

DE BEERS PENSION FUND

FUND PRACTICE NOTE

DISTRIBUTIONS TO PENSIONERS

<u>Revision no</u>	<u>Review cycle</u>	<u>Effective date</u>
001	Triennial	7 December 2023



DEFINED BENEFIT



DEFINED CONTRIBUTION

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1. BACKGROUND

1.1. INTRODUCTION

The De Beers Pension Fund introduced a pension increase target, subject to affordability, for in-Fund life annuitants (*"pensioners"*) of 100% of the change in the Consumer Price Index (*"CPI"*) with effect from 1 January 1996. This target was established years before legislation was enacted (in 2001) to compel boards of retirement funds to target increases at a percentage of inflation and to grant increases equal to inflation if they are affordable.

A formal pension increase policy, in terms of Section 14B(3) of the Pension Funds Act No 24 of 1956, as amended (*"the Act"*), also targeting increases of 100% of inflation, subject to affordability, was adopted with effect from 1 March 2004 and was updated and revised in 2022.

The payment of pension increases in excess of inflation and additional ad hoc pension payments (collectively referred to in this Practice Note as *"distributions"*) in each year since 2013 has been possible for a number of reasons, including the prudent financial management of the pensions account and the performance of the investments in the pensions account.

1.2. PURPOSE

The Board will aim to make distributions to pensioners in future, subject to affordability.

The purpose of this Practice Note is to set out the Board's agreed approach for determining a reasonable range for future distributions to pensioners. This approach aligns to the approach used by the Principal Employer to determine whether it will consent to a specific distribution proposed by the Board. The main principle underlying this approach is the *"sustainability"* of future distributions.

This Practice Note should be read in conjunction with the Fund's Pension Increase Policy and the relevant agreement with the Principal Employer.

1.3. DEFINITIONS USED FOR THE PURPOSES OF THIS PRACTICE NOTE

The expressions below have the meanings indicated next to them.

- 1.3.1 ***"Annuity factor"*** means a factor which is used by the Fund Actuary to determine the capital value at a specified date (i.e. the expected present value) of a series of future pension payments.
- 1.3.2 ***"Beneficiary"*** refers to the beneficiary of a DB or DC member in receipt of a pension from the Fund or in the case of the death of such member whilst in service or a surviving spouse / child in the case of the death of a pensioner.
- 1.3.3 ***"Category A employers"*** means De Beers Consolidated Mines Proprietary Limited and De Beers Group Services Proprietary Limited.
- 1.3.4 ***"CPI"*** means the Headline Consumer Price Index for all urban areas, as published by Statistics South Africa.

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- 1.3.5 **“DB member”** includes DB active members, deferred pensioners, deferred members and paid-up members.
- 1.3.6 **“DC member”** includes DC active members and DC deferred pensioners.
- 1.3.7 **“Distribution”** means a pension increases in excess of the pension increase target and / or an additional ad hoc pension payment. In terms of the formal agreement between the Fund and the Principal Employer and the Pension Increase Policy, distributions are subject to the approval of the Principal Employer.
- 1.3.8 **“Pensioner”** means a person in receipt of a life annuity from the Fund, including retirees from the DB and DC member sections and beneficiaries of members or pensioners. References to a “pensioner” for the purposes of this Practice Note specifically exclude those persons in receipt of a living annuity from the Fund and those persons who have elected to receive a pension from an insurance company outside the Fund.
- 1.3.9 **“Pension increase target”** means 100% of the year-on-year change in CPI up to 30 September of the preceding year.
- 1.3.10 **“Pensions account”** means the pool of assets underlying the liabilities and contingency reserves of the Fund’s pensioners.
- 1.3.11 **“Principal Employer”** means De Beers Group Services Proprietary Limited.

2. PRINCIPLES UNDERLYING THE DISTRIBUTION METHODOLOGY

The following guiding principles (or beliefs) underly the management of the pensions account and the model for future distributions to pensioners:

- 2.1 In managing the pensions account, future pension increases and future distributions, the Board’s principal aim is to meet the reasonable benefit expectation of pensioners over the long-term with a high degree of certainty.
- 2.2 Pensions in payment should, at a minimum, keep pace with inflation over time – pension increases in line with the pensioner increase target, therefore, represent a reasonable benefit expectation on the part of pensioners. Such increases are not, however, guaranteed.
- 2.3 The Board should ensure that the assets of the pensions account are, at all times, no less than the value of the liabilities, calculated on the best estimate funding basis (hereinafter also referred to as “the funding basis”). The investment strategy underlying the pensions account is managed in such a way that, only a default by the South African government on the Fund’s government bond holdings could result in the Fund not being able to meet this requirement.
- 2.4 Should the assets of the pensions account be insufficient to cover the liabilities, calculated on the funding basis, the Board will have to take corrective action, including, if necessary, reducing the pension increase target.
- 2.5 In managing the future pension increases and future distributions, the Board should not, under any circumstances, take action which may, on conservative assumptions, result in a future funding obligation for Category A employers in terms of the Fund Rules.

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- 2.6 As a measure of prudence, the Board will target a long-term funding level of at least 100% on the conservative solvency reserving basis – extreme caution should be exercised should the Board consider a distribution in circumstances where such target cannot be met after the distribution.
- 2.7 Pension increases in excess of the pension increase target improve the purchasing power of pensions and should improve the standard of living of pensioners if granted regularly over time.
- 2.8 Pensioners place great value on additional ad hoc pension payments received from the Fund as these payments fund short-term needs and provide relief from unexpected financial shocks to pensioners and/or their families.
- 2.9 If a distribution is affordable, a combination of a pension increase in excess of inflation and an additional ad hoc pension payment is generally desirable over only one or the other of these.
- 2.10 Retaining significant excess assets in the pensions account, on the solvency reserving basis, is not desirable and does not meet the Board's Treating Customers Fairly ("TCF") objectives. Specifically, it results in cross-subsidies for example, between healthy pensioners and those in poor health, between young and old pensioners and between existing and future pensioners.
- 2.11 Smoothing of distributions over time is desirable as this allows the Board to exceed reasonable benefit expectations on a regular basis and also provides the Board with another lever to manage short-term fluctuations in the funding level of the pensions account.

3. DIFFERENT LIABILITY BASES

The Fund has an obligation to pay an agreed pension to each pensioner, either for their lifetime or (in the case of children) for a defined period. The Fund also has an obligation to pay pensions/lump sum benefits on the occurrence of certain contingent events (for example, on the death of a DB principal pensioner). The true value of this obligation at any point in time is unknown. The estimated value of the obligation for each pensioner is referred to as the Fund's liability in respect of that pensioner.

The liability is determined using certain personal information (such as the pensioner's age, gender and the value of his or her current pension) and a number of assumptions. The value placed on the liability will depend on the assumptions used. The greater the margin of conservatism in the assumptions, the greater will be the value of the liability, and vice versa.

For statutory reporting purposes, the liability is determined on the funding basis. In addition to this liability, we recommend that, consistent with past practice, a margin of conservatism is retained in the Fund – the value of this margin of conservatism is determined on solvency reserving assumptions.

A description of the various assumptions that can be used to determine the Fund's liabilities is provided in Appendix A.

A summary of these various sets of assumptions (or bases) is provided below, ranked from the least conservative (i.e. smaller margins of conservatism and lower liabilities) to the most conservative (i.e. greater margins of conservatism and higher liabilities). Only the assumptions highlighted in green are used for statutory reporting purposes.

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Description	Discount rate	Inflation assumption	Mortality assumption
Contractual obligation basis	Includes allowance for equity risk premium	No allowance for future increases	PA(90) table rated down by 1 year
Best estimate basis, adjusted mortality	Includes allowance for equity risk premium	Includes allowance for inflation risk premium	Bespoke table, in line with actual experience
Funding (best estimate) basis	Includes allowance for equity risk premium	Includes allowance for inflation risk premium	PA(90) table rated down by 1 year
IAS19 basis	No equity risk premium used	Includes allowance for inflation risk premium at a reduced level	PA(90) table rated down by 1 year
Market-neutral basis ⁽¹⁾	No equity risk premium used	No inflation risk premium	PA(90) table rated down by 1 year
Solvency reserving basis	Includes allowance for matching costs (negative ERP)	No inflation risk premium	PA(90) table rated down by 2 years

(1) The Board aims to hedge roughly 100% of this liability (discounted value of the expected pensioner cash flows) using appropriate investment instruments.

4. SUSTAINABILITY OF DISTRIBUTIONS

Clause 4(f) of the Fund's pension increase policy states as follows with reference to the smoothing of distributions:

"The Fund will aim to smooth pension increases from year to year (relative to CPI) in order to provide pensioners with greater certainty over time."

Targeting distributions which are sustainable in the longer term is a way of formalising the Board's smoothing approach and codifying the method and level of distributions over time.

4.1 ASSESSING SUSTAINABILITY

Sustainability of future distributions can be seen as the combination of different elements:

- That the same (or a similar level of) "minimum" distribution is targeted in each future year for the remaining expected future lifetime of each pensioner currently receiving a pension from the Fund. The greater the "minimum" distribution, the greater margins of conservatism that should be applied (to be reasonably certain of achieving the outcome), thus allowing for far less discretion or variability over time; or
- Distributions that are targeted in each year in the foreseeable future are weighted so that more is distributed in the short-term versus the longer term. This takes account of the fact that there is already substantial surplus in the pensions account (generated on the assets attributable to the existing pensioners and those who have passed away) and also that

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mortality experience has, over time, been heavier than that allowed for in the Fund's best estimate (funding basis).

The approach adopted by the Board in the past has tended toward the latter. The Board considers it appropriate to continue with this approach in the short- to medium-term.

Considering the above, sustainability of future distributions will be assessed within a range of outcomes. This range will represent varying degrees of conservatism over time.

4.2 DETERMINING THE RANGE

A simple way to achieve a sustainable distribution outcome is to place a value on the excess assets in the pensions account and to divide this by the average annuity factor derived from the pensioner membership at that time.

The result of this calculation represents the initial approximate amount that can be distributed to pensioners in each future year over their (average) expected future lifetime, taking account of expected future pension increases and the other expected experience of the Fund. If experience is in line with expectations (i.e. the specific assumptions used), then this methodology should, theoretically, result in the excess assets being fully utilised toward the end of the lifetime of the pensions account.

The liability (and, therefore the excess assets in the pensions account and the average annuity factor) will differ depending on the assumptions used to calculate it. Using a more conservative basis (such as the market neutral basis) for the above calculation will result in a smaller sustainable distribution than using a more realistic basis (such as the funding basis).

Distributions will, therefore, be made within a range defined by an upper and lower bound, determined as follows:

- **Upper bound:** The amount available for distribution is determined based on excess assets and an average annuity factor determined in accordance with the best estimate basis, adjusted for historical mortality experience. This represents the least conservative (but still reasonable) future set of assumptions. Distributions at this level will only be affordable over the long-term to the extent that all experience is in line with expectations – there are no margins of conservatism whatsoever. Put another way, if all future distributions are implemented at this upper bound and future experience is in line with assumptions, the funding level will tend toward 100% on the best estimate basis, adjusted for historical mortality experience, over the very long-term.
- **Lower bound:** The amount available for distribution is determined based on excess assets and an average annuity factor determined in accordance with the market neutral basis. The Board will always aim to ensure that (roughly) 100% of the market neutral liability is hedged using appropriate instruments in the market, thus making distributions with this as a lower bound sufficiently conservative. Put another way, if all future distributions are implemented at this lower bound and future experience is in line with assumptions, the funding level will tend toward 100% on the market neutral basis, over the very long-term.

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4.3 SOLVENCY RESERVING FUNDING LEVEL

The upper and lower bounds, calculated as set out in section 4.2, will also be subject to a separate test to ensure that the pensions account remains at least 100% funded on the solvency reserving basis after any potential distribution.

Over the long-term, with all else being equal, if distributions are made at the upper end of the range, the solvency reserving funding level will reduce far more quickly than if distributions are made at the lower end of the range. In either event, the aim is to ensure that the solvency reserving funding level reduces to between 100% and 105% over the long-term.

Once the solvency reserving funding level has reached 100% the ability of the Board to make distributions to pensioners will be significantly diminished, i.e. these distributions will only be possible to the extent that surplus is generated in the pensions account from one year to the next (for example, through additional returns generated on the unhedged assets in the pensions account or through unfolding mortality experience which is heavier than that allowed for on the solvency reserving basis).

4.4 DISTRIBUTIONS OUTSIDE OF THE CALCULATED RANGE

The fact that there is a range does not mean that Board cannot, in future, elect to make a distribution outside of that range (subject to the consent of the Principal Employer) – there would, however, have to be good justification to do so. For example, if there is an identifiable one-off event which results in a significant increase or decrease in the excess assets in the pensions account in a particular year, the Board could reasonably motivate a distribution outside of the agreed range.

5. ADDITIONAL PENSION INCREASES VS. AD HOC PENSION PAYMENTS

Setting a range in accordance with that described in Section 4 provides the Board with a way to determine the value of any distribution. It does not, however, provide guidance on how this could potentially be split between a pension increase in excess of inflation and/or an additional ad hoc pension payment.

As set out in Section 2, if a distribution is affordable, a combination of a pension increase in excess of inflation and an additional ad hoc pension payment is desirable over only one or the other of these. The Principal Employer has also expressed a preference for a combination of the two but with a greater weighting to additional ad hoc pension payments rather than pension increases as this would limit the growth of its future defined benefit obligation to the Fund.

As the Principal Employer is required to approve any distribution proposed by the Board, it is appropriate that the Board's approach in considering future distributions takes account of the concerns raised by the Principal Employer.

Considering the above, the distribution will be allocated as follows:

- Where the amount available for distribution results in an (equivalent) affordable total pension increase of less than CPI + 2%, the total amount may be split by the Board in any proportion between a pension increase in excess of inflation and/or an additional ad hoc pension payment; or
- Where the amount available for distribution results in an (equivalent) affordable total pension increase of more than CPI + 2%, the pension increase in excess of inflation will be limited to a maximum of 2%, with the balance of the amount distributed being in the form of an additional ad hoc pension payment.

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6. DECISION MAKING PROCEDURE

6.1 BOARD DISCRETION TO DETERMINE DISTRIBUTIONS

Notwithstanding the affordable distribution and range of options generated by the documented process, at the time of any pension increase decision by the Board, the Board will need to apply its mind as to whether any other factors need to be taken into account in the declaration of the base pension increase, any additional pension increase and any additional ad hoc pension payments.

6.2 EMPLOYER DISCRETION TO DETERMINE DISTRIBUTIONS

Although the consent of the Principal Employer will still be required before any distribution can be implemented by the Board, the Principal Employer has reviewed the distribution methodology documented herein and has confirmed that, all else being equal, it will look favourably on any distribution made in future using the principles and methods documented herein.

6.3 CERTIFICATION BY THE FUND ACTUARY

The Fund Actuary will still be required to make certain certifications in accordance with the provisions of the Pension Increase Policy. Specifically, the Fund Actuary will be required to certify:

- (a) that any proposed distribution is affordable; and
- (b) that on a best estimate basis, the proposed distribution will not have the effect of putting the Fund into deficit or having a negative impact on the long-term viability of the Fund.

If the Fund Actuary cannot certify that any proposed distribution is affordable, the Board will not make such distribution.

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7. AUTHORISATION AND APPROVAL

Any revisions to this Practice Note must be formally approved by the Board of Trustees and the Principal Employer, in consultation with the Fund Actuary.

Approved by the Principal Employer

R Hannie
Chairperson of De Beers Group Service

Approved by the Chairperson of the Fund

C W Coltman
Chairperson of the Fund

Approved by an Employer appointed Trustee

Employer appointed Trustee

Approved by a member elected Trustee

Member elected Trustee

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APPENDIX A: ASSUMPTIONS

A description of the various assumptions that can be used to determine the Fund's liabilities is provided below.

A.1 CONTRACTUAL OBLIGATION ASSUMPTIONS

Should the assets of the pensions account be insufficient to cover the liabilities, calculated on the funding basis (refer to Appendix A.3 for details), the Board will have to take corrective action, including, if necessary, reducing the pension increase target. The pension increase target may, however, only be reduced to nil, i.e. existing pensions in payment may never reduce. Should the assets of the pensions account fall below the value of the liabilities (excluding any allowance for future pension increases), there will be a funding obligation on the employer for the balance.

The contractual obligation basis is, therefore, identical to the funding basis but excluding allowance for future pension increases. This basis is not considered appropriate for the purposes of determining a range of potential future distributions as it represents a catastrophic future outcome where no distributions of any sort will be affordable.

A.2 ADJUSTED BEST ESTIMATE ASSUMPTIONS

The adjusted best estimate basis is derived using the same best estimate financial assumptions (including risk premia), as set out in Appendix A.3. The post-retirement mortality assumption is, however, set exactly in line with the historically observed mortality (based on the most recent mortality investigation conducted) of the pensioner pool. It includes no margins of conservatism and makes no allowance for future improvements in post-retirement mortality or adjustments for the deterioration in experience during the COVID-19 pandemic.

The adjusted best estimate basis is not an appropriate long-term funding basis (for statutory reporting purposes) as it results in a valuation of the liabilities which would require everything to work out exactly as planned in order for the Fund to remain solvent. It is, however, a reasonable basis to use to determine an upper bound for the distribution of excess assets in the pensions account, especially in the short-term.

A.3 FUNDING ASSUMPTIONS (BEST ESTIMATE)

The funding valuation assumptions are set on a "best estimate" basis.

Importantly, best estimate implies that the valuation basis is realistic and has no margins of conservatism included in the individual rates. This means that a valuation basis is adopted such that there is a 50% chance that our assumptions will be either too conservative or too optimistic. To the extent that the Fund is at least 100% funded on the funding valuation basis, the Fund Actuary can confirm that the Fund is in a sound financial condition in terms of Section 16 of the Act.

The financial assumptions used in the funding basis are derived using government nominal and inflation-linked bond yield curves and include an allowance for an equity risk premium and an inflation risk premium.

The mortality assumption used in the funding basis includes an allowance for future improvements in post-retirement mortality relative to the (average) observed mortality experience of Fund pensioners. As such, if mortality experience in future is in line with past experience and future improvements in post-retirement mortality do not materialise, there is a margin of conservatism included in the mortality assumption used in the funding basis.

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A.4 IAS 19 ASSUMPTIONS

As the Fund represents a DB obligation to the employers, the employers must place a value on the obligation for the purposes of reporting under International Accounting Standard 19 ("IAS 19"). The derivation of the assumptions for the purposes of IAS 19 reporting is governed by the standard.

Similar to the market neutral basis (refer to Appendix A.5 for details), no equity risk premium is used to derive the discount rate but an inflation risk premium is used in the derivation of the inflation assumption.

The mortality assumption used is in line with that used in the Fund's funding basis.

In order for the employers to confirm that their DB obligation in the Fund is fully funded, the assets attributable to the pensions account must be at least equal to the liabilities calculated on an IAS 19 basis. As the IAS 19 basis is marginally weaker than the market neutral basis, this should always be the case if the market neutral liabilities remain fully hedged in the market.

A.5 MARKET-NEUTRAL ASSUMPTIONS

The Fund's liability hedging strategy is implemented on "market neutral" assumptions. This means that no risk premia are used to determine the financial assumptions, i.e. these are derived using only government nominal and inflation-linked bond yield curves.

The mortality assumption used is in line with that used in the Fund's funding basis.

In order for the Board to be able to confirm that 100% of the future inflation and interest rate risk has been hedged, the assets attributable to the pensions account must be at least equal to the liabilities calculated on a market neutral basis.

A.6 SOLVENCY RESERVING ASSUMPTIONS

Whilst the best estimate liability represents the funding basis, the Board also considers the financial position of the Fund using a more conservative valuation basis. This more conservative funding basis is referred to as the solvency reserving basis. The reasons for maintaining a solvency reserve are:

- It improves the security of benefits for members and pensioners, including the payment of pension increases in line with the pension increase target; and
- It reduces the chance that the Fund needs to call on the Category A employers to finance a deficit in future.

In deriving the solvency reserving assumptions, no risk premia are used in determining either the discount rate or the inflation assumption. An allowance for discontinuance matching costs are included in the derivation of the discount rate (this operates as a "negative" risk premium).

The mortality assumption used is more conservative than the Fund's funding basis.

The Fund does not need to remain 100% funded on the solvency reserving basis to be considered to be in a financially sound condition in terms of Section 16 of the Act. Notwithstanding the above, the Board will target such a funding level (as a minimum) in order to ensure an additional margin of safety for all stakeholders.

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