Eskom
Pension and Provident Fund

PENSIONER INCREASES EXPLAINED

<u>Who decides on the annual pension increase?</u>

The Board of Trustees of the Fund carries the sole responsibility for deciding on the annual pension increase. The Board makes the decision by reaching consensus among the individual trustees, after considering a range of critical factors. The decision is made following a detailed discussion and debate at the formal Board of Trustees meeting every November.

<u>What is “inflation” and why is it important in this decision?</u>

Inflation refers to the increase in the cost of living. The inflation rate is measured at the end of each month (by Statistics South Africa), and results in a measure called the Consumer Price Index or “CPI”. The inflation rate that is understood by most people is the percentage increase in the CPI over the last 12 months. Put simply, it measures the average percentage increase in the cost of living across all households over a year.

When the Trustees make their decision at the November meeting, they refer to the increase in the CPI in the 12 months to the preceding 30 September. This is the latest available measure of inflation at the time of making the decision.

<u>What do the Fund’s Rules say about the annual pension increase?</u>

Rule 32(5) is fairly complicated. It states that on 1 January every year, every pension in payment immediately before that date must be increased by an amount decided by the Board of Trustees, after consulting the Fund’s actuary. This increase must not be lower than 3% if the annual rate of investment return earned on the Fund’s assets in its most recent financial year was at least 6%. If the rate of investment return in the year was lower than 6%, then the pension increase must not be less than 2%.

So in practice:

- if the investment return for the year ended 30 June 2019 was greater than 6%, the 1 January 2020 increase cannot be less than 3%, and

- if the investment return for the year ended 30 June 2019 was less than 6%, the 1 January 2020 increase cannot be less than 2%.

In the year ended 30 June 2019 the Fund’s assets earned less than 6%, and therefore to satisfy the Rules, the January 2020 pension increase could not be less than 2%.

Eskom Pension and Provident Fund

What is the Fund's Pension Increase Policy?

To comply with the law, every Fund must have a written Pension Increase Policy, which aims to award a percentage of the CPI.

The Fund's policy is "*to target, but not guarantee, a pension increase on 1 January each year equal to the year-on-year increase in the Consumer Price Index (as published by Statistics South Africa). If the Fund's investment performance over the period to the preceding 30 June is such that it cannot afford such an increase, the Trustees will grant a lower increase that can be afforded without placing a strain on the Fund".*

So the Fund aims to maintain the full value of every pension by matching the rate of inflation each year. However, the policy of the Fund says that the increase must be restricted to a lower amount if investment returns are low. This is the main "affordability test" that the Fund applies. But, as we explain above, the Rules then specify a certain minimum increase and provides pensioners with a "safety net" in years when the affordable increase is very low or zero.

What else does the law say about pension increases?

In addition to the requirement that all Funds must have a Pension Increase Policy, the law contains extraordinarily complex provisions which must be applied when the pensioner assets in the Fund are sufficient. In very simplified terms, the Fund is required to track the growth of a "notional pensioner accumulation amount" (or NPAA) every three years, and compare it to the value of the Fund's long-term obligations to pensioners. It is a legal measure of "affordability", and is used to determine a minimum pension increase amount. However, we do not consider this further here, because the NPAA is not sufficiently large to influence the decision. However the Fund reviews the position each year (despite the law only requiring this to be done every three years) to ensure that it complies with the law.

How is the pension increase decision made?

The Trustees are bound by the Rules and the Pension Increase Policy as explained above. These are the main considerations, although there are some others which we explain here.

The latest CPI is a most important consideration. The rate of inflation as measured by the CPI at the end of September 2019 was 4.1%. So ideally the Trustees would have wished to grant a 4.1% increase at 1 January 2020. If the Fund could afford this, the decision would have been easy, because it would have satisfied both the Rules and the Pension Increase Policy together. Unfortunately the Fund is not in a position to afford such an increase, because the rate of return on its assets has been too low.

To stay financially sound, the Fund's actuarial and investment management is set up to require average investment returns of at least 4.5% <u>above</u> the CPI, annually. For the last 5 years in a row, investment conditions have been historically difficult, and the investment return has been significantly lower than this. The "smoothed" return which the Trustees use to decide on affordability was only just over 5% per year, which is barely equal to inflation for the same period. There is no reason to expect that investment conditions will not improve in the near future, but in the meantime the Trustees are compelled to act cautiously to protect the Fund's long-term financial soundness.

The affordable pension increase is in fact less than 1%, but of course the pensioners' "safety net" in the Rules specify that the increase must not be less than 2%.

The Trustees therefore decided on an increase of 2% to apply from 1 January 2020.

<u>How does this pension increase compare with previous years?</u>

For the 21 annual increases since 1999, the average increase (6%) has been just higher than average inflation as measured by CPI (5.7%). However this hides a more complex picture. In 14 of the years, the increase was higher than CPI, and in 7 years it was lower than CPI.

In three of the last five years (2016, 2017 and 2019) the increase has been lower than CPI, but the average increase in the same period has been 5.5% compared with average inflation of 5.3%.   The 2% increase in January 2020 will obviously bring the average increase down a bit.

It is impossible to guarantee CPI increases every year, although the Fund certainly aims to award CPI. Some years it is simply not affordable.

<u>Can the Board of Trustees not do more for pensioners in these very hard times?</u>

As the Fund has both active members and pensioners, it needs to carefully balance the interests of all of them and act in an equitable manner. The law states very clearly that the Board of Trustees must "*<u>act with impartiality</u> in respect of all members and beneficiaries; <u>act independently</u>;……., <u>to ensure that the fund is financially sound</u> and is <u>responsibly managed and governed</u> in accordance with the rules and (the law)."*

(The underlining is our emphasis).

So the Trustees cannot favour any class of member above another, and must ensure that the Fund remains financially sound. Being a Trustee is a very difficult job!

However, the Board of Trustees is critically aware that a 2% pension increase is not sufficient to compensate pensioners for the increase in their cost of living in the past year. The Board is especially concerned that it is the lower income households that will be most affected by this decision.

The Board therefore decided to take the extraordinary measure of providing a larger lump sum bonus for December 2019. The payment of a lump sum bonus does not increase the long term liabilities of the Fund in the same way as a pension increase does, and therefore does not have the same impact on the sustainability of the Fund. Additionally, the Fund is able to weight the bonus in favour of lower income households, as it has done for many years. This affords pensioners some relief in compensation for the low pension increase. The Board decided to grant a December 2019 bonus of R7 000, which is nearly 17% higher than the December 2018 bonus. For households receiving a monthly pension of less than R3 500, an additional slice of bonus will be added, on a similar sliding scale as in previous years.

It is very important to understand that the bonus is not guaranteed in the Rules of the Fund, and the bonus formula is currently at the full discretion of the Board of Trustees. Given that the December 2019 bonus is so much larger than the 2018 bonus, there is a high probability that the December 2020 bonus will be smaller than the current bonus.