



# Toolkit for Risk-based pensions supervision

## Case Study **South Africa**

Risk-based Pensions Supervision provides a structured approach focusing on identifying potential risks faced by pension funds and assessing the financial and operational factors in place to mitigate those risks. This process then allows the supervisory authority to direct its resources towards the issues and institutions which pose the greatest threat.

The IOPS Toolkit for Risk-based Pensions Supervisors provides a 5-module framework for pensions supervisors looking to apply a system of risk-based supervision. A web-based format allows: a flexible approach to providing updates and additions; users to download each module separately as required; and a portal offering users more detailed resources, case studies and guidance. The website is accessible at [www.iopsweb.org/rbstoolkit](http://www.iopsweb.org/rbstoolkit).

This document contains the **South African Case Study**.

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## SOUTH AFRICA<sup>1</sup>

### I. Background

#### A. *Pension System*

Although the main source of income for over 75% of individuals over the retirement age in South Africa is a means tested, social grant (the SOAG), the country also has a well developed occupational pension and private retirement savings system, albeit with a limited coverage of the working population.

Employment based retirement provision, with joint contributions by both employers and employees, may take two forms: pension funds (which must pay out a least 2/3 in annuities with employee contributions tax exempt), or provident funds (paying out in lump sum form with generous tax concessions) – employers often establish both to maximise tax concessions.

Most pension funds are now defined contribution in nature, with the system characterised by a large number of small funds (over 13,000, with more than 50% having less than 20 members). 'Umbrella' funds covering more than one employer are also common. Funds are often managed by professional administrators, with the licensing of service providers therefore being a key role for the supervisory authority.

The pension system operates on a 'trust' basis, with funds having a legal personality separate from the plan sponsor and a management board being responsible for the assets. Quantitative investment restrictions still apply within the country. Personal savings also exist in the form of retirement annuity funds, individual insurance policies, housing and other savings. Problems with coverage and 'leakage' have led to the government proposing reforms for the South African pension system, including the possible introduction of mandatory individual accounts.

#### B. *Risk-based Supervisory Approach*

The pension industry is supervised by the Financial Services Board (FSB), a partially integrated supervisor with oversight responsibilities for all financial services outside banking.

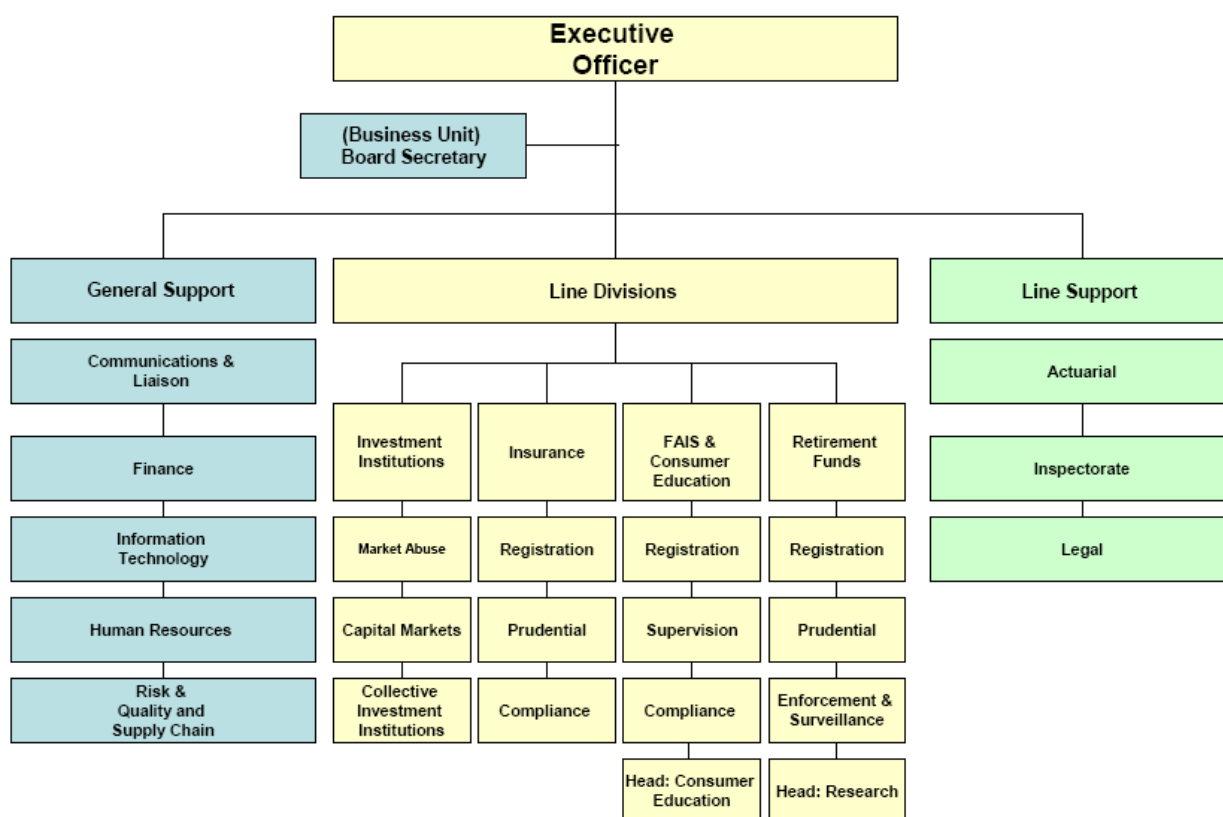
The risk-based supervisory approach of the FSB has been adapted from the Australian model. The FSB uses the same model for all financial institutions, assigning a risk score to each pension fund which then determines the supervisory approach.

In South Africa, the Financial Services Board (FSB) is currently structured primarily along functional industry lines, although, within each functional line, there is a common departmental structure.

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<sup>1</sup> This case study was prepared by the Financial Services Board

Figure 1: The Organisational Structure of the South African Financial Services Board



The line divisions in the middle of the above diagram (The Organisational Structure of the South African Financial Services Board) are the primary functions that interface with the financial service industries:

Table 1: Functions of FSB Divisions

<b>Market Conduct and Consumer Education</b>	Focuses on the business conduct of institutions and the fair treatment of consumers of financial products. As part of its function, the department licenses intermediaries and investment managers.
<b>Investment Institutions:</b>	Monitors the JSE Securities Exchange South Africa, the Bond Exchange of South Africa, houses the Directorate of Market Abuse and supervises collective investment plans or funds
<b>Insurance:</b>	Supervises registered long-term and short-term insurers in South Africa
<b>Retirement Funds:</b>	Supervises pension and provident funds as well as friendly societies

Within these divisions:

- “Licensing and Registration” is responsible for the licensing of new institutions (in the retirement fund department case, this consists of registering new funds and licensing new administrators) and registration of amendments to rules
- “Prudential Supervision” is responsible for the analysis of financial statements filed with the Financial Services Board and liquidations.
- “Compliance” is responsible for all complaint handling, conducting of compliance visits and the management of risk-based supervision.
- “Research and policy” is responsible for conducting of research and the establishment of policy.

The general support and line support departments reporting to the Executive Officer (Communication & Liaison, Risk & Quality and Supply Chain, Finance, Information Technology, Human Resources, Legal, Inspectorate and Actuarial) assist the departments that interface with the industries. In this context the Actuarial Department is unusual in that, with regard to retirement fund transactions, the Actuarial Department, itself, supervises transfers between funds and surplus apportionment, and has joint responsibility with the Retirement Funds Department for the financial soundness of rules. This has created a very close link between the Actuarial and the Retirement Funds departments.

## II. Risk-based Supervision Process

Figure 2: RBS Process



### 1. Risk Focus

#### *Supervisory Objectives*

The vision of the Financial Services Board (FSB) is to promote and maintain a sound financial environment in South Africa. Further, the mission of the retirements fund department is to promote a sound and stable environment for all stakeholders of retirement funds and to ensure proper management and governance of retirement funds that such funds are able to meet their obligations when due.

The processes and procedures in respect of Risk-based Supervision (RBS) attempts to proactively identify and manages possible risks that could have a detrimental effect on the assets of funds thereby

#### *Nature of Pension System*

The Financial Services Board's approach is based on the premises that the responsibility for risk management rest with the board of funds and with the management of the administrator as a service provider to retirement funds. Supervision is done within the ambit of the act, regulations and guidelines

issued by the regulatory authority. Prudential investment guidelines are set out in the regulations stipulating the maximum investment limits in an attempt to ensure spreading of investment risk and counterparty risk.

### *Risk Appetite*

The FSB points out that it is not possible for the regulator to ensure a zero failure objective. Risk-based Supervision (RBS) attempts to identify and mitigate risks as far as possible. However, the RBS process is dependent on the submission of certain information from the retirement funds under its supervision and as these reports are only submitted on an annual basis, the time delay from one reporting period to another could lead to failure of timeous detection and intervention.

## **2. Risk Factors**

### **A. Individual**

An initial rating of institution (*N.B.* the Financial Services Board rates both pension funds and administrative and fund management institutions) will be given based on the following, weighted risk factors.

Due to the large number of retirement funds and administrators supervised, it was not possible for the Registrar to conduct an initial risk assessment for each fund and administrator. Respective Risk Assessment Questionnaires were designed, for funds and for administrators as a self assessment of an initial risk rating. These are electronically submitted. Clients can enter the information, update it, and, once they are happy, electronically sign it. Thereafter the information will not be able to be changed, but will be accessible to authorised Financial Services Board employees. Returns and other information relevant to the interim rating will be drawn from the Registrar's database and the rating will be adjusted accordingly.

The outcome of the risk rating will not be disclosed to funds or administrators but will be used to identify possible high risk or high impact funds or administrators to be subjected to compliance visits.

**Table 2: South African Financial Services Board: Control and Risk factors**

<b>Inherent Risks</b>	<b>Management and Control</b>	<b>Capital Support</b>
Counterparty risk	Board	Current coverage
Balance sheet risk	Senior Management	Earnings
- Investment risk		
- Expenses risk		
Operational risks	Operational management (including systems + service levels)	Access additional capital
Liquidity risk	Risk management	
Legal + regulatory risk	Compliance	
Strategic risk (incorporating contagion risk)	Independent review	

**B. Systemic**

The regulatory authority is not responsible for identifying and monitoring the systemic risk of the financial industry as a whole in South Africa. Within the National Treasury, on a Governmental level there is a financial stability unit which is responsible for this function.

**3. Risk Indicators****A. Quantitative**

The supervisor in South Africa, extracts information from annual financial statements for its risk assessment Early Warning System (EWS), in particular:

- if the audit opinion is negative or the audit report contains a disclaimer;
- if outstanding contributions exceed 15% of total contributions;
- if any bank overdraft exists;
- if there are negative reserve accounts; and/or
- if the pension fund has exceeded the prudential investment limits.

**B. Qualitative**

The initial risk rating is adjusted continuously based on specific risk criteria, which include amongst others, the non-submission of statutory returns, qualifications in the financial statements, complaints received, determinations by the pension funds adjudicator, etc.

**Figure 1.**



**Table 3: FSB Risk Ratings for Administrators -**

It should be noted that the relevant risk rating of an administrator will have an impact on the overall risk rating of all funds under its administration

	<b>Probability rating</b>	<b>Impact rating:</b> <i>Asset value under administration:</i> 1 = < \$67 Million 2 = > \$67 Million < \$134 Million 3 = > \$134 Million < \$1,339 Billion 4 = > \$1,339 Billion	<b>Rating (P X I)</b>
Number of funds under administration	1 = 0 - 24 funds 2 = 25 - 49 funds 3 = 50 - 499 funds 4 = 500+ funds		
Number of outstanding financials statements under administration as % of total funds under administration	1 = 0 - 5% 2 = 6 - 15% 3 = 16 - 50% 4 = 51 - 100%		
Number of outstanding valuation reports under administration as % of applicable funds	1 = 0 - 5% 2 = 6 - 15% 3 = 16 - 50% 4 = 51 - 100%		
Number of outstanding regulation 2(e) certificates as % of applicable funds	1 = 0 - 5% 2 = 6 - 15% 3 = 16 - 50% 4 = 51 - 100%		
Number of outstanding surplus submissions under administration as % of total funds under administration	1=0 - 25% 2=25 - 25% 3= 50 - 75% 4= 75 - 100%		
Outstanding Section 13B returns	1= No 4 = Yes		
<b>Qualifications on audit reports</b>			
- Current assets exceed liabilities	1= Yes 4 = No		
- Liquid assets equal to or greater than 8/52 of annual expenditure	1= Yes 4 = No		
-Unregistered funds	1= No 4 = Yes		
-Fidelity cover not in place	1= yes		

	4 = No		
Complaints on administrator	1= No 4 = Yes		
PFA determinations against administrator	1= No 4 = Yes		
<b>TOTAL NET RISK RATING</b>			

Table 4: FSB Risk Ratings for Pension Funds

	Probability rating	Impact rating: <i>Asset value of fund:</i> 1 = < \$803 313 2 = > \$803 313 < \$6,7 Million 3 = > \$6,7 Million < \$13,4 Million 4 = > \$13,4 Million	Rating (P X I)
Rating of administrator who administer the fund	1 = 0 -40 2 = 41 – 80 3 = 81 -120 4 = 121+ 4 = own administered		
Number of outstanding financials statements	1 = 0 2 = 1 4 = 2+		
Number of outstanding valuation reports	1 = 0 2 = 1 4 = 2+		
Number of outstanding regulation 2(e) certificates	1 = 0 2 = 1 4 = 2+		
Surplus scheme submission	1 = Yes 4 = No		
<b>Early warning – information obtain from latest available financial statements</b>			
- Audit opinion	1 = Emphasis of matter 2 = Modified opinion 3 = Disclaimer 4 = Qualified		
- Bank overdraft <i>Cash at bank/current assets</i>	1 = >1<30% 2 = >30<50% 3 = >50<75%		

	4=>75<100%		
- Arrear contributions <i>Contributions receivable/total contributions</i>	1= 1 month 2= 2months 4=>3months		
-Reserve accounts	1=Total>0 4=Total<0		
- Prior year adjustments	1= No 4=Yes		
- Exceed prudent investment limits (Regulation 28)	1= >0<5% 2=>5<15% 3=>15<20% 4=>20%		
- Exceed 5% investment limit in a participating employer	1= No 4=Yes		
- Arrear contributions + investment in participating employer	1= No 4= Yes		
<b>TOTAL NET RISK RATING</b>			

Table 5: FSB Risk Ratings

	Minimum risk rating	Maximum risk rating	High risk rating <i>Compliance visits will be conducted on all the funds/ administrators with this risk rating or higher</i>
Administrators rating	11	178	81
Fund rating	6	216	80

#### 4. Risk Mitigants

See Management and Control and Capital factors outlined in tables above.

#### 5. Risk Weightings

The weightings within the risk ratings outlined in the table (Risk Ratings) above are fixed.

## 6. Probability

Probability is not considered separately in the Financial Services Board model - *i.e.* the risk rating of the fund reflects the probability of that risk materialising. The probability will depend upon risk factors and the associated weights, using the formula:

$$\text{Probability} = \text{Inherent Risk Score} + (\text{Management \& Control Score} - 3) + \text{Capital Support Score}$$

## 7. Impact

The risk rating of the entities is calculated by Impact X Probability. Impact depends upon size. The possible impact of risk is determined by the total value of the assets of the retirement fund or the total value of assets under the administration of an administrator.

**Table 6: FSB Impact Measures**

Impact rating: Funds	Determine impact rating according to asset value of the fund as at the latest available financial statements (R1 = \$7,47)
1	<= \$803 313
2	> \$803 313 <= \$6,7 Million
3	> \$6,7 Million <= \$13,4 Million
4	> \$13,4 Million
Impact rating: Administrator	Determine impact rating according to asset value under administration of administrator (R1 = \$7,47)
1	< \$67 Million
2	> \$67 Million < \$134 Million
3	> \$134 Million < \$1,339 Billion
4	> \$1,339 Billion

## 8. Quality Assurance

The interim assessment will be communicated to institutions and to other relevant departments within the Financial Services Board who are also responsible for the supervision of the entity, such as the Insurance Department, where an insurer is the administrator, evaluating the results; reviewing the probability and impact ratings and determining the final priority. The final probability and impact ratings will take account of management and control actions and shareholder, capital and reinsurance support. An appropriate supervisory response must be determined. This must be internally reviewed in order to provide overall quality and consistency control.

## 9. Supervisory Response

The Financial Services Board's supervisory response matrix is as follows:

**Table 7: Supervisory Response Matrix of the South African Financial Services Board**

	Low risk	Moderate risk	Significant risk	High risk
<b>Low Impact:</b> <i>funds with asset value &lt;\$803 313</i>	Monitoring incoming data and adjustment of risk assessment	Monitoring incoming data and adjustment of risk assessment	Monitoring incoming data and adjustment of risk assessment	-Compliance visit -Continuous monitoring and reporting -Inspection -Removal of Board -Curatorship -Liquidation
<b>Below Medium Impact:</b> <i>funds with asset value &gt;\$803 313 &lt;=\$6,7 Million</i>	Monitoring incoming data and adjustment of risk assessment	Monitoring incoming data and adjustment of risk assessment	-Monitoring incoming data and adjustment of risk assessment -Communicate with trustees	-Compliance visit -Continuous monitoring and reporting -Inspection -Removal of Board -Curatorship -Liquidation
<b>Above Medium Impact:</b> <i>funds with asset value &gt;\$6,7 Million &lt;=\$13,4 Million</i>	Monitoring incoming data and adjustment of risk assessment	-Monitoring incoming data and adjustment of risk assessment - Communicate with trustees	-Monitoring incoming data - Communicate with trustees - Compliance visit -Continuous monitoring and reporting	-Compliance visit -Continuous monitoring and reporting -Inspection -Removal of Board -Curatorship -Liquidation
<b>High Impact:</b> <i>Funds with asset value &gt;\$13,4 Million</i>	- Compliance visits in 3 years cycle - Assessment done of fund	- Compliance visits in 2 years cycle - Assessment done of fund	- Compliance visits annually - Assessment done of fund	- Compliance visit -Continuous monitoring and reporting -Inspection -Removal of Board -Curatorship -Liquidation

It is intended that only the funds or administrators identified with the highest-risk rating will be told their interim rating and will be given an opportunity to challenge this rating. Funds whose rating is below the threshold will not have their computer-generated interim ratings reviewed. Low priority cases will not necessarily be visited, except perhaps as part of an investigation into a particular aspect of retirement funding practice or regulation, *i.e.* as part of theme work.

Where the fund proposes mitigatory action that is acceptable to the Financial Services Board, and this can be followed up without an on-site visit, (for example, through monitoring the subsequent questionnaire/annual statements/actuarial valuation), the files will be appropriately annotated as to the action required and the relevant department of the Financial Services Board will be informed to watch out for this when the documentation is supplied.

Based on the risk based supervision model, compliance visits are conducted on high risk funds and administrators (*i.e.* with initial risk scores over 80 and 81 respectively) as well as on high impact funds with an asset value exceeding USD13,4 million and high impact administrators with the total value of assets under administration exceeding USD1,339 billion.

During the conduct of compliance visits, amongst others, the following risk areas will be assessed:

**Table 8: Compliance Assessment Areas**

<b>Business Risk</b>	<b>Prudential Risk</b>	<b>Oversight &amp; Governance</b>	<b>Operational Risk</b>
Nature of fund	Solvency risk Cash flow risk Liquidity risk Credit risk Investment risk Insurance risk	Board of Management Corporate governance Culture issues and business ethics Complaints lodge with Registrar Internal audit Litigation risk Quality of risk strategy	Legal risk IT Systems Regulatory Risk

An assessment report will be completed following a compliance visit, taking into account the abovementioned risks areas and would further assess if adequate controls are implemented to reduce or mitigate specific risk areas where after the initial risk rating of the fund or administrator is adjusted accordingly.

## ANNEX: IN-DEPTH EVALUATION QUESTIONNAIRE

	Question	Yes	No	Comment (where Yes or No is inappropriate)
1.	<b>Investment</b>			
1.1	Has the board established and implemented an investment strategy, which is available in writing and which has been signed off by the actuary to the fund?			
1.2	Who manages the investments: (a) An investment manager registered under FAIS other than the sponsor? (b) The sponsor (or a subsidiary of the sponsor)? (c) Fund itself (through a board or a subcommittee)? Kindly give the percentage of total asset value of the fund administered by each.			%
1.3	(a) Is investment performance monitored regularly? (b) Where you do monitor investment performance please rate your investment manager's performance over the medium term on a scale of 1 to 5 (1 being excellent, 2 being very good, 3 being average, 4 being poor and 5 being very poor). Notes - Where the investment manger has managed your investments for less than 5 years, rate the full period for which investments have been managed - Where more than one investment manager handles your investments, please identify the investment manger and provide a score per investment manager.			
1.4	Is the investment strategy reviewed at least once a year?			
1.5	(a) Is there individual member choice over investments? (b) Where so, (1) Is each portfolio in which members can invest compliance with regulation 28? (2) Is there a default portfolio selected or managed by the trustees?			

2.	<b>Administration</b>			
2.1	<p>(a) Is administration performed in-house by the fund itself or by employees or the sponsor<sup>1</sup>, or by a specialist administrator which has been appointed by the sponsor with the primary purpose of administrating this fund?</p> <p>OR</p> <p>(b) Is the administration performed by a specialist administrator, which is independent of the fund or the sponsor?</p> <p><b>Note 1: The sponsor could be the employer, or a trade union in the case of a negotiated fund, or a bargaining council.</b></p>			
2.2	<p>(a) Over the course of the last financial year were there any arrear contributions?</p> <p>(b) Where so,</p> <p>(1) How many months worth of arrear contribution payments were reported to trustees?</p> <p>(2) Kindly express the arrear contribution as a percentage of the contribution collections.</p> <p>(3) Where any of these incidents handed over to the Directorate of Public Prosecutions?</p> <p>(4) Kindly express the amount of late payment interest as a percentage of the late contributions.</p>			
2.3	<p>(a) Has the board received complaints regarding the administration of the fund during the year (which will include benefit payments, answering queries, switching monies between investments and communication to members)?</p> <p>(b) Were the complaints resolved?</p>			
2.4	<p>(a) Is there a signed Service Level Agreement (SLA) between the fund and benefit administrator?</p> <p>(b) Has the board experienced any problems with administrative standards?</p> <p>(1) No, within the SLA</p> <p>(2) Sometimes (but not materially) over and above the SLA</p> <p>(3) Materially over and above the SLA (but you are satisfied with the steps being taken to address the problems)</p> <p>(4) Materially over and above the SLA and you are not satisfied with the steps being taken to address the problems (which should indicate that you will tender for replacement of the administrator as soon as practicable)?</p> <p>(c) Please rate your administrator on a scale of 1 to 5 (with 1 being excellent, 2 being very good, 3 being average, 4 being poor and 5 being so poor that you are intending to tender for replacement of the administrator (this must be completed even when administration is performed in-house).</p> <p><b>Note 2: The SLA is the service level agreement with the administrator which will state time frames within which the administrator expects to perform (such as the making of different types of benefit payment).</b></p>			
2.5	<p>What benefit structure does your fund have?</p> <p>(a) Defined Contribution</p> <p>(b) Defined Benefit</p> <p>(c) Hybrid</p>			
2.6	Has the administrator recently had any problems accommodating the benefit structure within its systems without manual intervention?			
2.7	<p>After the lodgement of the claim, does the fund's administrator settle death claims:</p> <p>(a) within 6 months?</p>			



	(b) between 6 months and 12 months? (c) between 12 months and 18 months? (d) more than 18 months?			
2.8	Is the annual benefit statement compliant with PF Circulars 86 and 90?			
2.9	Were annual benefit statements issued to members/ pensioners?			
2.10	Is there any process in place to ensure that annual benefit statements issued via the employer or intermediary are received by members?			
2.11	Have there been any complaints to the board concerning non-receipt of members/ pensioners benefit statements?			
<b>3</b>	<b>Umbrella Fund and Retirement annuity fund questions</b> (not applicable to ordinary funds)			
3.1	Does the sponsor subsidise the administration and /or trustees costs of the fund?			
3.2	Is the sponsor one of a group of companies which offers various financial services?			
<b>4.</b>	<b>Management and Control</b>			
4.1	Is the fund managed by a board with at least half of the members of the board elected by members of the fund?			
4.2	Does the board evaluate at least once a year: (a) Its own performance? (b) The performance of the Principle Officer? (c) The performance of consultants? (where applicable) (d) The performance of the benefit administrator?			
4.3	Does the board operate by means of a code of conduct which stipulates that the board members act independently of the sponsor and of their constituencies and with a duty to disclose any conflicts of interest?  Note: where the fund has a code but the code or any associated documentation does not required you to act independently of your constituencies and the sponsor with full disclosure of any conflicts of interest the answer is 'no'.			
4.4	Were service providers appointed after a tender process involving competitive quotations?			
4.5	When was the last time the fund's services were put out to tender (in years) – please answer separately for each type of service below: (a) administration (b) investments (c) insurance (d) actuarial (where applicable) (e) benefit consultation (where applicable) (f) investment consultancy (where applicable)  Note: where you do not use any of these services please leave it blank			
4.6	Do you have a contract with each service provider which specifies service levels and /or benchmarks by which the provider's performance will be measured?			
4.7	(a) Does the Principle Officer have the necessary experience? (b) Is the Principle Officer appointed by (1) the board? (2) the sponsor?			
4.8	Is the Principle Officer an employee of the sponsor?			
4.9	Where your fund is administered in-house, is the board satisfied with the information provided to them on service performance?			
4.10	Who developed your system?			

	(a) The administrator? (b) A software house which specialises in the development of administration systems for pension funds? (c) Other			
4.11	Is there any need for manual intervention in order to run your fund?			
4.12	Has the fund arranged adequate fidelity guarantee and indemnity insurance?			
4.13	Has the fund arranged adequate fidelity guarantee and indemnity insurance?			
4.14	Has the board performed a risk assessment exercise?			
4.15	Has the board a risk management programme in place?			
4.16	(a) Are there any indications of fraud being perpetrated against the fund? (b) Where so, how serious is it: (1) not at all serious (2) serious but manageable (3) very serious			
4.17	(a) Has the fund lodged any claims in terms of its fidelity insurance? (b) Has the fund lodged any claims against any service providers which have been settled by the service provider or the service provider's fidelity insurance?			
4.18	Please rate the performance of your (a) auditor (b) actuary (where applicable) (c) benefit consultant (where applicable) (d) investment consultant (where applicable) Please use a score of 1 to 5, with 1 being excellent, 2 being very good, 3 being average, 4 being poor and 5 being very poor.			
<b>5.</b>	<b>Access to additional funding</b>			
5.1	Is the employer able and willing to contribute additional money to the fund to meet any shortfall?			
<b>6.</b>	<b>Financial Intelligence Centre Act (FICA)</b>			
6.1	Are there processes in place to report suspicious or unusual transactions?			



