

EXAMINATION

22 September 2008

Subject SA4RSA — Pensions and other Benefits Specialist Applications

EXAMINERS' REPORT

Introduction

The attached subject report has been written by the Principal Examiner with the aim of helping candidates. The questions and comments are based around Core Reading as the interpretation of the syllabus to which the examiners are working. They have however given credit for any alternative approach or interpretation which they consider to be reasonable

Comments

The solutions contained in this document are more detailed than what would typically be required for a clear pass. Any relevant points made by candidates were given full marks, even if they are not contained in the solutions presented below.
Further comments are given in the solutions presented below.

Question 1 - comment

The candidates, in general, showed little knowledge of the fundamental equations and processes of actuarial science. Only on the simplest of tasks, the investment return, were the candidates comfortable, but not even half of them answered that satisfactorily. With one exception, the candidates could not find appropriate expressions for the liabilities or assets in question 1(ii).

In sub-part (c) of question 1(iii), some candidates felt that the approximation had not allowed for decrements (which incidentally had been close to the allowance therefor in the basis). This was obviously incorrect. More to the point was that the approximation had included the cost of benefits on death and withdrawal.

In question 1(iv) the candidates did not, in general, sufficiently address the issue of the risks associated with the various policies. They had some ideas about the weaknesses in the pension increase policy, but no one answered the remaining part of question 1(iv) well.

Question 1 - answer

(i) *Net investment return in year t for Fund A as a whole*

$$(a) \quad r_t = I_t / [A_{t-1}^T + 0,5 \cdot \{C_t^r + C_t^v - L_t - P_t - E_t^a - E_t^p\}]$$

$$(b) \quad r_1 = 99\,070\,000 / [459\,470\,000 + 0,5 \cdot \{9\,870\,000 - 2\,505\,000 - 15\,100\,000 - 230\,000\}] \\ = 21,75\%$$

(ii) *Derive formulae to show how you would determine the surplus accounts at t=1, t=2 and t=3, before any improvement in the accrual rate or any award of bonus*

Assets - actives

$$A_t^a = (1+r_t) \cdot A_{t-1}^a - V_t^n - S_t^n + (1+r_t)^{1/2} \cdot [C_t^r - L_t - E_t^a]$$

Assets - pensioners

$$A_t^p = (1+r_t) \cdot A_{t-1}^p + V_t^n + S_t^n - (1+r_t)^{1/2} \cdot [P_t + E_t^p]$$

Assets - employer

$$A_t^e = (1+r_t) \cdot A_{t-1}^e + (1+r_t)^{1/2} \cdot C_t^v$$

Liabilities - actives

$$V_t^a = [(1+i) \cdot V_{t-1}^a + (1+i)^{1/2} \cdot \{C_t^r - L_t - E_t^a\} \cdot [(1+e_t)/(1+s)] - V_t^r$$

Liabilities - pensioners

$$V_t^p = [(1+i) \cdot V_{t-1}^p - (1+i)^{1/2} \cdot P_t] \cdot [(1+j_t)/(1+u)] + V_t^n$$

Surplus – actives, pensioners, employer and total

$$S_t^a = A_t^a - V_t^a$$

$$S_t^p = A_t^p - V_t^p$$

$$S_t^e = A_t^e$$

$$S_t^T = S_t^a + S_t^p + S_t^e$$

- (iii) As at 31 August 2008 derive formulae for (a) and (b) below to determine the cost of:
- (a) increasing the accrual rate from 1,3% to 2% for pensionable service over the last three years; and
 - (b) awarding a 10% bonus to accrued pensionable service and pensions in course of payment.
 - (c) Outline two shortcomings in your estimate of (a).

(a) Accrual rate improvement cost = cost_a

$$\begin{aligned} \text{cost}_a = & (0,7/1,3) \cdot [(1+i)^{5/2} \cdot [C_1^r - E_1^a] \cdot \{(1+e_1) \cdot (1+e_2) \cdot (1+e_3)/(1+s)^3\} \\ & + (1+i)^{3/2} \cdot [C_2^r - E_2^a] \cdot \{(1+e_2) \cdot (1+e_3)/(1+s)^2\} \\ & + (1+i)^{1/2} \cdot [C_3^r - E_3^a] \cdot \{(1+e_3)/(1+s)\}] \end{aligned}$$

(b) Bonus award to active members = cost_b and to pensioners = cost_c

$$\text{cost}_b = 10\% \cdot [V_3^a + \text{cost}_a]$$

$$\text{cost}_c = 10\% \cdot [V_3^p]$$

- (c) One area for error in the estimate of the cost of the accrual rate improvement is that it makes no allowance for the difference between the reserves released on retirement and the reserves required for new pensioners. Another area is that the estimate includes the cost of death in service and withdrawal benefits in respect of the three years of service.

- (iv) *Discuss the risks associated with the pensions increase policy, the rule that governs the improvement in the accrual rate and the rule that governs the award of bonus service and bonus increases to pensions.*

The risks are interrelated and some points can be made for each aspect (but no point can count more than once). The following sets out points under headings for clarity.

Pension increase policy

- The policy is to grant increases at the full rate of the increase in CPI;
- The Fund holds the PMA for the pensioners which is to be debited when the investment return is not sufficient to meet the cost of an increase;
- And the PMA is credited when the return is more than adequate;
- While no bonus award can be made that would reduce the PMA below 10% of the value of the liabilities of pensioners;
- the same is not true of ordinary annual pension increase;
- Moreover, there is no mention of how the cost of improvements in longevity in excess of the valuation allowance would be met;
 - If such cost would also be debited to the PMA;
 - then over time this could prove to be a significant strain;
- Also, a sharp fall in asset values in one or more years;
 - might leave the cost of the pension increase uncovered;
- It might be advisable to change the pension increase policy;
 - to allow for affordability;
 - or for the employer to meet cost when PMA unable to do so;
 - by direct contribution
 - otherwise the employer surplus account would have to be debited.

Accrual rate rule

- It is stated that the trustees, on the advice of the actuary, must determine that the balance in the employer's surplus account is of a sufficient size;
- The employer appointed trustees might have a very different view of a sufficient size from the member elected trustees;
- As the former would have the final say in the matter of the employer's surplus, it is possible that they might require a very substantial surplus;
 - with the consequence that improvements in the accrual rate might take place very rarely;
- But immediate past experience shows that the accrual rate had been raised to 2% for all service to 31 August 2005;
 - leaving an employer's surplus of under 8% of the value of the liabilities;
 - suggesting that the employer elected trustees may not have been sufficiently cautious;

Pension bonus rule

- While no bonus award can be made that would reduce the PMA below 10% of the value of the liabilities of pensioners;
 - there is no indication of an upper limit in a year when the investment return is very high;
 - and no smoothing mechanism has been mentioned;
- Moreover, one or more poor investment years could seriously deplete the PMA;
 - whereas there is no suggestion that past bonuses could be withdrawn;
 - which in any event would be very unsatisfactory from viewpoint of pensioners;
- The investment return data shows high volatility;
 - which indicates that the Fund probably has a significant equity exposure;
- Therefore, a level of 10% of liabilities for the AMA and PMA is probably not sufficient to ensure solvency;
- And trustees should consider matching issues.
- Albeit that in event of difficulties the employer surplus account is also available;
- Indeed would be accessed at same time as members account.

Bonus service rule

- The considerations in regard to the PMA apply mutatis mutandis to the AMA;
- However, with bonus service it might be less objectionable to have a rule that allowed accrued bonuses to be reduced, if necessary;
- Of course that could be seen as unfair;
 - if pensioners retained their bonuses;

General comment

- So long as assets and liabilities are unmatched there is no level of surplus that will suffice in all circumstances to protect a fund, its membership and the employer.
- Although one could determine levels of surplus that might have very low probabilities of becoming exhausted;
- In association with different asset allocations;
- The problem, of course, especially in regard to the accrual rate is that a higher equity allocation is going to be required;
 - if sufficient profits are going to be earned to permit the continuation of improvements on an ongoing basis;

- with the implication that a rather substantial employer's surplus account is going to be required;
- to effectively subsidise normal contributions;
- or a higher level of normal contributions will be needed;
- [Examiners: next five points express valid alternative approach to previous five. Exercise care not to award duplicate marks.
 - Cost of 2% accrual is over 50% more than cost of 1,3% accrual;
 - Whereas employer's additional contributions have averaged only 9% more;
 - With implication that "aggressive" investment policy required to achieve 2% accruals;
 - But significant risk that such a policy would not suffice;
 - To subsidise normal contributions]
- The overall level of surplus as at 31 August 2005 was just under 18%
- And even though the excess over 10% in the members' account;
 - is governed by the rules;
 - it is available for solvency purposes;
 - in that Act specifies that the whole of employer's and members' accounts must be proportionately reduced in event of a shortfall
- The 10% is subject to risk of high inflation in combination with low investment returns;
 - and as mentioned to improving longevity;
- And as already observed the employer's surplus was under 8%;

Question 2 - comment

Candidates seemed to lose sight of fact that some form of pension provision was obligatory - state, private DC or umbrella DC

Hence there was little merit in exploring issues that did not focus on these choices.

Candidates spent too much effort on extraneous issues which might have been valid under other circumstances, but not in the context of this question.

Candidates asked about comparative tax advantages when the question stated clearly that tax issues were the same for each option - candidates must read question and make notes in the reading period before exam commences.

In question 2(i) candidates were asked to list issues they intended to investigate. Some candidates confused this with listing advantages & disadvantages which was a part of question 2(ii).

When asked to list issues, a candidate should avoid going into a detailed response on any particular issue.

Some candidates seemed to have a false idea of how the financial soundness of a DB fund is managed – the thinking seemed to be that surplus could not be retained in fund as part of management process

Candidates failed to comment on fact that career average and defined contribution funds are similar in certain respects

And they failed to comment on fact that the revaluation process was subject to affordability. This in a certain sense strengthened the similarity between the State arrangement and the DC arrangements because the career average plan gains from a revaluation process if investment return is sufficient to meet cost of revaluation. Candidates did not observe that State Fund was funded as compared with a pay-as-you-go arrangement - thus risk was further muted. Candidates seemed to see the risk in the DB arrangement but not in the DC arrangements and generally failed to note that the revaluation process was subject to affordability. However, some candidates did answer question 2(i) well and only two did poorly on it. And half of the candidates identified the advantages and disadvantages of umbrella arrangements in question 2(ii). But on the more testing question 2(iii), the candidates were found wanting.

Question 2 - answer

(i). List the issues you intend to investigate.

(a) In respect of the State fund

- Rules of the State fund
 - its benefits and pension increase policy
- Taxation of benefits and deductions in respect of contributions
- Matters relating to foreigners
- Past valuation reports
 - solvency level
 - membership profile
 - method and basis of valuation
 - history of the actual demographic experience
- The fund's investment managers
 - asset allocation
 - investment return history
 - nature and frequency of investment reports
- Consumer price index history
- The fund's administrators
 - nature and frequency of administration reports
 - service levels

(b) In respect of private fund and umbrella arrangements

- Investigate what client's competitors, other foreign investors, and local companies do and why
- And what they've done with their foreign employees
- What is the calibre of
 - local employee benefit firms
 - local pension fund administrators and
 - local asset managers
- What are their fee arrangements

- Who are the providers of umbrella arrangements
 - what is the range of products
 - and investment options
 - scale of fees
- Which insurers operate in this country
 - and what is their financial standing
 - and service delivery
- What arrangements exist for the conversion of defined contribution lump sums into pensions

(c) General

- Investment markets – nominal & inflation-linked bonds and equity
- Economic outlook – GDP growth
- Inflation outlook
- HIV/AIDS statistics / data for this country

(ii). Outline the advantages and disadvantages of using an umbrella pension fund instead of a private pension fund.

(a) Umbrella fund advantages:

- As a generalisation, an umbrella fund is more suited to small employers
 - Off-the-shelf package possibly appeals to small employers
 - Administration fees will be lower due to economies of scale
 - As will cost of preparing annual financial statements
 - Significant human resource time is saved - no member or employer trustees
 - Thus no trustee training programmes required
 - No onerous fiduciary responsibilities assumed because the umbrella will have a professional board of trustees
 - Employer can focus on its business
- Whereas these might not be important issues for larger private funds

(b) Umbrella fund disadvantages:

- Not suitable for an employer who wants close control over retirement fund arrangements
- The employer will not be identified with the fund as clearly as applies with a private fund
- And while no member and employer trustees, the employer will need a “committee” within his company that understands matters
- And which can act as liaison between members and fund
- Even if employer not required to have a satellite board of trustees to liaise with umbrella fund’s board
- If unhappy with the arrangement, for whatever reason, a switch to another umbrella fund might be only solution

- Which represents a major step for what might be an issue that could have been resolved easily within a private fund
 - And this has cost implications
 - Possibly less flexibility in terms of benefit design
 - Umbrella trustees will choose the available menu of investments
 - But a small private fund might find difficulty in offering a suitable array of investment choice to its members
 - Some umbrella funds restrict the investment menu to portfolios managed by an investment manager associated with the sponsoring insurer
 - Some umbrella funds restrict the choice of risk insurer to an insurer associated to the sponsoring insurer.
- (iii). Discuss the main factors that have influenced your choice between the State fund, a private pension fund and an umbrella fund

(a) State vs private or umbrella

- The State fund is a defined benefit fund putting the employer at risk of increasing contributions due to adverse experience relative to the actuarial basis
 - The participating employer does not have control over much of this risk, including salary escalations, cross-subsidies between employers, and longevity
 - But good experience could result in a reduction in employer contributions
 - Whereas in a private or umbrella fund members assume the investment, mortality and expense risk.
- The State fund pension is based on career average earnings
 - This type of defined benefit is more comparable to a defined contribution arrangement than a final average salary scheme would be
 - But members in a defined contribution fund would to some extent still bear the risk of salary escalation that is in excess of price inflation
 - However, because the State fund provides for revaluation of each year's salary
 - Subject to affordability in terms of investment earnings
 - The likely end benefit might not be very different from the end benefit under a defined contribution fund
 - Although even in a career average fund there is some degree of cross subsidy from younger member to older
- The State fund is funded, as opposed to pay-as-you-go, and therefore more secure than many other state funds.
 - However, employers may terminate participation in respect of new employees
 - And an increase in required employer contributions could also lead to the withdrawal of employers from the State fund for new employees
 - Such withdrawals might impair the solvency of the State fund
 - Which in turn could threaten benefit security.

- In a private pension fund or umbrella fund there is some admin risk (e.g. misallocated contributions or investment returns).
 - And private insurers may look to include substantial margins to cover the longevity risk of pensioners.
 - Members' perception/preference in regard to benefits from the State fund or from a private or umbrella fund should be assessed.
 - The private or umbrella pension fund's fixed member and employer contributions may fit better into the company's remuneration strategy. Cross-subsidies are avoided.
 - A defined contribution arrangement might sit more comfortably with shareholders.
 - Who may even prefer to pay the additional 1% for the extra flexibility and guaranteed contribution rate.
 - A private or umbrella fund will require trustees which incur direct and indirect costs.
 - The State fund would not permit an employer to design specific benefits for his staff.
 - Whereas a private or umbrella fund permits employer to decide on allocation of contributions between saving and risk benefits
 - And within risk benefits on the type of benefit
 - A private or umbrella fund also provides opportunity to give views on investment matters
 - Also there may be a choice of acceptable service providers (admin, investments, insurers).
 - But this flexibility costs more.
 - Especially for a small private fund
 - Profit margins of service providers to private and umbrella funds will further dilute the money available for retirement saving
 - The employer can contribute more to a private or umbrella fund if it wants to ensure adequate pensions or enhance its competitiveness in the eyes of potential employees.
 - Additional voluntary contributions might be better accommodated in a private or umbrella fund.
 - The State fund will also have costs but it is possible that these are met by the State
 - But if not, the State fund has more members and therefore enjoys greater economies of scale.
 - Although the State fund's risk profile may be more exposed to HIV/AIDS.
- (iv). Set out the issues in respect of any foreign employees.
- The State fund does not permit foreign residents/employees to join.
 - Thus if defined benefits are required, the foreigners (SA employees employed in Country X) would need to be accommodated in SA. [As alternative answer: A solution would be required outside Country X if DB required for foreigners.]

- While foreigners are excluded from State fund, we would need to clarify what regulations apply in regard to their membership of a private or umbrella fund or external arrangement.
- Moreover, there are foreign exchange risks for any foreign member of a private or umbrella fund in Country X on repatriation of benefits to South Africa.
- And possibly taxation difficulties.
- It may be advisable to employ foreigners in a clearly defined (temporary) capacity to avoid compulsory membership of a private or umbrella fund.
- But, difficulties could emerge in obverse case of any foreigner who eventually settled in Country X.
 - He would have exchange risks if his benefits to that time had been funded in South Africa or elsewhere outside Country X.
 - And there could be taxation issues.

Question 3 - comment

Some candidates showed poor knowledge of the Act and some confused apportionment of surplus after the surplus apportionment date with surplus apportionment as at the surplus apportionment date. Three candidates failed to score at all on question 3(i), which was largely knowledge based.

Candidates did not answer question 3(iii) well. Instead of looking for the various ways the company could gain access to the surplus, candidates spent their efforts discussing other issues. And again did not address risk issues satisfactorily.

In question 3(iv) candidates gave insufficient discussion on relevant matters of transfer values in the particular circumstances of the question. And it seemed that they did not appreciate fully the reserving process, or that it would be difficult, if not impossible, to justify transfer values at less than the full actuarial reserve. While the fund had clearly been incurring losses regularly over a long period of time, no candidate mentioned the matter of the allowance for salary increases which is unnaturally constrained in PF117. Thus no candidate suggested that the losses might have been attributable in the main to inadequate provision for salary increases. Only one candidate suggested looking at a “buy-out” basis. And only one candidate thought that the matter of a future service shortfall should be considered. No candidate considered the possibility that the basis should be strengthened. And no candidate felt that the basis might need to be updated for changes in economic conditions since January 2008.

Only one candidate was able to discuss the matter of voluntary and involuntary transfers to a creditable level in question 3(v).

The candidates did very poorly on the final part. The question called for the objectives to be identified and discussed. Some were able to identify one or two objectives, but the discussion as to whether the proposals might achieve the objectives was not developed.

Question 3 – answer

(i) Two methods as per 15C are:

- Rules determine split between member surplus account and employer surplus account
- Determined by Board at the time.

Advantages of rules determining:

- Registered rule brings certainty.
- The resultant certainty possibly minimises the risk of members' expectations becoming unreasonable.
- Minimises and possibly eliminates the risk of trustees having to exercise discretion.
- Especially the risk of poor decisions by unknown future trustees.
- Reduces the risk the trustees will act primarily in the interests of their own constituencies rather than in the interests of the fund.
- And thereby reduces, and possibly eliminates, the risk of stalemate or the need for arbitration.

Disadvantages of rules determining:

- Binds trustees to a certain course when flexibility could be desirable in certain circumstances.
- Unless some provision for judgement incorporated within the rule.
- Not possible to consider all possible future scenarios when drafting the rule.
- Practical difficulty of amending the rule because board of trustees usually 50/50 split between member-elected and employer-appointed representatives.

Note to examiners: Advantages of method 1 could be listed under disadvantages of method 2, and vice versa. Only award marks once.

(ii) S15E lists the ways for employers to access moneys residing in the employer surplus account:

- Contribution holiday in Fund XYZ
- Payment of pensions in lieu of employer post-retirement medical scheme subsidies (if applicable).
- Meeting expenses employer must pay in terms of rules.
- Transferring to a similar employer surplus account in the defined contribution fund (and then used in one of more of these listed ways).
- Payment to employer on liquidation of fund XYZ.
- Payment to the employer to avoid bulk retrenchments.
- Improving benefits to members of Fund XYZ.
- Transfer to member surplus account in Fund XYZ.

- (iii) As regards methods that should be considered in the case of Company XYZ.
- Full contribution holiday in Fund XYZ should continue as long as there are contributing members remaining in the Fund.
 - It might be possible to reimburse the employer for costs that it incurs associated with Fund XYZ.
 - Although a rule amendment might be required.
 - Transfer a significant portion of the employer surplus account to a similar account in the defined contribution fund.
 - Which should be possible in the circumstances
 - Especially considering that the requirements of S15E.(2) appear to be satisfied.
 - But the rules of the defined contribution fund would need to be amended to create an employer surplus account in that fund.
 - A full contribution holiday could then be enjoyed in the defined contribution fund.
 - An option is to consider liquidating Fund XYZ.
 - But the liquidation route is costly and time-consuming.
 - Although the costs are not significant compared to the R120 million balance in the employer surplus account.
 - Control over the employer surplus account is then handed to an independent liquidator subject to the rules and legislation.
 - And Company XYZ would need to be sure that the rules are worded sufficiently tightly to protect its' interests in advance of the liquidator being appointed.
 - The liquidation route would be facilitated if the vast majority (or preferably all) of the remaining members agree to transfer to the defined contribution fund.
 - Transferring members to the defined contribution fund will not in itself accelerate Company XYZ's access to the employer surplus account.
 - Benefit restructuring could also be considered e.g.
 - Move unapproved insured benefits into either or both funds as approved cover so as to enjoy a greater contribution holiday each month
 - But need to consider tax impact on insured benefits and premiums.
 - Or make funds non-contributory with a corresponding increased employer contribution rate (extra 7% of salaries can be enjoyed as an employer contribution holiday).
 - Or increase employer contribution to defined contribution fund (e.g. partially in lieu of general salary increases).
 - But beware that the reasons for such a change could easily be lost in the sands of time.
 - Or flexible additional employer contribution categories within a cost to company remuneration structure.
 - But flexibility will be limited by the need to consider maximum tax-deductible levels.
 - Important to take specialist legal advice prior to implementation given the quantum in the employer surplus account.

(iv) Possible transfer values:

- The registered rules must be considered as a starting point.
 - Noting that these can be amended in advance of any transfer offer if deemed desirable to do so.
- The legislated minimum benefit is the absolute minimum permitted in law.
- But in practice it may not be possible to obtain the Registrar's approval for a bulk transfer at less than full actuarial reserve.
 - Especially given the strong financial position of the Fund.
 - Moreover, the valuator has to certify that the transfer fully recognises the rights and reasonable benefit expectations in respect of accrued service.
- We would need to consider whether to use the basis employed for the statutory actuarial valuation as at 1 January 2008.
 - Or that basis as updated for changes in economic conditions subsequent to that date.
 - It would be most reasonable to update the economic assumptions to reflect current nominal and real interest rates.
 - Especially considering that minimum benefits would in any event require updating to reflect current market conditions.
- The valuator would need to consider whether the basis should be strengthened.
 - Because bulk transfer terms and conditions might not have been a priority issue in setting the basis for the statutory actuarial valuation.
 - In particular the strains that have arisen over the recent valuation periods are likely to be salary related.
 - Post-retirement mortality should be updated to reflect any mortality improvement trends not already allowed for.
- Many would argue that a solvency reserve should be determined and added to transfer values.
 - As compensation for the investment risk being transferred to members upon transfer to the defined contribution fund.
- Or that a buy-out basis be used to compensate members for a life office's margins when members ultimately purchase annuities.
- The benefits under Fund XYZ are very good,
 - And future service accrual in Fund XYZ will require a much higher employer contribution rate than the 12% defined contribution rate.
 - Which means there is a case that transferring members should be compensated for the present value of this future service shortfall.
 - Noting that the remaining members would have cross-subsidised older members in the past, and will not in turn enjoy such a subsidy after transfer to the defined contribution fund.
 - Although another method would be to create a category of membership in the defined contribution fund with a higher employer contribution rate.
 - But this could be problematic because it would highlight the differentials between different employees.
- Enhancements to any of the above reserve values could be considered to entice members to accept the transfer offer.

(v) Voluntary or compulsory transfer:

- A voluntary transfer offer is always safest to protect from the possibility of legal comeback.
- Although this would only be the case if the pros and cons of transfer are properly explained so that members are in a position to make informed decisions.
- It should be noted that consultation with members is required even in the case of a compulsory transfer.
- In this case, we are dealing with a closed group who specifically declined the 1999 transfer offer.
- And who are long-serving and presumably loyal employees.
- These considerations lean in favour of a voluntary offer.
- A compulsory transfer will most likely cost more as there would be a greater onus to ensure members are not prejudiced by the transfer.
- But a voluntary transfer could also require the use of enhancements as an inducement to members to transfer.
- The danger of a voluntary transfer is that the employer will be left with a very small and unviable residual defined benefit fund.
- Although this is possibly not a serious drawback in the context of a R120 million employer surplus account.
- A variation is to make the transfer voluntary, but to impose a condition that all members will be compelled to transfer should more than x% elect to transfer.
- But legal guidance should then be sought as to an appropriate minimum percentage in the specific circumstances.

(vi)

- The employer surplus account grew threefold in less than 8 years despite a full employer contribution holiday over the period and despite funding experience strains.
- This is hardly a poor return over the period.
- Although past returns are not a reliable guide to future returns.
- If, however, this is the concern, then Company XYZ could consider a different investment strategy for the employer surplus account.
- The financial director is correct in the sense that manufacturing companies are not in the business of investing in pension funds and balanced portfolios.
- And those shareholders who desire such investments could acquire these directly.
- Although possibly not as tax efficiently.
- There are mechanisms to manage employer risk in a defined benefit fund:
 - The investment strategy in respect of the balance of the Fund's assets could also be moved closer to a matched investment strategy.

- Although it is accepted that perfect matching is not possible particularly in respect of salary increases.
- Although on the other hand the employer has control over salary increases.
- But such action carries risk that it could be deemed an unfair business practice, and it could back-fire on the employer.
- Liquidation would be best option if the objective is to bring the surplus into the company
- For cash flow purposes or capital projects
- But closing down the defined benefit fund will most likely cost Company XYZ as a consequence of the need to offer enhancements.
- Although enhancements might in any event be necessary as an inducement in a voluntary transfer.
- Company XYZ might have to borrow money at high interest rates to fund its liquidity requirements.
- And so it could consider borrowing money from the employer surplus account subject to the restrictions of Regulation 28.
- Which might make this an ineffectual means of accessing the surplus
- Optimising company XYZ's return on capital is not an actuarial issue, and specialist advice should be obtained.
- Transferring all members to the defined contribution fund will assist the human resources director to implement more flexible remuneration arrangements.
- But such flexible arrangements could in any event be implemented for the balance of employees who represent the substantial majority of the workforce.
- In summary, the proposed changes could help achieve some, but probably not all, of the expressed objectives

Another approach to answering question 3(vi)

1. One objective is to improve return on capital
2. and a reduction in contributions in DC fund or investment of surplus, might help
3. but we have no information on DC fund contribution requirement
4. Another objective is to avail company of maximum amount in employer surplus account
5. an arrangement (liquidation or transfer) that involves the likely need to enhance a member's transfer value will absorb surplus
6. and thus might not produce optimum amount for employer
7. But liquidation is final and means there can be no residual risk in future of managing DB fund benefits
8. giving employer the comfort of certainty in regard to risks - other options uncertain in that regard
9. If DB fund continues there could be a drain on surplus in future to match experience losses as in recent past
10. and so under that scenario there might be no more surplus - via contribution holidays - available to employer
11. moreover, if surplus is transferred into an employer surplus account in the DC fund that would weaken DB fund
12. and possibility of a shortfall emerging in DB fund would be that much greater

13. which could then give rise to need for funding from employer to eliminate shortfall
14. or lead to liquidation of DB fund if employer was unable or not prepared to fund shortfall
15. but even then, if shortfall were large on a funding basis, there might not be enough assets to meet minimum benefits
16. in which case employer would have a debt to meet
17. And so while the transfer of surplus to the DC fund might achieve objective of maximum for employer in near term
18. there is risk that in longer term employer would in effect have to return some surplus to DB fund
19. Moreover, a future liquidation of DB fund under stressful conditions would be very bad for staff involved
20. There were clearly other objectives - not wanting to sponsor a DB fund and having uniform employee remuneration
21. the first obviously requires termination of DB plan
22. while for the second, the termination of the DB fund certainly facilitates objective
23. Termination of DB fund in terms of section 28 will incur high costs
24. but these would be small relative to R120 million surplus
25. All things considered, however, liquidation with compulsory transfer to DC fund or other private arrangement, optimal

END OF EXAMINERS' REPORT