SCA cases and Surplus CRA's

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The Problem

- S 15B of the PFA required funds to
  - Pay minimum benefit top ups to former members who exited after 1 January 1980
  - Include for consideration these former members in respect of the residual surplus (after minimum benefit top ups and pension catch ups)
- So former members could benefit on two grounds – minimum benefit top up and residual surplus
- Much of the surplus went on minimum benefit top ups
- Significant amounts of minimum benefit tops were not paid because very difficult to trace the former members

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The Problem (cont)

The Registrar was concerned about unclaimed surplus benefits and Reg 35(4) was promulgated in 2003:

"Where a board is able to determine the enhancement [the minimum benefit top up]due in respect of a particular former member in terms of section 15B(5)(b) or (c)of the Act, but is unable to trace that former member in order to make payment, the board ***shall put the corresponding enhancement into a contingency reserve account*** *specific for the purpose. Notwithstanding anything in the rules of the fund,* ***moneys may not be released from such contingency reserve accounts except as a result of payment*** *to such former members or as a result of crediting the Guardians Fund or some other fund established by law to include such amounts*." [emphasis added]

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What is a Contingency Reserve Account (CRA)?

Defined in PFA as:

“”contingency reserve account”, in relation to a fund, means an account provided for in the rules of the fund, which has been amended in accordance with the requirements of the registrar, or which has not been disallowed by the registrar, and ***to which shall be credited or debited such amounts as the board shall determine, on the advice of the valuator*** *where the fund Is not valuation exempt,* ***in order to provide for a specific category of contingency***” [emphasis added]
(current wording, after amendments in 2007 and 2014)

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What is a Contingency Reserve Account (cont)?

A contingency is

- *"a future event or circumstance which is possible but cannot be predicted with certainty." (Oxford)*
  or
- *"something that might happen in the future" (Collins)*

I.e. this is a Board decision – whether to hold and how much to hold
On advice of the valuator
For some uncertain event

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What is a Contingency Reserve Account (cont)?

As per Notice on Financial Soundness, 2016:

- *"any **margins of conservatism** in the valuation basis should be reflected in the contingency reserves that are maintained"*

- *" All benefits of the fund must be included in the calculation of the value of the **liabilities** of the fund. **Contingency reserve accounts** may not include the value of liabilities, but **only act as a buffer against adverse experience**."*

- *"It is not a requirement to fully fund contingency reserve accounts"*

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What is a Contingency Reserve Account (cont)?

Examples:
- Data Reserve Account
- Processing Error Reserve Account
- Expense Reserve Account
- Solvency Reserve Account

I.e. a Contingency reserve is additional money which the Fund holds which is not allocated to anyone, to protect the Fund against adverse future experience.

It is set up by the Board on advice of the valuator.

It does not belong to nor is it allocated to anyone specifically
There is no requirement to hold one
There is no requirement to fund one

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What is a Liability?

A liability of a Fund is the amount held by the Fund in respect of benefits owed by the Fund to a specific individual based on the Rules of the Fund.

DC – Fund Credit
DB – expected present value of a future benefit payment stream

It is the expected value of the amounts which are due by the Fund to its members.

This must be fully funded

Importantly the existence of a liability is certain. A contingency is not certain and might never arise.

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How does the financial soundness of a fund operate?

Financial soundness is at the heart of a fund's financial architecture because it must be financially sound in order to pay the benefits it promises.

A fund is financially sound if it's assets are sufficient to cover its liabilities EXCLUDING contingency reserves.

As per Notice on Financial Soundness, 2016:

- *"Funding level = (Assets – Employer Surplus Account – Member Surplus Account) / Liabilities + Contingency Reserve Accounts"*

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How does the financial soundness of a fund operate?

Because Contingency Reserve Accounts are not required, a valuator will start by comparing assets to liabilities:

If Assets < Liabilities then Fund is in a deficit

If Assets > Liabilities then Fund has excess assets to hold contingency reserve accounts (magnitude of which is determined by the Board, but to the extent that these are affordable)

If Assets > Liabilities + full contingency reserves then Fund has surplus

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The decisions of the Supreme Court of Appeal (SCA)

Three decisions:

- Hortors Pension Fund (054/2020)
- Southern Sun Group Retirement fund (215/2019)
- Vrystaatse Munisipale Pensioenfonds (1161/2018)

Decisions handed down 2 November 2020

The decisions of the Supreme Court of Appeal (SCA)(cont)

The facts were different for each fund but all the cases related to unclaimed benefits due to former members in terms of S15B SAS.

Reg 35(4) required these surplus unclaimed benefits to be held in a CRA and no monies could be released other than payment of the benefit or transfer to the Guardians Fund or an unclaimed benefit fund (UBF).

The appellants' case was based on the following:

- The Registrar could not prescribe that an unclaimed benefit be placed in a CRA
- The Registrar could not prescribe how monies in such a CRA could be used
- In terms of the PFA it was the board only that decided these two issues
- Reg 35(4) was therefore ultra vires the PFA and invalid

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The decisions of the Supreme Court of Appeal (SCA)(cont)

Against the appellants' case it was argued by Minister of Finance and FSCA that:

- Nothing in the PFA that precludes the terms of Reg 35(4), especially as it was to enhance the remedial measures of S15B to restore to former members what they should have received in the past
- Once the surplus allocated to the former members for whom their minimum benefit top up could be calculated a liability to them was created which was absolute and which was not extinguished if they could not be traced.
- Although Reg 35(4) refers to a CRA it must be understood as recognizing a fixed liability to the former members.

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The decisions of the Supreme Court of Appeal (SCA)(cont)

What the SCA decided:

- Looked at definitions in PFA of CRA (see slide 5) and actuarial surplus:
  - actuarial surplus is difference between
    value of fund's assets less balances in MSA and ESA
    and
    benefit liabilities and amounts to the credit of those CRAs "*which are established or which the board deems prudent to establish on the advice of the valuator*"

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The decisions of the Supreme Court of Appeal (SCA)(cont)

What the SCA decided (cont):

- Looked at what the provisions in s 15B say about a CRA for surplus due to former members:
  - s15B(4)
    (a): where don't have the info to calculate minimum benefit top up then board must take specified steps to find information in order to do minimum benefit calculation; if can't calculate can then exclude such former members; or
    (b): put an amount in a CRA to satisfy claims of former members per s 15B(5)(e)
  - s 15B(5)(e): board decides how former members are to benefit from SAS; provided that can allocate to a CRA if former members who
    - (i) have been indentified per s 15B(4)(a) but not traced
    - (ii) did not provide info to calculate minimum benefit top up within period in s 15B(4)(a) but do so at end of that period

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The decisions of the Supreme Court of Appeal (SCA)(cont)

What the SCA decided (cont):

- From these provisions clear that it is the board which decides how former members are to benefit
- S 36 of PFA gives Minister power to make regulations "*not inconsistent with the Act*"
- Reg 35(4) was contrary to PFA because:
  - Requires board to establish CRA when it is at the board's discretion whether to do so,
  - Stipulates how CRA to be used when it is at the board's discretion whether to release
- Both these provisions are thus contrary to PFA
- Once a surplus unclaimed benefit is in a CRA then:-
  - "*the contingency relates to the likelihood of claims materializing*"
  - It is in respect of this that valuators make assumptions

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The decisions of the Supreme Court of Appeal (SCA)(cont)

What the SCA decided (cont):

- In *Vrystaat* the surplus unclaimed benefits of former members are only in respect of minimum benefit top ups that were calculated. Although it had a rule that these unclaimed benefits reverted to the fund after 2 years the SCA said

  "the Fund was mistaken as to the claims of former members being extinguished. They continue to adhere. The question is whether actuarial assumptions in valuation reports as to their eventuating are within an acceptable compass."

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The decisions of the Supreme Court of Appeal (SCA)(cont)

What the SCA decided (cont):

- In Hortors the former member unclaimed benefits were also in respect of minimum benefit top ups that could be calculated. There was no rule similar to that in Vrystaat. The SCA said
  - *"The [fund] has not, nor could it, extinguish the claims of those that remained untraced. Its actuaries…calculated what it might cost the funds to pay the claims of those untraced members that might come forward in the future. In so doing it took into account the probability of the claims materializing. It set out the measures that were put in place to meet the claims if they eventuate, including drawing on existing surplus and…an undertaking from the employer."*

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The decisions of the Supreme Court of Appeal (SCA)(cont)

What the SCA decided (cont):

- FSCA had extensive regulatory powers available to it to ensure that attempts are made to trace former members and to ensure financial soundness

- Clear that SCA considered:-
  - The surplus unclaimed benefit liabilities could not be extinguished
  - But could nevertheless have amounts released from the liability held in respect of these claims provided the fund remained financially sound if the claims were made

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The FSCA Guidance Notice :

Note: for information and not binding per s 141(b) FSR Act

The GN –

- Emphasises board fiduciary duty to both the the fund and members
- Confirms its view that surplus unclaimed benefit is a liability that cannot be written off
- States again the importance of maintaining financial soundness of the fund

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The FSCA Guidance Notice (cont):

- Stated that:-
  - *"funds must carefully consider the release of such assets for these obligations [former member surplus benefits] in a former member surplus apportionment account"* – is this a CRA or a reserve?
  - Funds must show steps taken to trace former members; historic tracing not enough
  - Boards must motivate assumptions justifying amounts retained to meet future claims
  - Boards must say how future liability will be met (cf Hortors)
  - If board tries to transfer liability to UBF the UBF may not accept it if assets do not match full liability

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The problems with the SCA decisions and FSCA Guidance Notice

The SCA decisions

- Do not deal with the situation where surplus unclaimed benefits were, per s 15B(4)(b) or s 15B(5)(e), correctly credited to a CRA.
- Do not state what must, if anything, be done about amounts credited to CRA per Reg 35(4) which are not in accordance with s 15B(4)(b) and s 15B(5)(e)
- Clarifies that –
  - At least in respect of surplus unclaimed benefits *the contingency relates to the likelihood of claims materializing;* and assets in respect of this can be released
  - Even though surplus unclaimed benefit liability always remains, cannot be extinguished
  - This is not restricted to CRA
  - There must be financial soundness provisions in place

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The problems with the SCA decisions and FSCA Guidance Notice (cont)

FSCA Guidance Notice

- Accepts the above
- Does not deal with how amounts to the credit of CRA per Reg 35(4) but not established per s 15B(4)(b) or s 15B(5)(e) must be dealt with
- Does not appear to deal with the issue of releases from a CRA correctly established per s 15B(4)(b) or s 15B(5)(e)
- Gives no guidance as to whether residual surplus allocated to untraced former members can now be credited to a CRA per s 15B(5)(e)
- Does not deal with what fund must do in respect untraceable unclaimed benefits

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The way forward

What can be said is that:

- Amounts to the credit of CRA per per s 15B(4)(b) or s 15B(5)(e) can be released per the SCA decisions
- In my view residual surplus allocated to untraced former members whose minimum benefits could not be calculated can now be credited to a CRA per s 15B(5)(e)
- Amounts for unclaimed minimum benefit top ups can’t be held in CRA but can be released provided there are financial soundness provisions in place
- Unlikely that a UBF would accept transfer of such a CRA because that would make it subject to valuation
- On liquidation amounts to the credit of such CRAs must be released and no further claim will lie once deregistered pursuant to liquidation

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The way forward (cont)

Current situation is untenable-

- Surplus unclaimed benefits are static capital and should be released into economy
- Waste of expense of maintaining records, expending energy on hopeless task of looking for untraceable former members
- Trustees should be focused on benefits for existing members

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The way forward (cont)

Clear that legislation is needed to resolve the outstanding issues which are:

- Clarify whether estimated minimum benefit top ups fall within s 15B(4)(a) or not
- What to do with untraceable surplus unclaimed benefits –
  - What are the criteria for this?
  - Transfer to central UBF or not?
  - Revert to the fund to meet deficit, or allocate as surplus and if so to surviving members and former members of s 15B SAS and employer?

THANK YOU

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