# **IPEBLA**: Uses of pension surpluses in South Africa

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## Introduction

South Africa has a mature pension surplus legal framework as a result of the extensive surplus apportionment provisions ("the surplus Act")[1] inserted in 2001 in the primary pensions legislation, the Pension Funds Act ("PFA")[2]. The background to this, which helps understand why the provisions are so extensive, is as follows.

As with many jurisdictions, the benefit regime in South Africa was predominantly DB, which was designed at least in part to reward long service. In the 1980s and 1990s there was a significant migration of members of DB funds to newly established DC funds in consequence of two driving factors: (a) the realisation that early withdrawals from DB funds were prejudicial to members who only received their own contributions and not those of their employer, the inequity of which was exacerbated by the prevailing fluid employment environment, especially amongst middle income and blue collar employees; and (b), a view by newly legitimised African trade unions that the financial heft of pension funds conferred, in the apartheid environment at the time, valuable political power. Employers supported this move from DB to DC not least because changes in accounting rules required recognition on their balance sheets of the contingent liability flowing from their typical balance of cost obligation in relation to DB funds.

Such transfers from DB to DC funds generated surplus in the transferring (DB) fund because only the member contributions were transferred; consequently, such resulting surplus was used by those DB funds to benefit employers, and the issue of who enjoyed preferential rights to such surplus – the employer or the members and pensioners – soon resulted in litigation. The celebrated case of *Tek Corporation Provident Fund v Lorentz*[3] was precisely on this issue, holding that all surplus belongs not to the employer or the members but to the fund itself and highlighted the need for legislation to provide for how such surplus was to be distributed; further that the source of the surplus was irrelevant.

At the same time there was a growing realisation of the magnitude of the surplus in existence, primarily in occupational DB funds[4], and that not only had there been a manifest injustice in how it had arisen (through the low transfer values to DC funds and low withdrawal amounts), but also that its use in funds was inappropriate both by benefitting employers through employer contribution holidays, the conferral of pension benefits on

[1] Through the Pension Funds Second Amendment Act, No 39 of 2001.
[2] No 24 of 1956.
[3] [2000] 3 BPLR 227 (SCA)
[4] Estimated around the time of the surplus Act as being in the region of around ZAR 45 billion.

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executives and the assumption of employer liabilities such as post-retirement medical aid subsidies, and by such surplus not being used to provide pension increases that increased with inflation even if affordable.

**The Surplus Act**

The consequence of the above, after extensive debate including with employers and unions, was the surplus Act which was detailed and comprehensive, defining two fundamental concepts that would change how funds would be administered: minimum benefits and actuarial surplus. Both applied to DB and DC, were highly complex concepts and required extensive actuarial and legal expertise to understand and apply.

The minimum benefit provisions[5] differentiated between DC and DB, each containing a formula[6] applicable to the respective regime. There were also detailed actuarial provisions applicable to pensioners in order to ensure that they were not shortchanged on pension increases[7], as had happened in the past in some funds[8]. The impact of the minimum benefit provisions on active members was profound: in DB funds members now became entitled to the contributions by the employer on withdrawal (whether retrenched, voluntary and fired from employment)[9] by the requirement of being entitled to their "*accrued deferred pension*"; as for DC members, no longer were vesting scales allowed[10] and both DB and DC members were also required to receive a share of any investment and contingency reserve account on exit or transfer[11].

The issue of who had rights to the surplus was put to rest by affirming what had been the decision in *Tek*[12]: surplus belongs to the fund, and no one has a right to it until apportioned[13]. This was accompanied by a mandatory surplus apportionment process to be undertaken by every fund; of special importance to standalone occupational funds which was where almost all the surplus was to be found. These surplus apportionment provisions were extensive, requiring every fund to be subject to actuarial valuation in order to ascertain whether any surplus existed[14], and if there was surplus, to apportion it according to strict criteria (see allowable uses of surplus below). The assets of a fund were also to be clearly demarcated as backing benefit liabilities or to be in respect of a contingency and retained in a specified contingency reserve account which required the approval of the Registrar of Pension Funds, the regulator ("the registrar"), to be established[15] and for which the registrar laid down guidelines[16]. Any asset not so held in respect of a benefit liability or contingency was surplus[17] which, if it was so revealed in the first valuation after the surplus Act, was required to be apportioned. The board of trustees of the fund ("the board") was responsible for the surplus apportionment; if for some reason it could not do so[18] then a tribunal appointed by the registrar undertook that responsibility[19]

[5] See sections 14A and 14B of the PFA.
[6] There were two formulae that applied to DB members, see section 14B(2).
[7] See section 14B(3), which requires that a fund adopt a pension increase policy, determined by reference to the inflation rate, with a review every year and a catch-up pension to be payable if the increases over that period had been overly conservative.
[8] That pensioners had been short-changed previously is apparent from section 15B(5)(b), which required in the statutory surplus scheme inter alia that pensioners receive an inflationary pension increase as a first charge against any surplus to be apportioned.
[9] See section 14B(2)(a)(i), in particular the notion of "accrued deferred pension", which unfortunately is not defined.
[10] Vesting scales were intended to mimic the DB reward of long service by gradually crediting the member with the employer contributions over an extended period, such as service for 10 years.
[11] See sections 14B(2)(b) and 15G.
[12] Supra.
[13] Section 15A.
[14] See section 15B(1)
[15] See the definition of contingency reserve account in the PFA.
[16] See PF 117.
[17] See the definition of actuarial surplus in the PFA.
[18] Such as, for example, the board being required to be comprised in equal parts of employer appointed trustees and member elected trustees considered itself too conflicted to do so.
[19] See s 15K of the PFA.

The mandatory surplus apportionment exercise was a detailed, lengthy and complicated process, entailing significant new responsibilities on the board: (a) the appointment of a former member representative[20] who was to be involved in the tracing of and communication to former members, dealing with objections and reporting to the registrar[21]; (b) the calculation of minimum benefit top-up payments to former members where calculable from records that could be obtained and from information obtained from the former members themselves[22]; and (c) to assess whether any amount was repayable by an employer in respect of any improper use of surplus[23].

The process required an actuarial valuation to be carried out at the fund's surplus apportionment date (according to new more conservative prescribed requirements laid down by the registrar[24]) and if any surplus was revealed, the board was required to apportion the surplus by applying it firstly to paying pension catch-up payments to pensioners and minimum benefit top-up payments to former members[25] who had exited that fund after 1980. An unfortunate consequence in the allocation of the minimum benefit top-up payments to members is that many have not been traceable, or it is not known whether they have died, so that a significant amount of such surplus is unpaid.

Any residual surplus was to be apportioned equitably amongst the stakeholders (members, pensioners, former members and the employer) taking account of the financial history of the fund[26], on which both the former member representative and the fund actuary were required to certify was "*not unreasonable taking account of the demands of equity and the bounds of practicality*"[27]. The registrar was required to approve these mandatory surplus apportionment schemes before they could be implemented[28].

Accompanying this was a deluge of PF Circulars[29], Information Circulars[30], Interpretation Notes[31] and Regulations[32]. This included subordinate legislation setting out deemed equitable methods of surplus apportionment[33]. The jurisdiction of the Adjudicator[34] was excluded in respect of surplus disputes relating to the mandatory surplus apportionment[35], but that did not limit the referral of surplus issues that were disputed

[20] Section 15B(3) of the PFA.
[21] Those who had withdrawn or transferred out of the fund after 1 January 1980.
[22] Section 15B(4) of the PFA.
[23] Section 15B(6) of the PFA. This was a disputed terrain, as such improper use was not unlawful prior to the surplus legislation. See *Sanlampensoienfonds v Registrar* [2007] 1 BPLR 55 (G).
[24] See PF 117.
[25] Section 15B(5)(b) of the PFA.
[26] Section 15B(5)(c) of the PFA.
[27] Sections 15B(3)(b)(ii) and 15B(9)(b)(ii) of the PFA.
[28] Section 15B(9) of the PFA.
[29] PF Circulars 105, 112 – 118, 121, 125, 127 128.
[30] Information Circulars 3, 5 and 6/2005, 4 and8/2008.
[31] Interpretation Notes 1/2010, 3/2010, 1/20122.
[32] Regulations 34 and 35.
[33] See Board Notice 37 of 2003, which included, for example, the apportionment of surplus as between the employer and members in proportion to their respective contributions to the fund.
[34] The Pension Funds Adjudicator, a quasi-judicial forum established in terms of the PFA, to resolve complaints about pension funds.
[35] Section 30H(4) of the PFA.

to the Financial Services Appeal Board[36], the High Court[37] and the Supreme Court of Appeal[38], which has been very helpful in developing considerable jurisprudence in pensions law around the distribution of surpluses.

The surplus Act provided not only for the mandatory apportionment of surplus, which was largely completed by 2010, but also for the apportionment of surplus thereafter[39], the so-called "future surplus". The fund rules could prescribe how surplus was to be dealt with in the fund[40], and if there were no such provisions in the fund rules then the surplus could be apportioned as the board decided "*taking into account the interests of all the stakeholders of the fund*[41]".

Unlike in the mandatory surplus apportionment process, the apportionment of future surplus is not excluded from the jurisdiction of the Adjudicator and also does not require the approval of the registrar.

**Allowable Uses of Surplus**

The surplus Act sets out that surplus apportioned was to be allocated to the member surplus account ("MSA"), the employer surplus account ("ESA") or directly for the benefit for the members and former members subject, in respect of future surplus to the statutory provisions relating to the MSA.

The MSA provisions[42] allow four uses of such surplus: (a) to improve benefits to members, (b) to improve benefits paid to former members who exited the fund after the mandatory surplus apportionment, (c) to reduce members' contributions, and (d) to meet fund expenses which would otherwise be deducted from members' contributions.

The ESA, on the other hand, allows surplus only to be used for the following eight purposes[43]: (a) for a contribution holiday, (b) to provide an additional or increased pension to compensate for the loss of the employer's post-retirement medical aid subsidy, (c) to meet those fund expenses for which the employer is liable, (d) improving member benefits, (e) transferring an amount of surplus from the ESA to an ESA in another fund in which that employer participates, (f) on liquidation of the fund, to pay the amount in the ESA to the employer (taxable in the employer's hands), (g) subject to certain stringent conditions, to pay an amount to the employer to avoid job losses, (h) transferring an amount of the ESA to another ESA in the same fund (this would only apply to a multi-employer fund), and (i) setting off a positive balance in the ESA with the amount payable to the fund by the employer in respect of improper use of surplus.

[36] See Coca-Cola Southern Africa Pension Fund v Registrar of Pension Funds [2018] 2 BPLR 544 (FSAB); Earlybird Farm Provident Fund v Registrar of Pension Funds [2018] 2 BPLR 560 (FSAB); Free State Municipal Provident Fund v Free State Municipal Pension Fund [2017] 1 BPLR 140 (FSAB); Klein Karoo Kooperasie Pensioenfonds v Registrar of Pension Funds [2017] 3 BPLR 794 (FSAB); Nederduitse Gereformeerde Kerk in die OVS v Registrar of Pension Funds [2017] 2 BPLR 462 (FSAB); NWK-Pensioenfonds v Registrar of Pension Funds [2017] 2 BPLR 467 (FSAB); Prefhold Group Pension Fund v Registrar of Pension Funds {2018] 2 BPLR 584 (FSAB); Robert Bosch Retirement Benefit Fund v Registrar of Pension funds [2017] 1 BPLR 178 (FSAB); Romatex Pension Fund v Registrar of Pension Funds [2018] 1 BPLR 298 (FSAB). [Note many of these matters were decided in the mid 2000s – mid 2010s but only reported later.]
[37] See Registrar of Pension Funds v KZN Retirement Fund [2013] 2 BPLR 170 (KZD);
[38] See Registrar of Pension Funds v Angus NO [2007] 1 BPLR 12 (SCA); Registrar of Pension Funds v British American Tobacco Pension Fund [2017]1 BPLR 65 (SCA); Registrar of Pension Funds v ICS Pension Fund [2011] 2 BPLR 133 (SCA); Edcon Pension Fund v Financial Services Board of Appeal [2008] 1 BPLR 1 (SCA); Hortors Pension Fund v FSCA [2021] 1 BPLR 1 (SCA); Tellumat (Pty) Ltd v Appeal Board of Financial Services Board [2016] 1 BPLR 12 (SCA).
[39] See s 15C of the PFA.
[40] S 15C(1) of the PFA, such as by being used for fund expenses.
[41] S 15C(2) of the PFA.
[42] S 15D(1) of the PFA
[43] S 15E of the PFA.

Decisions as to how a positive balance in the MSA may only be taken by member elected trustees; similarly, decisions about the use of a positive balance in the ESA may only be taken by employer appointed trustees[44]. Generally, where surplus is allocated to the MSA its use has already been decided and applied fairly promptly; but amounts allocated to the ESA may remain there for a long time until fully utilised.

**Apportionment of Surplus in Practice**

In general terms, notwithstanding that in terms of the PFA no one has a right to surplus until apportioned, the most fertile grounds for disputing an apportionment of surplus as between the employer on the one hand and the members, pensioners and former members on the other is the view by the one side that the other is receiving too much. This appears to be so especially where the surplus is large[45]. The use of one of the deemed equitable methods[46] did not, generally find traction.

From the writer's experience the extent of risk borne by each party in the pension arrangement was the most defensible basis (the party exposed to risk should also enjoy the associated reward). Thus in DB funds whether the employer owed a balance of cost obligation, and was thus potentially exposed to substantial investment risk, was a defensible basis to allocate surplus to the employer; but in general terms the employer does not bear all the risk on this basis because the board is obliged, in the face of an event that results in financial strain, to take steps to mitigate that strain before invoking the balance of cost obligation. Such steps may include weakening the pension promise or not giving pension increases for a period. Showing how the surplus arose – usually from investment return rather than overconservative actuarial assumptions, and during what periods (to determine which members should receive – is another helpful basis.

With the demise of all but some very large DB funds, and the dominance of DC funds, which have little opportunity for substantial surplus to arise, the incidence of surplus is much less than previously and, correspondingly, there are now few disputes about surplus apportionments.

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[44] See the provisos to s 15D(1) and 15E(1) respectively.
[45] See the Tellumat case, fn 38 above.
[46] See fn 33 above.