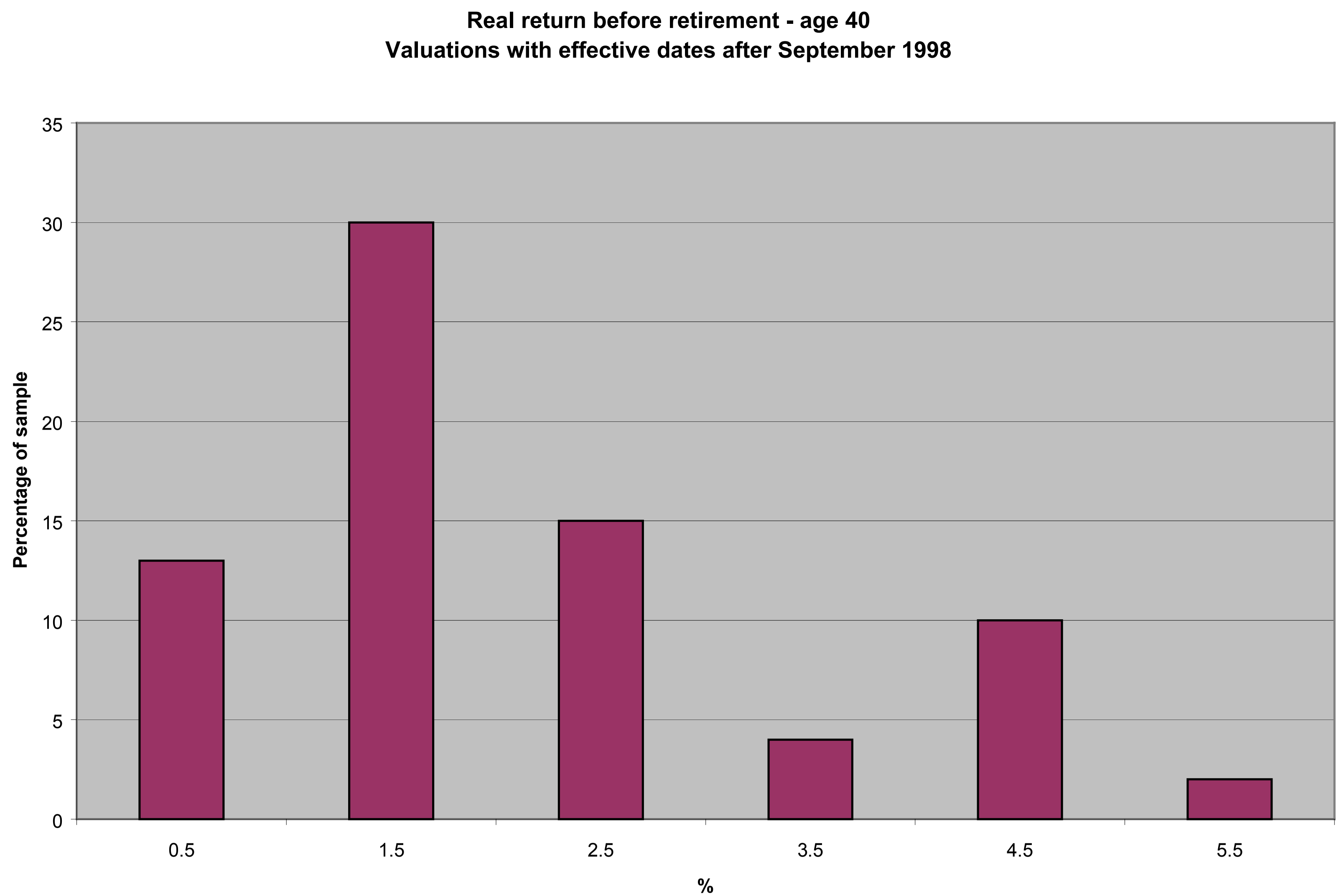
The basic pension assumed was a pension of 2% of the average pensionable earnings over the two years prior to retirement age for each year of pensionable service. The pension offered a 5 year guarantee and a 50% spouse's pension from the later of expiry of the guarantee period and death of the member. Retirement was assumed at age 65. The member contribution rate was 7,5% of pensionable remuneration. The benefit on resignation was a refund of the member's own contributions plus interest at 8% per annum compound, increased by a multiple depending on pensionable service, namely 1 for less than one year's service, 1,1 for between one and two years' pensionable service, 1,2 for between two and three years' pensionable service, etc, to a maximum of 2.

The pension was capitalised assuming PA(90) Ultimate mortality and the various real interest rates as follows:

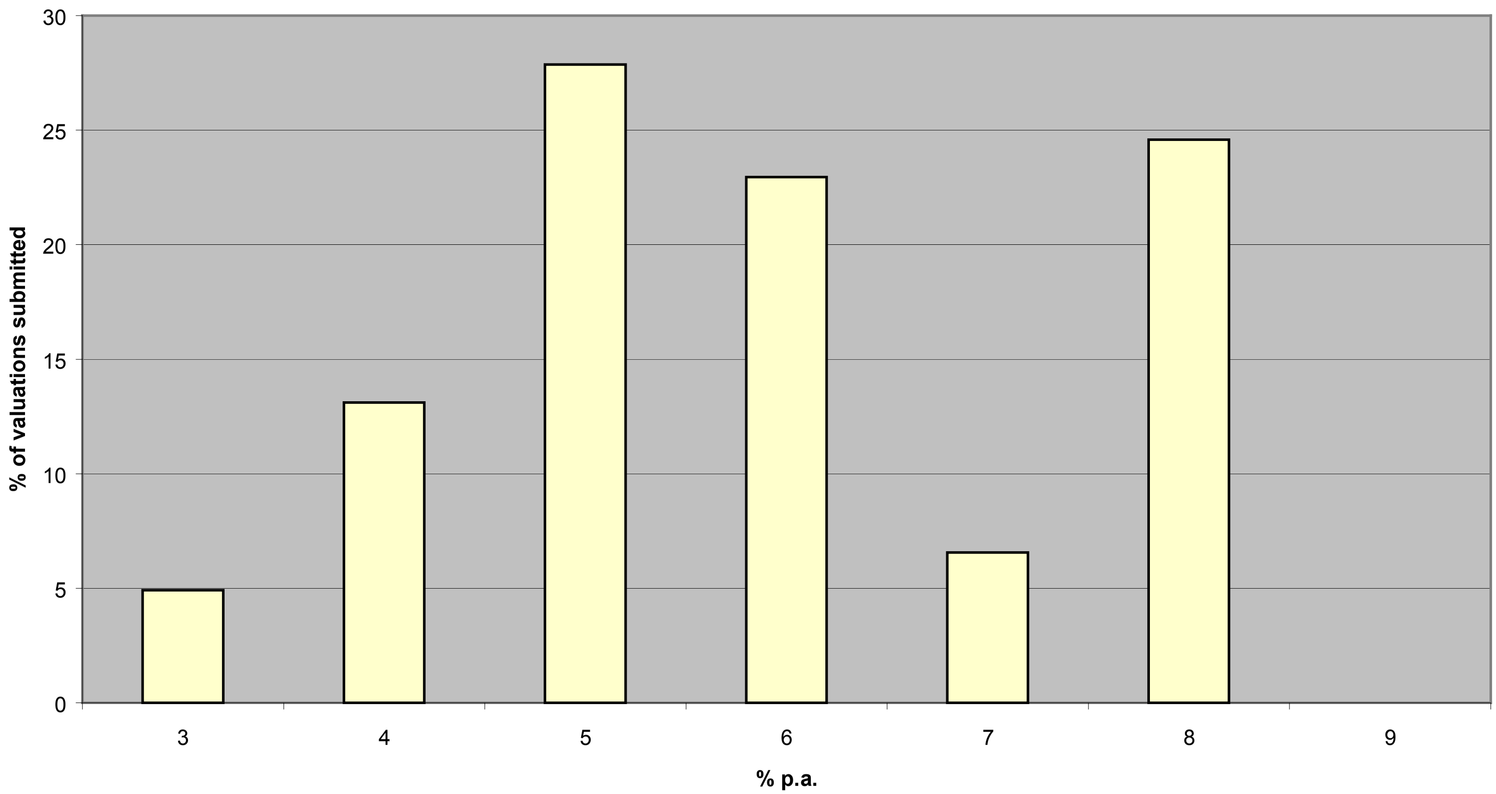
Real rate of interest after retirement	Capitalised value at age 65 of a pension of R1 per month
8%	9.540
7%	10.177
6%	10.885
5%	11.667
4%	12.557
Minimum basis	11.112

Accumulated contributions (which depended upon the promotional scale)

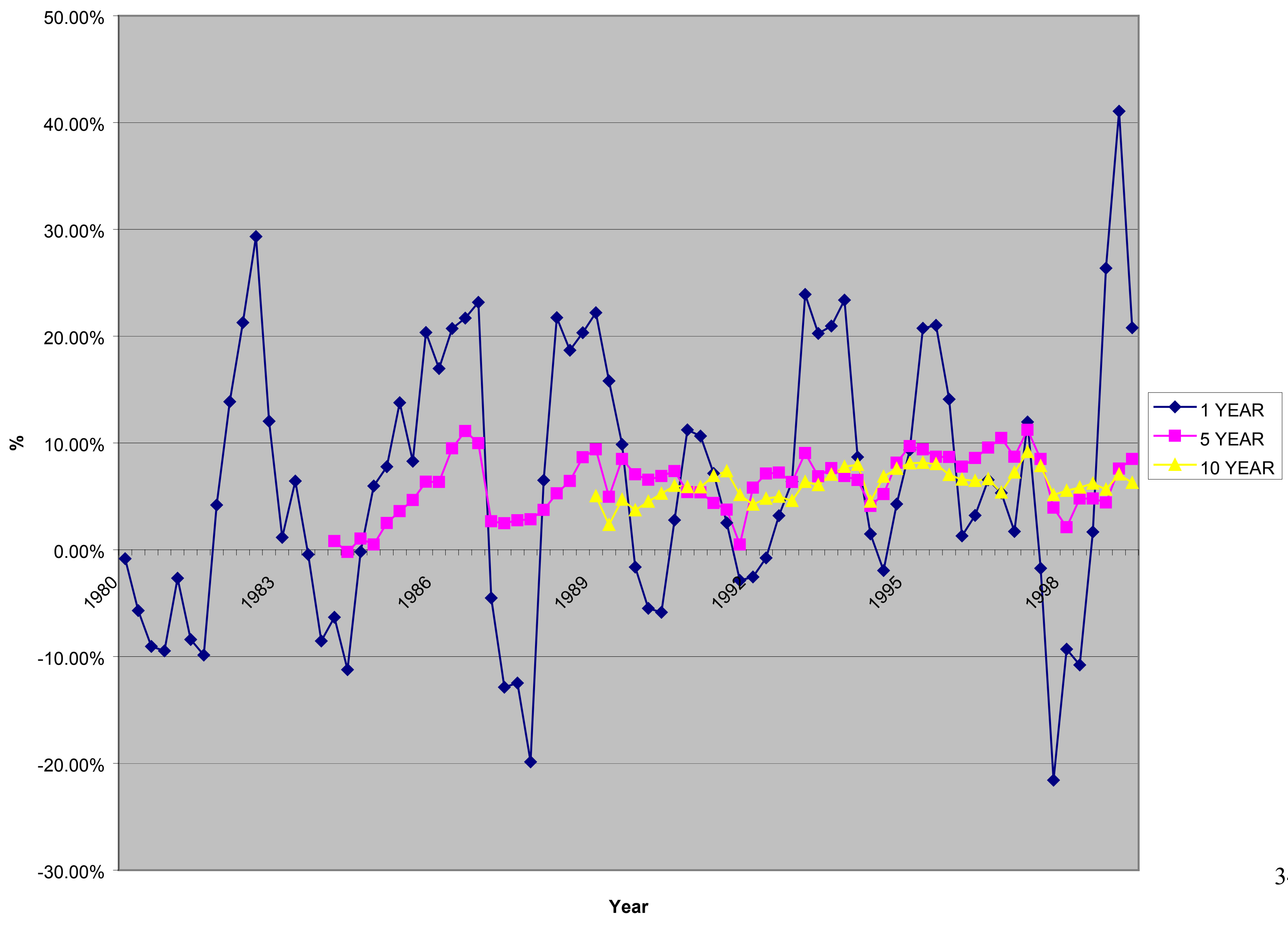
Age	Past service	No promotional scale		Medium promotional scale	
		2% real	3% real	2% real	3% real
30	5	34062.18	34999.51	31178.29	32017.87
40	10	65138.33	68423.05	60585.21	63556.90
50	20	119356.30	130822.00	115008.90	125745.50
60	20	119356.30	130822.00	119307.00	130763.00


Real return before retirement - age 40
Valuations with effective dates after September 1998
Percentage of sample
35
30
25
20
15
10
5
0
0.5
1.5
2.5
3.5
4.5
5.5
%

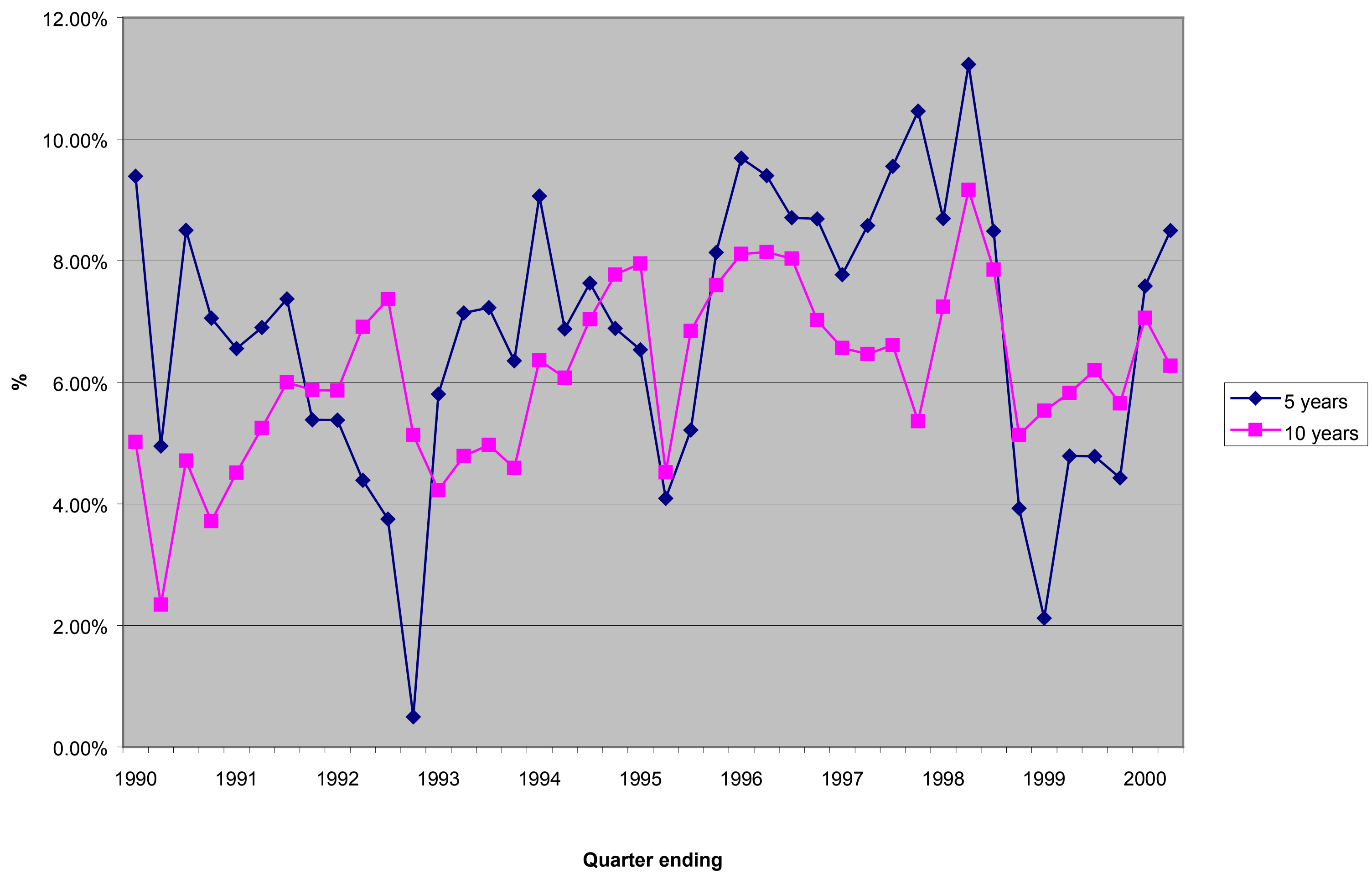
Graph 2: Effective real return after retirement



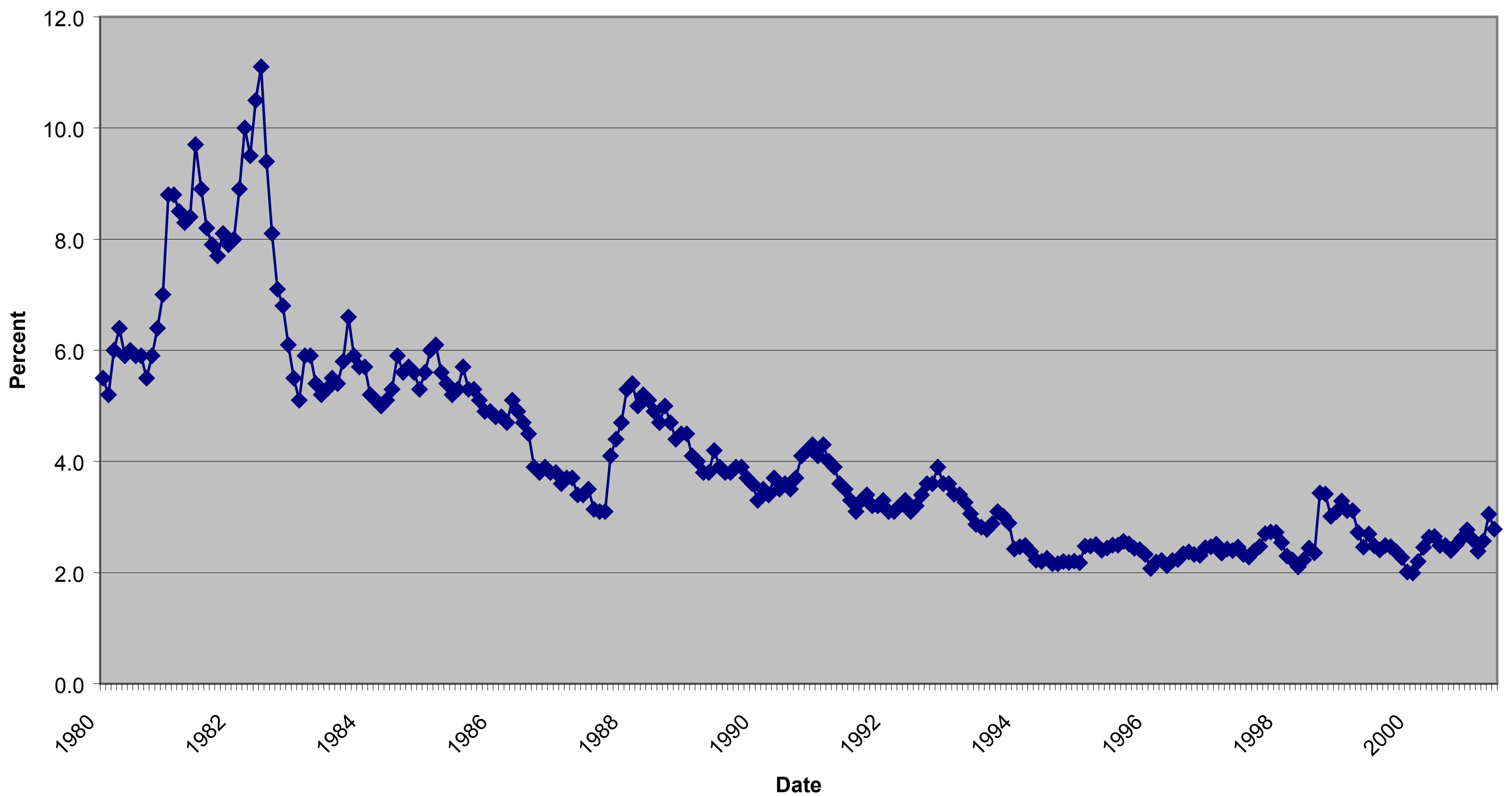
Graph 3: Gross real return earned p.a. - Universe compared to CPI



Graph 4: Gross real return - pa; quarters ending on date shown
Universe compared to CPI



Graph 5: Dividend yield on South African All Share Index



Graph 6: Adjustment to achieve MV equivalent at age 40 in respect of equity portion only