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IMPLEMENTATION OF INDIVIDUAL INVESTMENT CHOICE IN A PUBLIC SERVICE DEFINED CONTRIBUTION PENSION FUND

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A research report submitted to the Faculty of Management, University of the Witwatersrand, in partial fulfilment of the requirements for the Degree of Masters of Management (in the field of Public and Development Management).

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Abstract

This report focuses on trends which have occurred internationally and nationally within the retirement fund arena. Various forms of funds i.e. defined benefit (DB) or defined contribution (DC), as well as the possibility of the implementation of individual member investment choice (IMIC), are explored within private, parastatal and public sector funds. Case studies are used to illustrate the problems, successes and failures experienced with the conversion process and implementation of IMIC. All of the above areas were analysed in order to propose an optimal solution for public sector retirement funding within South Africa.

The report concludes that a dual approach is required. It is proposed that the Government Employees' Pension Fund remain a DB fund in the short to medium term, while various forms of modernization occur in order to bring the fund in line with the requirements of the Pension Funds Act as well as to reduce the financial burden on the State. For local government retirement funding, the evidence is inconclusive and an optimal solution can therefore not be proposed at this stage. Recommendations are however made as to the process to be followed in order to introduce a sense of urgency into the matter of finalizing the debate on the optimal future state for local government retirement funding.

I declare that this report is my own, unaided work. It is submitted in partial fulfilment of the requirements of the degree of Masters of Management (in the field of Public and Development Management) in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in any other University.



.....

Colleen Heather Robinson

28 February 2001

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Table of contents

Abstract ii
Acknowledgements iv
Table of contents v
Tables viii
List of Abbreviations ix
CHAPTER 1 – Background to the Research Problem 1
1.1 Introduction 1
1.2 Research Problem and Questions 4
1.3 Structure of the Report 6
CHAPTER 2 - Methodology and Research Limitations 10
2.1 Introduction 10
2.2 Methodology 11
2.2.1 Documentary Research 11
2.2.2 Multiple case studies 12
2.2.3 Participant Observation 15
2.3 Data Reliability 15
2.4 Limitations of Research 16
CHAPTER 3 – The Evolution of Retirement Funds 18
3.1 Introduction 18
3.2 The Great Debate: Defined Benefit versus Defined Contribution 19
3.2.1 Pension Fund versus Provident Fund 21
3.2.2 So which is Best? 21
3.3 Conversion from a DB to a DC fund 24
3.3.1 Risk Transfer 24
3.3.2 Transfer Value and Surplus Ownership 26

3.4 Decisions Leading to the Implementation of Individual Member Investment Choice 27
3.4.1 Investment Risk Transfer Leading to Additional Member Input 28
3.4.2 Sharing Investment Risk 31
3.4.3 Similar Benefits for all Members 32
3.4.4 Managing the Cost of Death and Disability 33
3.5 Changing Roles of the Employer, Trustees, Unions and Members of the Fund 33
3.6 Other Issues to be Considered 38
3.7 Conclusion 39
CHAPTER 4 - Considerations when implementing Individual Member Investment Choice 40
4.1 Introduction 40
4.2 Number of choices and frequency of change 41
4.3 Default portfolio 43
4.4 Correct Asset Allocation 44
4.5 Communication and Education Requirements 45
4.6 Administrative Requirements 47
4.7 Those against Individual Member Investment Choice 48
4.8 Conclusion 49
CHAPTER 5 - Case Study on the Implementation of Individual Member Investment Choice 50
5.1 Introduction 50
5.2 Funds Studied 50
5.2.1 Basis for analyzing respondents 51
5.2.2 Background of respondents 51
5.2.3 Forces leadi[illegible]cisions and processes 57

5.2.4 Costs involved with conversion and implementation.... 59
5.2.5 Options for investment choice 60
5.2.6 Change in focus of the fund, Board of Trustees and the members..... 64
5.3 Conclusion..... 66
CHAPTER 6 – Current Reality: Public Sector Funds **67**
6.1 Introduction..... 67
6.2 Government Employees' Pension Fund (GEPF)..... 68
6.3 Local Government Retirement Funds..... 77
CHAPTER 7 – The Future of Public Sector Retirement Funds: A Conclusion..... **84**
7.1 Introduction..... 84
7.2 Reflecting on the Initial Research Problem and Questions: Some Recommendations..... 87
References..... **91**

Tables

TABLE 1: COMPARISON OF RESPONDENTS.....54

TABLE2: COMPARISON OF ORGANIZATIONS: INVESTMENT PORTFOLIOS.....62

Table 3: OPTIONS PROVIDED FOR MEMBER CHOICE.....63

List of Abbreviations

COSATU	Congress of South African Trade Unions
CJPF	City of Johannesburg Pension Fund
DB	Defined Benefit
DC	Defined Contribution
DCAs	Defined Contribution Arrangements
FSB	Financial Services Board
GEPF	Government Employees' Pension Fund
I & J	Irvin and Johnson
IMATU	Independent Municipal Association Trade Union
IMIC	Individual Member Investment Choice
JMPF	Johannesburg Municipal Pension Fund
JSCOF	Joint Standing Committee on Finance
NRCF	National Retirement Consultative Forum
PF	Pension Fund (s)
PFA	Pension Funds Act (Act No 24 of 1956)
PIGS	Prudent Investment Guidelines
SALGA	South African Local Government Association
SALGBC	South African Local Government Bargaining Council
SAMWU	South African Municipal Workers' Union
SARS	South African Revenue Services
SMS	Senior Management Services
UK	United Kingdom
USA	United States of America

CHAPTER 1 – Background to the Research Problem

1.1 Introduction

The provision of retirement benefits has developed steadily over the years, and has been encouraged by government, as it is in the interest of the fiscus for organizations to ensure that retirement provision is made available for their employees, as well as for people to make their own financial provision for retirement, and thus reduce the burden on the state.

Wedell's quote, on the eve of the new millennium, captures the continuing changing enviro nent within which retirement benefits are found:

> *"The landscape of benefits is bound to change in the new millennium. An increasingly diverse workforce, a shortage of skilled workers, continuing developments in technology are all factors that will produce changes, as are issues such as the return of concerns about health care costs, employees' desire for more control over their benefits and the continuing debate about defined benefit versus defined contribution plans" (Wedell, 1999)*

Many complex issues are arising in an environment where members are seeking increased influence over benefit arrangements, and demanding increased transparency and accountability in the management of their retirement funds. Employers are focusing on ensuring that benefits can be financed within acceptable financial parameters. The Board of Trustees finds itself between these two groups and is responsible for ensuring prudent fund management within an increasingly complex and regulated environment.

Significant trends have been emerging world wide, taking into account the economic, commercial and legal climate. The relationship between employer and employee is also changing, as Mthandazo Moyo of Old Mutual Employee Benefits points out: "Life-time employment in a single company is rapidly giving way to shorter careers with an array of employers, resulting in a focus on short-term benefits and more portable retirement benefits" (Moyo, 1999).

These changes have led to a reappraisal of company benefits, including the manner in which companies provide retirement funding to their staff (Crighton, 1998). For companies to survive in modern times, financial discipline and more precise forecasting of costs and liabilities are essential. This is true in the private as well as the public sector. With many of the local authorities facing bankruptcy in the past couple of years, it is essential for the public service to be able to forecast, with greater certainty, the actual cost of retirement funding for its employees.

The change in approach, in many instances, has led to the introduction of "money purchase" (defined contribution) schemes in place of existing "final salary" (defined benefit) schemes. In 1998, the results of Sanlam's ninth biennial survey indicated that some 25% of defined benefit funds were considering switching to defined contribution funds, this being in an environment where most of the funds in the private sector had already made the transition. This transition is slowly permeating into the local government sector, however the majority of local government funds, as well as the national government fund, are still defined benefit funds. This will be discussed in detail in Chapter 6.

A second trend is the move from pension funds to provident funds, meaning that instead of receiving a pension on retirement, a lump sum is paid to the individual from a provident fund. From one point of view this movement allows for greater control (and responsibility) by the member for his own financial well-being on

retirement. However, Ron Cuthbert (1999 Chairman of the Retirement Association) indicates, this constant move towards defined contribution provident funds could be "laying the way towards widespread disaster". He bases his gloomy outlook on the following:

The very idea of retirement is fairly modern, especially in the third world. People previously expected to work until they were physically no longer able to work, and thereafter, for the remaining short period of their existence, they expected to be looked after by their families. Nowadays, however, the high unemployment rate in South Africa is a major reason causing companies to strongly enforce the retirement age, allowing younger people employment opportunities. Where this does not occur, natural attrition through retirement, is used to reduce staff levels in an attempt to reduce costs and avoid having to lay off workers in some instances.

Medical care, which is continually improving, along with better standards of living, has drastically increased life expectancy. People are living for significantly longer periods. In 1999, for each person on retirement there were roughly three and a third still working. Over the next fifty years it is expected that the ratio of workers to pensioners will fall to two and a half to one. This will be further exacerbated by the increased death of the younger, economically active sector of the economy due to AIDS, the very sector which previously subsidized the aged sector. On the one hand, people now are able to work until they are 70 to 75 years of age, while on the other, companies forced to downsize are reducing the retirement age to 50 years leaving 25 to 40 years for people to live on their pensions alone, or having to find ways of subsidizing their pensions in order to survive. Old Mutual indicates that only one in every ten people retiring will have sufficient money at the end of their normal working lives to sustain themselves throughout their retirement. According to them, to be able to retire comfortably, one requires a lump sum payment of at least ten times one's highest average annual salary (i.e. ten times the average of one's salary for the last year of

employment). For the majority of South Africans, this will not be the case on retirement. A common reason for this is that when people change jobs, they cash in their investment benefits. On average, people change jobs at least seven times in their working lives, leading to retirement funding being squandered away.

Another factor contributing to the impending disaster is the move towards provident funds away from pension funds. On retirement, a provident fund places what may seem like a large sum of money into the hands of the new pensioner. The person would not, however, truly be a pensioner unless he secures the future by locking away all of (or a large part of) the apparent fortune into a pension of some kind that will see to his needs for as long as he lives. If the person acts recklessly, or is given unsound advice, there may not be sufficient left to cater for his needs and he may become a burden on either his family or the state (Cuthbert, 1999).

Throughout these changes, however, the main aim of a retirement fund should remain unchanged i.e. to perpetuate pre-retirement lifestyle into the period after retirement, as well as to provide sufficient cover for events such as death or disability prior to retirement (Davis & Kendal, 2000)

1.2 Research Problem and Questions

This research report asks whether a defined contribution pension fund offering individual member investment choice is the optimal solution for the public sector. Given the fact that the Government Employees' Pension Fund is currently still a defined benefit fund, and given the recent international move towards questioning the wisdom of the trend towards defined contribution funds, the research will consider three options for the GEPF:

1. Maintaining the status quo i.e a defined benefit fund
2. Converting to a defined contribution fund
3. Converting to a defined contribution fund which offers individual member investment choice.

Ascertaining an optimal future state for local government retirement funds is more complex, given the current situation of varied types of funds (DB, DC and DC with individual member investment choice), diverse sets of rules, forms of governance and administration as well as systems with different levels of sophistication utilised to provide service to the members.

For both the GEPF and local government retirement funding, the following additional questions need to be posed:

- What pressures are evident requiring adaptation to a new form of fund?
- What are the demographics of the members (age, level of education) as well as the geographical location of members' working environments?
- How sophisticated are current administrative processes and systems?
- Are the additional costs required for a conversion to a DC fund and implementation of IMIC affordable for the fund?

In order to test the proposition, the research will trace the developments of retirement funds from defined benefit (DB) funds to defined contribution (DC) funds, looking at the incidence of greater involvement of members on the Boards of Trustees, through changes to legislation but also through the general democratization of the workplace, and finally to the implementation of individual member investment choice in DC funds. The research covers both private as well as public funds (including parastatals) in order to establish general trends in the processes, areas of best practice and lessons that can be learned from mistakes within the field, but the final conclusions relate to public service funds.

Possible complications with the conversion from defined benefit to defined contribution Funds, owing to the majority of Public Sector Funds still being DB funds at this stage, will be addressed, though due to limitations of the research, only processes will be discussed. No detailed analysis will be included, regarding the debate on transfer values, actuarial arguments regarding the correct values to be used, legal analysis of the outcome of cases surrounding these issues, or specific taxation issues. It is incumbent on the funds to obtain specialist advice on these matters.

Individual member investment choice will be addressed, assessing the benefit it offers individual members where it is implemented. This, however, requires to be explored further in order to establish whether practical considerations, with regard to issues such as limitations on the freedom for individual investment choice owing to the possible asset allocations in the GEPF, would rule out the possibility of implementing IMIC in this particular fund.

1.3 Structure of the Report

The research report is structured into four parts. The first, chapters one and two, deals with the background to the research problem and the research questions. This is followed by the research methodology and limitations of the research.

The second part undertakes the theoretical literature review, in chapters three and four, and will document and analyze relevant literature on the DB/DC debate, conversion issues, as well as the implementation of individual member choice.
The third part, chapters five and six, will interrogate information collected through interviews as well as from various documents utilized in the process of the implementation of individual member investment choice in various companies and funds. Discussions were also held with actuaries and independent consultants, to glean a more holistic view, rather than one focused on a specific fund or company. This will be used to compare what is utilized from best practice found

in literature to actual conversion and implementation processes. The current state of affairs within the public sector retirement funds and the processes under way will follow. Gathering the relevant information pertaining to this section included holding interviews with top SALGA and government officials involved in pension transformation issues. Throughout these chapters, the focus will be on ascertaining whether a defined contribution fund is the most relevant form of fund for the public sector, and whether individual members' retirement benefits would be enhanced by implementing individual member investment choice.

Chapter seven summarises the salient points in order to support the researcher's assertion that a dual approach should be adopted for public sector retirement funding. This would entail retaining the status quo in the GEPF i.e. a DB fund, but simultaneously allowing certain traits of DC funding to be "borrowed" for implementation within the fund. This would be implemented in the overall context of modernizing the fund to move in line with the requirements of the Pension Funds Act. This does not, however, mean that further investigations following the proposed interim steps towards modernization of the fund would not lead to the conversion to a DC fund in the future.

With regard to local government retirement funds, the researcher asserts that the evidence is currently inconclusive as to the most suitable form of fund. The researcher proposes that a rationalization and restructuring of the entire local government retirement fund arena is required before a conclusive optimal outcome can be established. Recommendations as to the process to be followed in attaining this goal are proposed in this concluding chapter.

Chapter Two: Methodology and Research Limitations

Chapter Two outlines the research methods used in the study as well as motivations for the specific research techniques used. Data reliability and research limitations will also be discussed.

Chapter Three: The Evolution of Retirement Funds

Chapter Three will document and discuss major trends from international as well as South African literature pertaining to the movement from Defined Benefit to Defined Contribution Retirement funds, the conversion process, as well as the decision process leading to the implementation of individual member investment choice within DC funds.

Chapter Four: Considerations when implementing Individual Member Investment Choice

This chapter will concentrate on practical problems and solutions which would have to be considered during and after the decision process on whether to implement individual member investment choice.

The issues raised when exploring these topics in chapters three and four will be used to critically analyze the implementation of individual member investment choice in the funds discussed in chapter five.

Chapter Five: Case Study on the Implementation of Individual Member Investment Choice

The fifth chapter will introduce and explore the experiences of Transnet, Amplats, Nedcor, Denel and Irvin & Johnson with the implementation of individual member investment choice. Use of best practice as well as possible areas of improvement will be discussed and analyzed in this chapter, as well as words of warning from those who have already experienced the possible shortcomings of the conversion and implementation of IMIC.

Chapter Six: Current Reality: Public Sector Funds

This chapter will address the current situation within public sector funds giving an indication of the types of funds as well as the difficulties in current processes dealing with retirement fund issues.

Chapter Seven: The Future of Public Sector Retirement Funds: A Conclusion

The final chapter will draw on the previous chapters, taking into account the complexities of public sector retirement funding, as well as the trends in retirement funding internationally and in South Africa. This will lay the basis for responding to the research question posed as well as for recommendations pertaining to the national government pension fund and the process forward for organized local government in rationalizing retirement funds within local government in South Africa.

CHAPTER 2 - Methodology and Research Limitations

2.1 Introduction

Ackroyd and Hughes (1992) state that "research is simply a matter of defining one's problem and selecting the appropriate tool or method for that problem."

The object of this research report is to assess the appropriateness of a DB and a DC fund within the public sector. What initially may seem like a straightforward debate between defined benefit and defined contribution becomes more in-depth, taking the social, political, legal and administrative aspects into account. In order to make the assessment, the collection of data and evidence from multiple sources was required. Due to the form of certain of the data gathering techniques, data needed to converge in a triangulating fashion i.e. data collected in one form was utilized to confirm data collected through other methods and from other sources.

For the purposes of the report, the research has been conducted in the following manner:

1. Exhaustive secondary data collection and critical analysis thereof over the period of a year and a half
2. Primary data collection and analysis, through observation, multiple case studies, interviewing and document review.
3. Engagement with major role players within the retirement industry, both from the fund and company side as well as from an actuarial and consultants' point of view.

2.2 Methodology

The methodology or operational framework within which this research was conducted, was largely influenced by the topic of the research. The researcher took cognisance of the perceived strengths and weaknesses in assessing the most relevant methods to be used for data collection and analysis, as well as the limitations imposed on the research due to time constraints.

2.2.1 Documentary Research

During the period June 1999 to December 2000, the researcher collected cuttings of journal and newspaper articles, attended trustee training and retirement industry conferences and collected available pertinent information in the area under research. This process allowed the researcher to develop an understanding of the issues, as well as the role-players and relationships within the industry.

Due to the nature of the topic, it was critical to keep abreast of the changes in the industry including ongoing legislative reform. Secondary and primary data sources were utilized for this. Archival searches were performed on journals including Pensions World, Financial Mail, Business Week, Executive Business Brief, Professional Management Review and Personal Finance, and newspapers including The Star, Business Day, Sunday Times and the Mail and Guardian. In addition searches were performed on Sabinet as well as archival searches of The Actuarial Society of South Africa and the Institute & Faculty of Actuaries, UK. The internet was also used to access the Cape Joint Funds web site.

Documentation relating to actual conversions from defined benefit to defined contribution funds, as well as to the implementation of individual member investment choice, became available through interaction with role-players from various funds as well as actuaries.

The Internet served as a most valuable source of information, enabling archival searches to be done from a home and work environment.

2.2.2 Multiple case studies

Yin (1994) states that:

> *"a case study from a research strategy point of view may be defined as an empirical inquiry that investigates a contemporary phenomenon within its real life context, when the boundaries between phenomenon and the context are not clearly evident, and in which multiple sources of evidence are used. It is particularly valuable in answering* ***who, why*** *and* ***how*** *questions in management research."*

The aim of using case studies is to provide a three dimensional framework incorporating relationships, corporate political issues as well as patterns of influence. Whilst the gathering of the secondary and primary data provided valuable insight into the trends and general issues within the retirement industry, it was necessary to get an idea of nuances and potential problem areas that may not otherwise become general knowledge. Also to ascertain the processes which led to decisions of conversion and implementation of individual member choice within a specific environment.

2.2.2.1 Interviews

To enable the gathering of this data, telephonic requests for interviews with various funds, actuaries and retirement fund consultants were made. Personal interviews were held with the following people:

- Greg Morris – Divisional Director Investment Consulting: NBC Employee Benefits
- Devaraj Gounden - Divisional Manager Actuarial Services: NBC Employee Benefits
- Chris Bosenberg - Chief Executive: BSI Employee Benefit Consultants
- Geoffrey Nzau - Managing Director: NBC Employee Benefits
- Peet Maritz – Chief Director: Pensions Administration (Department of Finance)
- Kobus Reineke – Deputy Director: Pensions Administration (Department of Finance)

Due to time constraints and geographical location, telephonic discussions were held with the following role-players:

- Anne Cabot Alletzhauser - (M Cubed)
- Thabo Mokoena – Chief Executive Officer: South African Local Government Association (SALGA)
- Clive Dunstan – President: Independent Municipal Association Trade Union (IMATU)
- Roger Ronnie – General Secretary: South African Municipal Workers' Union (SAMWU)

Following poor response from funds themselves with regard to personal interviews, due to time constraints on the part of the interviewees as well as the researcher, questionnaires were e-mailed to the targeted stakeholders. This included a letter of introduction from the researcher as well as the need for information to be provided.

Three participants responded by e-mail, which was followed up with telephonic clarification of various aspects in the returns:

- Mike Tate - Principal Officer: Nedcor Defined Contribution Pension & Provident Funds

- Charles Buchanan – Chairman Investment Sub-Committee: Anglo Platinum Family of Funds
- Adela Walsh – Financial Administrator: Investments for the Denel Retirement Fund (Channel Management Services (Gauteng) Pty Ltd)

A telephonic interview was conducted with the following respondent, which allowed for immediate clarification of points where required:

- Esmarie Strydom - Investment Manager for the Transnet Pension Fund.

A personal interview was held with Greg Morris of NBC: Investment Consulting in order to discuss the I&J Retirement Fund.

Patton (1990) categorizes interviews into three general types:

> *"The informal conversational interview, the general interview guide approach, and the standardized open-ended interview."*

The personal interviews, being mainly with actuaries, consultants, unions and public sector officials generally followed the informal conversational interview form. The balance of the interviews with fund participants was of a general interview guide approach, with the following themes carried throughout all interviews:

- History of fund – DB/DC, previous conversion history
- Factors/pressures leading to the decision to convert and/or to implement individual member investment choice
- Processes followed
- Quantitative information regarding number of options offered, number of times options can be amended, cost of switching
- Changes to the funds' administration as well as the role of the Boards of Trustees

- Perceived successes and failures of conversion/implementation and measures used to quantify this.

2.2.3 Participant Observation

To Marshall and Rossman (1995), "participant observation is to some degree an essential element of all qualitative studies. As its name reveals, participant observation demands first hand involvement in the social world chosen for study."

By acting as an alternate trustee on one of the local government retirement funds, during the period of the research, the researcher was able to directly observe processes and practices (participant observation) within the retirement industry and the operation of funds. It also led to the development of networks within the actuarial field, which in turn allowed access to "high level" participants within individual funds.

2.3 Data Reliability

Marshall and Rossman (1995) in discussing in-depth interviewing, indicate that interviews are very useful in obtaining large quantities of information quickly. However, they also point out the weaknesses of interviewing:

> *"Interviews involve personal interaction; co-operation is essential. Interviewees may be unwilling or uncomfortable sharing all that the interviewer hopes to explore..".*

They go on to say that "interviewees may have good reason to lie" (Marshall & Rossman, 1995). This could be found, for example, where information regarding the success of a conversion or the implementation of individual member investment choice is required. If the motivation for such processes were not honest and transparent, it may be very difficult for individuals associated with the

fund to be totally honest in their responses to certain questions, as this may be used against them in future negotiations.

Case studies are considered to be unreliable by some. They are a distinctive form of empirical enquiry, but are seen to lack the rigorism of other methods. Taking this into account, this form of research strategy was still chosen, due to its ability to deal with a variety of evidence for example documents, interviews and observations. Much of the research in this area is exploratory, based on the "how" and "why" of the conversion from DB to DC and implementation of individual member investment choice. Case studies are suited to these types of research questions. What remains is for the case study investigator, the researcher, to report all of the facts or evidence fairly.

To overcome these weaknesses, research such as this, which seeks to make more objective assumptions, needs to triangulate interview and case study data with data gathered through other methods, in order to lend some credence to the data. This can be done through gathering and analyzing documents produced in the course of everyday events such as fund communication, member packs, minutes of meetings and formal policy statements.

2.4 Limitations of Research

The certainty of the lack of bias, given the research methodology, will remain a limitation inherent in any qualitative research. However, through direct involvement in certain of the processes as well as inputs gathered from many different stakeholders, from the funds, actuaries, consultants as well as the employer and union, it is hoped that all aspects have been taken into account. However, in certain cases, the sensitivity of the processes and relationships between the employer, unions, members and suppliers of retirement benefits, may have precluded the researcher from obtaining the total truth.

In addition, due to time constraints, the number of interviews and the depth of the case studies were reduced. The conversion to DC and the implementation of

individual member investment choice also occurred in the recent past in certain of the funds. The impact of these changes may therefore only become apparent in years to come, once members reach retirement age. Additional research would be useful in future years taking this into account.

Lastly, this research does not seek to replace or minimize the need for specialist advice relating to the conversion from defined benefit to defined contribution funds as well as the implementation of individual member investment choice. It is intended to emphasise the need for this in terms of legislative requirements in order to reduce the occurrence of future problems between the fund, the Board of Trustees, the employer and the members.

CHAPTER 3 – The Evolution of Retirement Funds

3.1 Introduction

The evolution of retirement funds in South Africa has followed the trend set by the USA and to a lesser degree the UK. According to Carol Woodley, Head of Pensions Practice at Arthur Anderson, "the problem with the defined benefit versus the defined contribution debate is that it has become polarized by conflicting objectives." DB and DC schemes are at opposite ends of the spectrum with regard to two aspects: the degre of cost control, and the extent to which employees/members bear investment risks and take responsibility for the outcome of their pensions.

What a company needs to ask is firstly, how much cost variability can the organization tolerate and secondly, how much employee responsibility/exposure does the organization feel comfortable with, taking into account employee profiles, education, culture, employment patterns, etc (Woodley, 1999).

In order to establish the optimal solution for public sector funds, it is important to ask what we want to achieve through changing the pension scheme. When considering the option of a defined contribution fund, with individual member investment choice, the trustees must ask themselves whether this option is appropriate for their particular fund. Chris Bosenburg suggests that the following areas are assessed before the option is made available to members of the fund:

- Are the members financially sophisticated?
- Can the administration accommodate it?
- Is there non-homogenous membership i.e. a range of ages
- Are the additional costs affordable?
- Is there a need/demand for it from the members

3.2 The Great Debate: Defined Benefit versus Defined Contribution

In general, defined benefit (DB) schemes are those where benefits are determined by the member's final earnings on or near retirement, the length of membership of the scheme and the rate at which the member accrues pension year on year (the accrual factor). From individuals' points of view, they as members are expected to make certain monthly contributions, but need not concern themselves with the overall cost of the fund or the return on the funds' investments, as they would be guaranteed certain benefits (pensions) in terms of the rules of the fund, (based on actuarial assumptions made by the funds' actuaries) on retirement. In most cases the member is blissfully unaware of the risks born by the employer on his behalf. The member would not necessarily have an indication of his benefit's value, unless he requested a transfer value (Crighton, 1998).

From the employer's point of view, the employer undertakes to meet any shortfall, which is required to meet the benefits in terms of the rules, on a member's retirement. It is uncertain as to the exact cost that the employer would have to carry, as the amount is dependant on the members' earnings increases, pension increases and the investment performance of the fund. The employer relies on valuation reports compiled by the funds' actuaries, normally every three years, to give an indication of the recommended funding level designed to provide adequate funds to meet all the benefits as they fall due. The employer, therefore, bears the risk of a possible increase in pension costs where insufficient contributions have been made, but it could also be argued that should equally enjoy the benefit if contributions can be decreased, where for example investment returns have been better than expected (Crighton, 1998). The issue of who the fund surplus belongs to will be dealt with later in this chapter.

When one considers a defined contribution (DC) scheme, the situation is rather different. The member would be able to ascertain the current value of his

investment, which is determined by the total of contributions paid into the fund (employer and employee contributions) plus the member's portion of the returns earned by the fund on its investments over the term of his membership in the fund. This accumulation is applied to the annuity rates current at the time, to arrive at the member's pension. The individual could calculate his current accumulation, but would only know the value of the pension that would eventually be paid to him, and how it would compare to his final earnings, at the date of retirement, as this depends on the volatility of the investment market (Crighton, 1998). A member must also take cognisance of the tax and investment charges which would reduce the total return on their investments (Meyer, 1998).

Under this type of scheme, the employer can calculate the exact cost of retirement fund benefits, determined by the level of contribution promised to members. However, this would leave no room for possible flexibility in reducing contribution, where fund surpluses exist and the rules of the fund allow this, as in certain DB schemes.

The vast majority of employers today, where given the choice, would offer their staff a defined contribution retirement fund. Mike Hogan, Retirement Funding Director of Aon Consulting, feels that the main reason for this is the recession and employers' desperation to reduce open-ended liability in DB funds. In DC funds the burden of the investment risk is carried by the employee. "Members get more say about their funds but have to look after themselves" (Hogan, Finance Week, 16 June 2000). However, along with the transfer of risk goes the requirement for excellent information flow and on-going education of members. New generation funds require advanced administrative systems if they are to provide the type of service expected from today's members. Modern technology is a must in improving data accuracy, time standards and access to information.

3.2.1 Pension Fund versus Provident Fund

Some people mistakenly understand that a DB fund is a pension fund and a DC fund is a provident fund. Though most DB funds are Pension Funds, one also finds many DC Pension funds. The main differences between a pension fund and a provident fund are:

(a) that a provident fund can pay out the total benefit as a cash lump sum on retirement, whereas with a pension fund members may draw only a third of their cash, the rest having to be spent on a pension fund.

(b) employee contributions to pension funds are tax deductible, unlike contributions to provident funds. (Employers can, however, compensate by making bigger tax-deductible contributions on behalf of their employees through a salary sacrifice scheme. This must, however, be in line with rules and regulations set down by the South African Revenue Services.)

Most schemes within the public sector are pension funds, either DB or DC in nature. This will be discussed in detail in Chapter Six.

3.2.2 So which is Best?

Though provident funds have increased in popularity over the years, the researcher has adopted a paternalistic approach to public sector retirement funding, with regard to a choice between pension and provident funding. Taking public sector membership numbers, levels of staff, as well as educational levels into account, the probability is that a person, on receiving a lump sum payment and no pension from a fund, would not normally place the amount into a pension fund allowing future monthly payments to be received. The money would be utilized to pay off a bond, buy other capital goods or else generally squandered. Though the first two options increase the assets owned by the individual, this does

not ensure ongoing income in future years. What initially appears to be a large amount of money is quickly reduced to nil.

Due to the fact that the State ultimately provides a "safety net" for those who do not receive a pension or who cannot afford private medical aid on retirement for example, it is in the interest of the state to ensure that as many people as possible receive adequate pensions on their retirement and thus reduce additional burden on services provided by the State. It is for this reason that a provident fund option is not considered as a suitable option for the State fund. Provident funds do exist within local government and will have to be taken into account in the final analysis.

The literature review, to this point, was in agreement as to the definition, and the general pros and cons of DB and DC funds. However, thereafter, two strains of thought emerge. The point in question as to "which is best" is highly contentious, depending on narrowing the question to include "best for whom?"

For an individual, it is difficult to say whether a DC scheme would provide a larger or smaller pension at retirement than that of a DB scheme. This would depend on a number of issues, but as Steve Walters (1998), the AIAC Training Specialist at Metropolitan Employee Benefits, points out, the yield earned by the fund over the period in question becomes crucial in a DC scheme, as it would then have a direct bearing on the member's benefits. Richard Davis, MD of Financial Administration Solutions and Dr Shannon Kendal, an independent consulting actuary, raise the concern that the majority of DC arrangements do not link pension and salary near retirement and do not include protection against inflation. This is in contrast to DB arrangements "where the perpetuation of lifestyle into retirement is theoretically intrinsic to the benefit design" (Davis & Kendal, 2000). This issue is being addressed in new generation DC schemes.

Sharon Wood of Personal Wealth Quarterly reports in the third quarter of 1999 that "employee benefit experts and consultants generally agree that the defined contribution schemes are better suited to the current job market. People tend to job-hop more than in the past and no longer stay with a firm for most of their working lives – a lifestyle better suited for defined benefit." A DB fund's rules normally penalize a member on resignation, as it is said that the rules were designed to reward long service. This can, however, be changed through rule amendments, as is found in the DB Government Employees' Pension Fund (Chapter 6), and some ingenuity on the part of the actuary. However, the additional benefits would either have to be covered by increased employee contributions, which is unlikely, or by the employer, making the liability even more costly.

Anthony Lester, Fifth Quadrant MD, in the same article[1] says that he believes employees are better off as members of a DC Pension Fund because the likelihood is that they would receive better pensions at retirement than they would have received through a DB fund. He indicates that there are no structural problems with DC funds. What is critical is that the investments are properly managed and earn 5% or more above inflation on a consistent basis. Over the medium to long term, this should not be difficult. Dave Thompson of Alexander Forbes agrees with this, as with a normal DB fund, individuals would get 60 to 70% of their average past two years' salary once they retire, which in most cases is not sufficient to allow them to live their golden years freely.

Anthony Asher, professor of actuarial science at the University of the Witwatersrand, takes a different approach[2]. He feels that with a DC fund, final benefits may not accumulate to a level sufficient to meet members' realistic benefit expectations. He bases this on "considerable evidence that share prices, around the world, are hugely overvalued. A considerable drop at some stage,

[1] Personal Wealth Quarterly, third quarter of 1999.
[2] Personal Wealth Quarterly, third quarter of 1999.

probably in this decade, could leave many retired people with much lower pensions than they presently expect."

It is important to note that the views expressed above look at the average situation. In dealing with specific individuals' cases, consideration must, however, be given to the contribution rates, real rates of return as well as the age of the individuals concerned. Only then can it be ascertained, for an individual, what rate of return above inflation would be required in order to accumulate an acceptable benefit on retirement.

Whilst the jury is still out on which option is best for members, it seems clear that, from an employer's perspective, the certainty of the financial implications in a DC fund is a tremendous advantage, even if the flexibility flowing from good returns in a DB fund no longer exists. In addition, in an era where major corporate restructuring continues to occur, a DC fund allows for greater flexibility due to DC benefits being more portable.

3.3 Conversion from a DB to a DC fund

Alexander Forbes estimates that about 85% of active members in the corporate sector have made the switch from DB to DC. However, when an individual transfers to a DC fund, various contentious issues raise their heads. Among these are the transfer of risk from the employer to the employee, as well as the question of the "suitable" value at which the individual's retirement benefit should be transferred. The issue of the surplus and who actually has a right to it has been hotly debated in the last year or so since the much publicised "Tek appeal case".

3.3.1 Risk Transfer

As indicated by Douglas Thompson (1999) of Investec Guiness Flight, the trend of the last ten years, away from DB plans towards DC plans, has resulted in a shift

of investment risk from the employer to the employee. Many of the first DC funds were negotiated provident funds, "whom in their infancy needed the stability and comfort of having their investment capital guaranteed and a low volatility of returns." The failings of these traditional guaranteed funds began to become apparent as the market became more sophisticated, and the trustees had an array of investment products from which to choose in order to meet their investment returns. Today it is imperative for trustees to regularly review the appropriateness of their investment strategy in the light of the changing market options (Thompson, 1999).

Trustees should structure an investment plan that manages the members' exposure to market risk. Sharon Wood of Personal Wealth Quarterly[3] points out that "people who have many years before retirement need actively managed exposure to local and offshore stock markets to beat inflation and build up a meaningful pension by retirement". A phased approach is considered appropriate as members reach retirement age, when their assets should be transferred from aggressive to moderate to conservative. This should protect members from market corrections i.e. from volatility risk. Wessels Vermaak of Metropolitan Professional Advisers, in Personal Wealth Quarterly[4], recommends that members nearing retirement move out of the market-linked investments not more than three years before retirement. However, where the market has crashed they may be advised to maintain the market-linked investment until such time as their benefit value has recovered sufficiently.

For younger members, inflation risk is more of an issue. In order for a suitable retirement benefit to be accumulated before retirement, investments in products that regularly beat inflation, by 5 to 6% per annum (after tax and fund managers costs) i.e. equities, are required. Where an individual is risk-averse and settles for

[3] Personal Wealth Quarterly, third quarter of 1999.
[4] Personal Wealth Quarterly, third quarter of 1999.

guaranteed funds from early on in his working life, it is highly unlikely that his expectations on retirement would be met.

3.3.2 Transfer Value and Surplus Ownership

The widespread movement from DB to DC funds over the past 10 to 15 years has left massive surpluses in the old DB funds, estimated to be in excess of R80 billion. On 27 January 2000, the Financial Mail reported that financial regulators had "ended years of legal uncertainty by giving employers the right to gain access to billions of rands in pension fund surpluses." Jeremy Andrews, the FSB's chief actuary, in response to the Congress of South African Trade Union's (COSATU) warning that this would "open the floodgates" to many other funds being liquidated, indicated that the surpluses were "concentrated in funds which were most ripe for liquidation". The funds were mainly residual defined benefit funds from which the majority of the members had switched to defined contribution schemes.

Labour claims that employees were given insufficient information in order to make informed decisions, and although fund transfers are generally the subject of negotiation, it is alleged that the workers were "wronged" in the process.

The issues of the ownership of the surplus as well as the transfer value when a member moves from one fund to another were brought under the spotlight in 2000 with the Tek Corporation Provident Fund and Others v Lorentz appeal case. The ruling was twofold: firstly, with regard to the issue of transfers from one fund to another, "the decision does not lie solely within the control of the employer, as to whether part of the actuarial surplus should be transferred or not. The employer may not take a decision solely in its own best interests against the interests of the pension fund members."

Secondly, "an employer is not entitled to require that the surplus be retained to enable the employer to take a contribution holiday unless expressly provided for in the rules of the fund."

In September 2000, at the end of COSATU's 7th national congress, the union objected to the fact that companies still viewed pension fund surpluses as part of their assets. COSATU believes that "the money belongs to the workers, to provide social security, not profit for the company", and sees the reserves as deferred wages.

The debate continues following the publishing of the Pension Funds Second Amendment Bill in February 2001, which stands open for comment until 31 March 2001. This Bill follows lengthy negotiations between government, business and labour, which ended in a "compromise", as agreement could not be reached. Financial Mail reported on 9 February 2001 that "from the date the Bill is enacted, retirement funds will have to provide minimum values in circumstances such as transfer, conversion or retrenchment. They will also have to provide for minimum levels of pension increase and minimum levels of interest to be added to member contributions in respect of early leavers." The bill specifies that minimum values include investment reserves and any contingency reserves which may have accumulated in the funds. It is felt that the Bill will prevent surpluses from accumulating in future by preventing inequitable treatment of members leaving the funds. It remains to be seen what occurs following the closing date for comments at the end of March 2001.

3.4 Decisions Leading to the Implementation of Individual Member Investment Choice

Two of the main factors which could lead to the implementation of individual member investment choice are: the transfer of risk from the employer to the

member in a DC fund; and the fact that not all members of a fund are alike, lending itself to differentiation in terms of investment options for individual members as well as differential management of the cost of disability and death benefits per member.

3.4.1 Investment Risk Transfer Leading to Additional Member Input

Coupled to the move from DB to DC schemes, and gaining momentum in South Africa, is member level investment choice (Kritzinger, 1998). The reason for considering allowing members' choice in investment products, is that in DB funds the investment strategy is set on behalf of the members for the entire life of the fund, and they are not adversely affected by any negative decisions taken, as the employer makes up the difference where insufficient funds are available.

Members of DC funds are, however, directly exposed to investment performance of their accrued retirement savings and should therefore, it is argued, be entitled to "influence the decisions on how and where their moneys are invested. In practice this means that they ought to have a choice of where and how to invest" (Marx, 1998). This would have to be done within the legal constraints e.g. asset allocation limits (Regulation 28 of the Pension Funds Act[5]), and implies that the fund would continue to own the money. though it is earmarked for individual members. Rosemary Hunter (Partner at Edward Nathan & Friedland) points out that "in law the fund cannot be split into 'sub-funds' comprising 'member shares'. The fund remains one fund and all of the assets in it belong to the fund (section 5 of the PFA)." Investments are done on behalf of members, but administered according to the rules of the fund and other legal limitations (Marx, 1998).

[5] Regulation 28 specifies the maximum percentages that retirement funds may invest in a single asset or asset class, otherwise known as PIGS (Prudential Investment Guidelines).

Member level investment would normally involve members being allowed to allocate their retirement savings among different investment portfolios according to their particular risk profiles (Moyo, 1999). With advancements internationally in the sphere of individual member investment choice, administrators of DC funds will have to find a way in the future of accommodating legislative requirements to balance at member level as opposed to at fund level, until such time as legislation is changed in a meaningful way. This has placed tremendous pressure on Regulation 28's Prudent Investment Guidelines (PIGS). The Pensions Advisory Committee of the Financial Advisory Board has authorized the formation of a sub-committee, chaired by Jeremy Andrews, the chief actuary, to review the PIGS. As David Weil (2000) points out, with increased complexity and sophistication of the investment markets and the massive increase in products offered, especially when taking derivatives, structured products and offshore investments into account, the situation could not continue indefinitely.

> *"The varied needs, different benefit expectations, risk profile and time horizons of retirement fund members makes monitoring a fund's overall exposure to the various asset classes a near impossible task"* (Weil, 2000).

The proposed new regulations will adopt a more flexible approach to a fund's investments. It would, however, require additional emphasis to be placed on the investment strategy put in place by the Board of Trustees. They would have to analyse their fund's needs and tailor their policy to best accommodate these needs. A compliance officer, independent of the investment manager, would need to be appointed. This person will be responsible for submitting annual reports to the registrar, regarding the Board's investment strategy and policy, as well as mandates given by the Board. The report will detail investments per asset class, differentiating between local and international investments. It will confirm the management of such investments in terms of the Board's strategy and that

ongoing monitoring of the investment manager is occurring. The fund's actuaries and advisors must confirm the suitability of the fund's investment strategy.

The final outcome of these deliberations ought to allow more flexibility with regard to individual member choice implementation, allowing more investment choice, but is more onerous on the Board of Trustees in ensuring a suitable investment strategy is implemented.

TYPES OF INVESTMENT RISK

The Investment Choice Strategy document of Irvin and Johnson, prepared by Fifth Quadrant Actuaries and Consultants, emphasises two main investment risks faced by members i.e. inflation risk and volatility risk.

Inflation risk is the risk of an individual not accumulating sufficient retirement benefits over his working life relative to inflation, in order to continue post retirement without having to drop his living standards. This can be overcome by investing, in the long term, in assets which provide the best results relative to inflation i.e. equities.

Volatility risk is most apparent when a person seeks to retire and exit the fund and the market is "low", leading to a reduced retirement benefit. This is not as much of a problem if the individual is going to reinvest his payout in a living annuity for example, as this will allow the benefit to regain some of the loss. If the benefit is consumed at the time when the person leaves the fund, however, he could sustain a marked reduction in his benefits. Fifth Quadrant suggest that this can be overcome, firstly, by diversification into other asset classes, such as bonds and property, for long term volatility risks; secondly, by investing in less risky asset classes e.g. cash products, for short term volatility risks; and thirdly, by "hedging" market risk through insurance products, using options, also for short term volatility risks.

3.4.2 Sharing Investment Risk

Geoffrey Nzau, Managing Director of NBC Employee Benefits[6], indicates that a popular option for trustees, especially in Union funds, in an attempt to avoid market risk, is to opt for "smoothing" investment returns. During good market cycles, a portion of the returns is held back to be utilized when the market has performed badly. This would require the use of a "smoothing reserve" and the inherent additional administrative and financial requirements. Where this solution is considered, actuaries or advisors can provide details regarding the advantages and disadvantages of such reserves. Anthony Lester of Fifth Quadrant does not see this as a long-term solution, however, as he believes it "creates major inequities over time."

Mike Luyt, Investment Practice Partner of Old Mutual indicates the rationale for smoothing of declared returns, flowing from the high volatility of investment returns:

> *"During the market crash of 1998, some fund members might have lost up to 40% of the value of their pensions. Over the long term markets recover. But what about the member who leaves or retires from the fund just after a market crash? He has no chance to take part in the market recovery. In order to protect these members, trustees often want to declare a more stable fund interest rate"* (Luyt, 2000).

Luyt continues, however, to clarify that cases where smoothing need not exist are:

- where members have individual investment choice, as there would always be some type of stable returns portfolio on offer, reducing volatility risks closer to retirement, and
- where a fund has implemented a "life stage" model, in which members usually switch into a stable portfolio close to retirement.

[6] Interview with Geoffrey Nzau, February 2001

Both of these possibilities are dealt with in Chapter 5 where individual funds are analysed.

3.4.3 Similar Benefits for all Members

Another reason for individual member investment choice gaining popularity, is the simple fact that not all members of a retirement fund have the same needs and objectives. Nowadays it is not beneficial for individual members to have a "global investment strategy" applied to all assets of the fund. Davis and Kendal argue that "current generation DCAs (Defined Contribution Arrangements) were designed before the advent of relatively cheap computing power and the Internet". (Davis & Kendal, 2000). Individual circumstances such as risk profile and the length of time to retirement age are not taken into account when deciding on benefits. Instead groups of members are given exactly the same benefits. What is absent is the linkage between the salary prior to retirement and the pension post-retirement of an individual, as well as a mechanism to reduce the effects of inflation on future pensions.

Metropolitan Professional Advisors' Wessell Vermaak, in Personal Wealth Quarterly[7], stressed that individual members' interests are not served well where a "one-size-fits-all" strategy is adopted. Fifth Quadrant's Anthony Lester agrees with the sentiment[8], indicating that this type of strategy is problematic, especially when members try to exit at retirement age, following a market crash, and have not had sufficient time in order to make up the loss. He suggests that, for those reaching retirement age, the correct strategy would be not to try to beat inflation by a wide margin, but to be worried more about volatility risk. For those who are far from retirement, inflation risk should be minimized and returns of around 6% above inflation should be achieved.

[7] Personal Wealth Quarterly, third quarter of 1999.

3.4.4 Managing the Cost of Death and Disability

Old generation DCAs typically offer the same death and disability benefits to all members. This type of global cover could lead to either under-cover, earlier on in a member's life when family are of concern, or over-cover when reaching retirement age, leading to this cover eating into retirement contributions. This area requires urgent attention taking into account the expected increase in the cost of insured benefits with the onslaught of the HIV/AIDS pandemic. Hogan[9] explains that with 'reinforced death benefits', "the level of insured benefits reduces as the member ages and the accumulated savings or asset build-up is offset against insured benefits. This reduces risk exposure and diverts increasing portions of risk premiums to retirement investment."

3.5 Changing Roles of the Employer, Trustees, Unions and Members of the Fund

Peter Strasheim (1998), an attorney of the Supreme Court and Director of Incapacity Management Solutions (Pty) Ltd, points out that many fundamental principles of trustee governance and management, retirement fund rules and benefits are profoundly affected by constitutional rights, labour law, (future) equity legislation and Pension Fund Adjudicator decisions." These and other "new agents of change" will force the employer, trustees and unions to constantly remain abreast of the changes and the consequences on themselves, their duties and the potential/real effects on the retirement fund members. He suggests that it is essential to establish a "co-operative, inclusive, multi-disciplinary approach for the process of identifying practices and developing policies which will meet and achieve the requirements set by legislation, which should include all stakeholders."

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[8] Personal Wealth Quarterly, third quarter of 1999.

Dual employer employee representation became compulsory from 15 December 1998 in both DB and DC funds. This led to many new trustees being appointed who did not necessarily have the legal, financial and investment skills to accept this onerous task. It became imperative for trustee training to occur, and to continue as an ongoing exercise as opposed to a once-off occurrence. In addition, it is the duty of the Board of Trustees to obtain the advice of experts on matters where the board lacks the necessary knowledge/expertise[10].

The move to member trustees began in the union-sponsored provident funds, known as negotiated funds. Godfrey Vatsha of Negotiated Benefit Consultants (NBC), in an interview with Financial Mail in 1998, reflected on the early relationship between member trustees and management trustees as being adversarial. The retirement fund became another forum for collective bargaining. This is still the case in some of the local government funds. Retirement fund issues need to be separated into those which need to be discussed and debated by Boards of Trustees, and thereafter taken to the members for agreement, and those that should be addressed in the Bargaining Councils.

While section 7D of the Pension Funds Act does not distinguish between DB and DC funds, in reality trustees of a DC stand a greater chance of being pursued by their members. As indicated previously, decisions taken by trustees in a DB fund do not have a direct impact on the benefits of an individual member on retirement. The employer acts as a safety net and covers any deficit on retirement, where investment returns were poor. In DC funds, decisions taken with regard to investments directly affect final benefits payable to an individual. Where members feel that poor performance was due to negligence of trustees, trustees may be sued to make good for members' losses. Willie Kritzinger, Senior Actuary Sanlam Group Benefits, warns trustees to take the necessary measures in order to

[9] Finance Week, 16 June 2000
[10] Section 7D of the Pension Funds Act.

be able to prove to their members that they have acted in the members' best interests (Kritzinger, 1998).

Peter Moyo of Old Mutual, in an interview with Financial Mail in 1998, stated that "as soon as trustees understand the extent of their responsibility, investment choice becomes more attractive as it potentially lets them off the liability hook." Considering the changing roles of trustees further, Professor George Marx and Hunter in 1999, asked the question as to whether trustees of a fund can relinquish their duty to manage the investment of a fund's assets by granting members individual investment choice? They suggest that in order to assess the above, one may use the approach adopted by the Pension Funds' Adjudicator to assess all trustee decisions. To be reasonable, decisions of trustees must:

> *"firstly, be motivated by the pursuance of a socially legitimate objective; secondly, the means of giving effect to the decision must be proportional, in the sense of being carefully designed to achieve that objective and should be rationally connected to it; and thirdly, the means should impair the rights and legitimate expectations of affected parties as little as is reasonably possible"* (Hunter, 1999).

To test whether the decision to grant individual member investment choice is justifiable, one should ask firstly what is the reason for the delegation? If it is to "grant members with financial acumen the power to make decisions which are more appropriate to their personal circumstances than would be decisions taken on behalf of the fund as a whole," this would be considered as a socially legitimate objective. Secondly, are the means adopted to achieve the objective proportional and carefully designed to meet that end? It would be disproportional and not appropriate to grant free investment choice to all the members of the fund, irrespective of their financial acumen. Thirdly, do the means impair the rights and legitimate expectations of affected persons as little as possible? Where investment choice is granted to all members, irrespective of their financial acumen, and they

suffer a loss as a result, the trustee decision would fail and the fund may be held liable for the losses suffered (Hunter, 1999).

Professor Marx and Kritzinger (1998) suggest that, when considering whether trustees could still be held liable under these circumstances, the following should be taken into account:

- Trustees still carry the onerous responsibility of making the decision regarding the selection of investment portfolios that will be available to members and the asset/investment managers, as well as monitoring performance against the various investment objectives. Kritzinger emphasises the fact that the communication strategy should ensure that all members are totally informed as to the various options provided. Information should be unambiguous in order to avoid misunderstandings by members. All documentation on communication with members and members' option forms should be safely kept, for future reference.
- Default portfolios would have to be decided on by the trustees for those members who do not want to take advantage of exercising their own choice.
- Continual member training and communication will have to be provided in order for members to be able to make informed decisions, and to avoid claims against the trustees or the fund for any losses suffered. As Chris Bosenburg (1998), then Chief Consultant with Sanlam Group Benefits, now independent consultant points out, "once investment options are provided, it becomes essential that information becomes available on a regular basis so that members can make informed decisions."
- Trustees need to ensure a balance between providing sufficient investment choice "to provide meaningful alternatives and the ability to ensure proper and effective communication and to contain costs" (Bosenburg, 1998).

Davis and Kendal (2000) concur that the implementation of individual member investment choice in no way absolves the trustees of their responsibilities to the fund and to their members. They also emphasise the importance of:

- adequate administrative infrastructure to ensure timeous execution of members' choices and correct record keeping; and
- access to competent investment advice for members.

Weil goes further by stating that "with the greater freedom for members comes greater responsibility for trustees". The trustees must ensure that their members are educated in investment and basic financial planning to allow individuals to match their investment style with their individual needs and attitude towards risk. Detailed explanations as to the choices available and the consequences of choosing a particular option should be communicated to members (Weil, 2000)

Taking the above into account, however, not only trustees are responsible to engage with the employer on issues relating to Retirement Funds. Many issues requiring discussion, such as freedom to disassociate, employment testing and medically based membership criteria, contribution rates to some extent, etc, are Human Resource issues which would need to be negotiated outside the context of the Board of Trustees and the fund, in the Bargaining Council between the employer and organized labour.

Strasheim gave examples in 1998 of the "early complexities emerging" in this sphere that need to be addressed:

- Which aspects of retirement funds and benefits are contractual service conditions?
- Can certain rule changes by trustees amount to unilateral changes to conditions of service?
- Which rules can be changed unilaterally and which have to be negotiated with labour? Must trustees/the employer negotiate certain specific rule changes with labour, and how should they go about doing this? In what forum should any negotiations on rule changes take place?
- Can a representative board of trustees be an effective substitute for the need to negotiate rule changes? If so, how can the member/union trustees practically

fulfill the mandatory consultation requirements, and what would these trustees' labour law status be? (Strasheim, 1998)

Although these areas were raised in 1998, many of them have still not been clarified in the retirement fund arena, certainly not in the public sector. Union representatives have become part of the Boards of Trustees, but this has not necessarily addressed the questions raised. Much more work is required in clarifying union versus Board of Trustees roles and responsibilities towards their membership, and is unfortunately out of the scope of this research report.

3.6 Other Issues to be Considered

Market volatility and individual members' changing needs render one rate of contribution inappropriate. Giving members the opportunity to decide on their own contribution rates will allow individuals to plan for their specific needs post retirement. The decision from the employer side is mainly an administrative one. Moving to a total cost to employer allows for more scope in this area (Davis & Kendal, 2000).

This point indicates the need for individuals to consider their entire retirement fund situation, taking not only their work related retirement funding, but also any other policies into account in order to make an informed decision. In many cases, however, the option for increasing the contribution towards an employment related fund does not exist at present. This type of right would be one that the unions would have to raise with respective employers in the Bargaining Council, and should be easy to implement administratively in a defined contribution fund in order for individuals who wish to contribute more to obtain the additional benefit.

3.7 Conclusion

The retirement industry is in a constant state of change. Following international trends, many funds have converted from defined benefit funds to defined contribution funds, and in many cases have now implemented individual member investment choice. This is due to the fact that the investment risk which is passed from employer to member, normally leads to members wanting more say over the investment decisions made for themselves, as well as the needs of individual members being different and requiring different strategies to enable maximization of their pension benefits on retirement.

Many issues pertaining to retirement funds within South Africa, are awaiting outcomes currently. The Pension Funds Second Amendment Bill is open for comment until the end of March 2001 and proposals for alterations to the Prudent Investment Guidelines are anxiously awaited. In the interim, Boards of Trustees and members are being faced with a barrage of new developments. What is considered essential is that members are kept on board with these changes. Member communication and education cannot be over emphasised and dare not be ignored, if the Board is to escape future legal action from members. In addition, Boards should not shy away from obtaining specialist advice where they do not have specific knowledge. This will ensure that they are kept abreast of the latest trends and legislative changes within the retirement fund arena.

CHAPTER 4 - Considerations when implementing Individual Member Investment Choice

4.1 Introduction

This chapter will analyse the trend towards implementation of individual member investment choice in more detail, through a review of the literature. This will then be expanded on in chapter five, where cases of actual implementation in funds are explored, through the means of case studies. This will be used as the basis of identifying relevant facts with which to motivate for public funds not to hastily approach such implementation.

Individual member investment choice has been debated in South Africa since as early as 1998. In an interview with Financial Mail, 11 December 1998, Frans Mahlangu, Mineworkers' Provident Fund principal officer said that he and most other South African union leaders were opposed to individual member investment choice, with this opposition extending to the more sophisticated end of the market. The reason for this was that:

> *"investment choice is diametrically opposed to the union belief in concensus. It gives more affluent members the chance to "opt out" of the agreed investment strategy. Member choice can be seen as a way of disempowering member trustees"* (Mahlangu, 1998[11]).

This seems to follow the trend in the US where some unions see defined benefit schemes as a vested right. General Motors management was forced to put billions of dollars into the blue-collar pension plan, which was close to insolvency. Australian unions, on the other hand, seem to favour defined contribution schemes and member choice.

[11] Financial Mail, 11 December 1998.

In South Africa, the unions do, however, welcome the 50/50 split between management and member trustees. Mahlangu says that "it makes the trustees appreciate that the money does not belong either to the union or to the company, but to the member." Peter Moyo of Old Mutual reminds us that there is no distinction, in law, between the duties and responsibilities of an employer and an employee trustee. They are nominated by the members or management, but they do not represent them. Their only responsibility or duty is to the members and the fund itself. Before implementing IMIC, this should be kept in mind.

The rules of the fund would need to be amended to allow for the implementation of individual member investment choice. The Financial Service Board (FSB) is very strict, requiring specifics regarding the rights of the members with regard to investment choice. Particular areas that would need to be dealt with in the rules are:

- Definitions of each of the portfolios
- Details pertaining to the respective model which is chosen i.e. life stage or risk profile model and how it would operate.
- The frequency of and basis for charging for switching from one portfolio choice to another.

Additional information would need to be set out in the Investment Policy Statement of the Fund. This would include the investment policy for each portfolio.

4.2 Number of choices and frequency of change

Research has shown that members become confused when confronted with too many choices initially. The choice offered should be wide enough to accommodate the needs of most members, while still being manageable in terms of the control of the various portfolios as well as the information needs of the members. The information provided should increase the success of the selection by a particular members of the most suitable investment portfolio for himself.

In general it is agreed that members should be offered a choice of three to four portfolios initially, covering a conservative, a "middle-of-the-road" investment and an aggressive equity exposure approach. Weil suggests the following:

(a) a cash portfolio (safest asset class)
(b) a low equity portfolio
(c) a balanced equity portfolio
(d) a high equity portfolio (close to the maximum allowed by Regulation 28 of the Pension Funds Act) (Weil, 2000).

One of the excuses given by Boards for not implementing member choice is that, with the amount of financial information available, members are likely to switch funds frequently. This can be dealt with in a number of ways:

- The number of times switches are allowed can be limited, for example, to twice yearly or once every quarter.
- The initial option on implementation could be at no cost to the individual, but thereafter a cost of R200 to R400 per switch could be charged.

Other proponents for individual choice say that, if no limits were set, the need to constantly switch would not be there, as the opportunity was always available. The researcher does not agree with this sentiment, initially on implementation of the scheme, as most members would need to be educated first, developing an understanding of the fluctuating nature of the investment chosen. Until this is accepted by the individual, he may be tempted to make short term switches between investments, abandoning his long term strategy, based on past performance. NBC Employee Benefits recommend that it should be clearly communicated to members that it is not in their interest to switch unless their needs have changed, or as they progress between different life stage phases, as they would be taking on excessive market and timing risks, not to mention incurring administrative costs each time a switch is made.

Greg Morris of NBC Employee Benefits[12] warns that "chasing performance can be a recipe for disaster". As explanation he adds that empirical evidence has shown that where members are given the freedom to switch at will, they try to chase past performance. The member follows an aggressive fund after a "run" in the market, only to experience the correction. Seeing this correction in the aggressive fund, the member then switches to a low risk option, thereby locking in losses without giving the aggressive portfolio time to correct. Morris explains that portfolios are usually structured to give an appropriate risk return payout over the period of a t least a few years. Frequent switching does not allow sufficient time within any portfolio to benefit from the intended characteristics.

According to Fifth Quadrant, the current industry benchmark is to allow switching on the last day of each month. However, before this frequency is decided on, one must be absolutely sure that the fund's systems can accommodate such frequent switching, ensuring timeousness, accuracy, and process security. It is recommended that, initially a switch twice yearly can be offered, until such time as systems can be scrutinized and tested to ensure more frequent switching would occur without negative consequences.

The market benchmark charge for switching ranges from R200 to R400 per switch. There are some funds which charge a percentage according to the amount switched, however this is not logical, as the administrative effort is roughly the same, irrespective of the amount switched. Certain of the funds investigated in chapter five have chosen this option.

4.3 Default portfolio

Taking note of the US, when member choice first became popular only 20% of the members chose options other than the guaranteed option. In the Australian New South Wales Superannuation (Retirement) Fund, 70% of the members took

[12] Interview with Greg Morris in February 2001.

the default option, a middle of the road, balanced fund, as they did not feel comfortable taking another choice. South Africa has had similar experiences, for example in the Nedcor retirement fund, where the majority of members also opted for guaranteed insurance products.

In cases where individuals are automatically placed in a "best fit" investment portfolio, taking their age into account, as one would find with a "life stage" model, it would not be a negative occurrence to find the majority of members on the default option. In this case, one would need to question members' choices where the majority of members opted out of the default portfolios, as this would mean that the risk profile is not necessarily matched correctly to the most suitable investment choices.

4.4 Correct Asset Allocation

Two key factors need to be taken into account when determining the most appropriate investment strategy for an individual – risk tolerance and the time horizon. Correct asset allocation should take these two aspects into account e.g. a younger person would be able to tolerate a higher risk in stocks as the greater time period before retirement allows for a smoothing of short-term market volatility. However, age is not the only factor which should be taken into account. Weil suggests that the stage of an individual in the investment cycle is also crucial i.e. wealth creation or wealth management. He gives the following as an example:

> *"during the wealth creation phase, we are mainly preoccupied with: asset accumulation; budgeting; estate planning; debt servicing; insurance and assurance. .....Wealth management...involve(s): income generation; asset allocation; estate duty and reduction of tax; wills and offshore trusts."* (Weil, 2000)

4.5 Communication and Education Requirements

In today's world, communication is a must in all funds, whether DB or DC, pension or provident. Phasing in changes to a fund, as well as implementing a communication strategy that goes beyond merely passing on information to members, can assist in ongoing empowerment of members. This could include providing access to accredited advisors to provide members' peace of mind regarding their retirement fund investments. Trustees will need to balance the need for improved education for members and the costs involved in doing this.

Communication, however, becomes even more necessary when the matter of a conversion from DB to DC or the implementation of individual member investment choice is considered. Clear and unambiguous communication is required.

With both processes, given the enormity of the changes, it is recommended that written communication should be backed up by presentations. Written communication should be sufficiently detailed, yet understandable, in order to cover the Trustees legally. Research has found that "face to face" presentations to member groups are given a very high value. This allows the members to ask questions for clarity and learn from the experiences or questions of others, and the responses given. Following these two steps, a call centre or "fax hotline" requires to be established, to accept and respond to further questions and concerns from members. The length of the intensive member communication would depend on the size of the membership i.e. a larger number of members spread across the country would require an extensive road show. It is recommended that a minimum of two months is set aside for this as a comprehensive communication strategy will reduce problems experienced following a conversion or implementation of IMIC. Nedcor embarked on an extensive 18 month consultation and communication exercise, prior to the conversion to a DC fund and implementation of IMIC in 1994.

Financial Mail in September 1998 reported that the question of education is one of the strongest reasons for benefit consultants in South Africa to defer the introduction of individual member investment choice. This was, however, in the early days of implementation in South Africa, and the retirement industry has become braver since then, following the global trend.

Steve Wright, a member of the Institute of Retirement Funds' (IRF) legal and technical committee suggests that in order for members to be able to take full advantage of the investment choices provided, they should be kept abreast of what options are available, their consequences, advantages and disadvantages, in a clear and uncomplicated way. He indicates that regular feedback on performance of the various portfolios or investment choices is also vital.

Weil suggests the following minimum information needs to be communicated for each portfolio on offer:

(a) The objective of the portfolio;
(b) The structure of the portfolio;
(c) The retirement fund tax implications;
(d) The expected behaviour of the portfolio;
(e) The long-term historical return of the portfolio (or its proxy if it is to be simulated);
(f) Measures of expected risks (e.g. expected frequency of negative returns, expected frequency of returns below inflation).

Basic investment training needs to address areas such as:

(a) the allocation of funds across the various asset classes depending on risk profile;
(b) the various investment vehicles such as guaranteed funds and segregated funds;
(c) the risk connotation attached to the various asset classes;

(d) the risk attached to the various products or vehicles on the market (Weil, 2000).

4.6 Administrative Requirements

Hannes Victor (1998), of Western Cape Old Mutual, indicates that "real-time member-level accounting and timeous accurate data management" are imperatives for efficient administration, with "greater transparency and member access to key information" becoming essential in an environment where the member makes the decision on where to invest. The following three areas are critical for efficient fund management where member investment choice is available:

> *"1. timeous execution of member instructions*
> *2. data accuracy which is beyond reproach, and*
> *3. direct and [illegible]nt member access to the appropriate information"* (Victor, 1998).

Point three would not only include the availability of the information, but would also include the empowerment through education of members in investment concepts and the dynamics of the market, to be able to make sound investment decisions.

Fifth Quandrant, in their Investment Strategy Report prepared for I&J recommend the following as the ideal for effective administration of individual member investment choice:

- Either a single custodian with strong unitization capability, or all portfolios would require to be unitized. With most South African funds, daily or even monthly switching has not been implemented as yet. Therefore daily pricing is not essential on implementation. However, monthly credits of investment returns should be reflected on individual member accounts, which necessitate monthly unit pricing.

- Records of the number of units held in each portfolio must be kept by the administrator at a member level.
- The administrator must be capable of implementing all the rules regarding the particular fund's individual member investment choice e.g. rules pertaining to the phasing in from one portfolio to another of a member reaching retirement age, or regarding monthly investment of contributions.

4.7 Those against Individual Member Investment Choice

It is the belief of the researcher that individual member investment choice is not always for the members' benefit. This was echoed in a Financial Mail report in October 2000 where John Kingsley, IPAC SA Chief Executive Officer, confirmed that in the US, members do not adopt a strategic approach. They focus on fund managers instead of aligning themselves to their risk profiles and choosing the correct asset classes. When members do assume risk, they are either over cautious, placing the bulk of their money into money market investments or guaranteed funds, or not sufficiently cautious, and chase the "hot fund of the week", leading to disastrous results on retirement in both cases. In the Anglo Platinum fund offering individual member investment choice, 60% of the membership chose to be placed in the balanced fund. Only 5% chose the aggressive portfolio. When compared to the demographics of the membership, this means that the majority of the members are not earning the rate of return which is required to meet to meet their expectations relating to benefits on retirement.

Business Brief reported in January 2000, following the International Pension and Employee Benefits Lawyers Association's (IPEBLA) conference held in Italy, that an increasing awareness of the disadvantages of defined contribution schemes was occurring in the UK. In the US, a revival of the popularity (by whom is not specified) of defined benefit plans was anticipated after they had waned in

popularity in recent years. This could occur if the prolonged equity bull market changes. On the other hand, Australian employers were reported to have lost confidence in DB schemes, showing a decline from 70% to 30% of the pensions' market.

4.8 Conclusion

It appears that the momentum towards individual member investment choice in South Africa will continue. The latest Biennial Survey of Retirement Funds, produced by Sanlam Employee Benefits, indicates that in 1998 only 13% of DC funds offered individual member investment choice (rising from 6% in 1996). This has grown to 36% in 2000. About 40% of the funds offer five or more options, usually divided along risk profile, with most funds allowing switches at least twice a year. A big concern, however, is that only 64% of DC funds provide regular feedback on investment performance to their members.

What remains to be seen is how Boards of Trustees manage the issues and how the regulatory framework will be adapted in order to address areas of concern, which will continue to become apparent as the trend continues. The main area of concern remains the education of the members to enable them to make informed decisions regarding their future, not being too risk averse and at the same time not chasing the "hot fund of the week". This would ultimately ensure that the member obtains the benefit of individual member investment choice and not the burden of it.

The suitability of implementing individual member investment choice in the GEPF, at present, will be assessed and discarded due to a number of critical factors which do not exist in the GEPF, and which cannot be altered in the short to medium term to allow implementation. This will be discussed in detail in Chapter six and in the concluding chapter.

CHAPTER 5 - Case Study on the Implementation of Individual Member Investment Choice

5.1 Introduction

Chapter five will utilize case studies to understand the critical success factors, which must be present in order to convert to a DC fund, and to implement individual member investment choice, with few problems experienced. As mentioned in Chapter 2.3, the reason for choosing the method of case studies was to accommodate various forms of evidence, for example interviews, documents and observations. The conversion process from DB to DC and individual member investment choice implementation was studied within the real life context. The researcher felt this to be of utmost importance, as theory does not always take root in every day life. There is a great need to be able to understand the relationships between the fund, the employer "sponsor" of the fund, the member and the board of trustees. Within this context there are many corporate political issues and varying degrees of power and patterns of influence which occur, which needed to be investigated.

5.2 Funds Studied

In choosing the funds to be investigated, the researcher was assisted by Greg Morris of NBC Employee Benefits and Anne Cabot Alletzhauser of M Cubed. Both these organizations are investment specialists in the field of retirement funding, and have extensive knowledge of the processes as well as the organizations that have been through the processes under review. One may contest that this may lead to trends being reflected due to similar advice being given to funds in the implementation process. However, the nature of the funds (public and private) as well as their specific circumstances (for example some were already defined contribution funds before implementation of IMIC), are different. This point is, however, noted.

5.2.1 Basis for analyzing respondents

The analysis of the respondents was separated into the following areas:

- General, including the respondents' background i.e. industry, whether DB/DC funds exist, conversion dates, implementation of IMIC dates etc;
- Forces within the organizations leading to decisions, relationships and balance of power;
- Costs involved in the conversion and implementation processes;
- Options for investment choice;
- Processes and changes occurring during these processes.

5.2.2 Background of respondents

It was not the intention of the researcher to compare similar organizations' processes, but to undertake the research within a number of organizations covering diverse industries.

A brief overview of each of the respondents is given as background, for those who are not familiar with the organizations. This will include the person who responded, designation, as well as specifics of the employer company:

- **Mike Tate: Principal Officer of the Nedcor Defined Contribution Pension and Provident Funds.**
  Nedcor is a leading South African financial services group consisting of Nedcor Ltd and its subsidiaries Nedcor Bank Ltd (Nedbank, Permanent Bank, Peoples Bank), Nedcor Investment Bank, Cape of Good Hope Bank, Commercial Bank of Namibia and American Express. The group

also has a growing international presence through outlets in London, Isle of Man, New York, Hong Kong, Beijing and sub-Saharan Africa.

- **Charles Buchanan: Chairman of the Investment Sub Committee of the Anglo Platinum Family of Funds.**

  The Anglo Platinum Group, previously known as Amplats until 30 September 2000, is the world's leading primary producer of platinum group metals. The group comprises the holding company (Anglo Platinum) and its wholly owned subsidiaries; Rustenburg Platinum Mines (RMP), Potgietersrust Platinums Limited (PPRust) and Lebowa Platinum Mines Limited (Leplats). Its operations are situated in the Northern and North Western provinces of South Africa, where the world's richest reserve of platinum group metals is found, dubbed the Bushveld Complex. It is comprised of the following: six mines, two smelters, a base metals refinery and a precious metals refinery. Base metals such as nickel, copper and cobalt sulphate are important by-products produced.

- **Adela Walsh of Channel Management Services (Gauteng) Pty Ltd: Financial Administrator – Investments for the Denel Retirement Fund and Pension Fund**

  Denel (Pty) Ltd was established on 1 April 1992 as a private company, the State being its sole shareholder. It is managed by a Board of Directors, appointed by the Minister for Public Enterprises. The Denel group consists of a controlling company with divisions and subsidiary companies that are managed as separate self-sufficient business entities. Denel's corporate office is situated in Pretoria with its 18 divisions grouped into four major areas (aviation and guided weapons, ordnance, commercial and information services and training), spread across four provinces. The group's key capabilities include systems design, development and production across all major engineering disciplines.

- **Esmarie Strydom: Investment Manager of the Transnet Pension Funds**

  Transnet was established on 1 April 1990, and functions as a public company managed by a Board of Directors. The entire issued share capital is controlled by the Minister for Public Enterprises, on behalf of government. Transnet is a transport and related services company that is recognized as a dominant player in the transport arena in Southern Africa. It focuses on the movement of goods, people and information for customers in the freight, passenger and related services industries, which includes the provision and maintenance of a highly sophisticated transport infrastructure. Transnet supports the initiatives of government in its efforts to build a strong and growing economy.

- **Greg Morris of NBC Employee Benefits: Chief Investment Consultant for the I & J Retirement Fund**

  Irvin and Johnson (I&J) is incorporated in the Republic of South Africa and is part of the Anglovaal Industries (AVI) Group of Companies. I&J and its subsidiary companies focus on the procurement, processing, marketing and distribution of frozen foods. Eight hundred active food product lines are distributed to 19 000 retail, wholesale and food service customers throughout South Africa and beyond its borders.

Organisations which did not respond to the requests for information were the Human Sciences Research Council (HSRC) and the Development Bank of Southern Africa (DBSA).

The respondents can be categorized as follows (Refer to Table 1):

- Organisations where the two processes i.e. conversion and implementation of individual member investment choice (IMIC) occurred simultaneously and those where there was a phased approach, first converting then

implementing IMIC. This would be utilized in order to assess which of the two would be most suitable within the public sector.

- Organisations where the processes were completed within the last year and those completed before this period. This is to identify any changes in the processes over time, taking into account new lessons learned from the USA, Australia and the UK.
- Private organizations versus public organizations. To investigate further difficulties which may be experienced with parastatal or governmental institutions with which the private sector would not necessarily have to contend.
- Those organizations which consider the conversion and implementation to be a success and those where success can either not be measured accurately, due to the process only having taken place recently, or where certain areas are perceived to have not been as successful as the organization would have liked. This is to draw on lessons learned and to identify key occurrences which could lead to success.

The common strain amongst respondents is that they have all implemented IMIC in a defined contribution fund. The manner in which they accomplished this will be analysed within the specific context of the organization.

TABLE 1: COMPARISON OF RESPONDENTS

ORGANI-SATION	PRIVATE OR PUBLIC	DB/DC	ONCE OFF VS PHASED	CONVER-SION DAE	IMIV IMPLEMEN-TATION DATE	SUCCESS IN IMPLEMEN-TATION
NEDCOR	Private	DB & DC	Once off	1994	1994	Yes and no
AMPLATS	Private	DB & DC	Once off	July 1999	July 1999	Yes
DENEL	Private *	DB & DC	Phased	1994	October 1999	Yes & no
TRANSNET	Private *	DB & DC	Once off	Nov-00	November 2000	Yes
I&J	Private	DB & DC	Phased	1998	September 2000	Yes

Notes: * Denel and Transnet are 100% government owned companies.

Phased versus once off: Phased means that the organization first converted to DC and then implemented IMIC. Once off would mean simultaneous conversion and implementation.

The general trend in South Africa, of late, is to covert from DB to DC and to implement individual member investment choice simultaneously. In 1994, when Nedcor and Denel converted to a DC fund, IMIC was a very new idea in South Africa, only becoming topical from 1998 onwards. Nedcor, being in the financial services sector, decided to combine the conversion with implementation of IMIC. Denel, being more conservative and controlled by a Board appointed by the Minister for Public Enterprises, decided only to convert in 1994. This would allow for any problems pertaining to the conversion to be solved before considering further modernization of the fund.

In general, funds give their members the choice of converting to a DC fund or remaining in the DB fund. This would protect the rights of older members and pensioners. In some funds, if a large majority vote is obtained in support of the conversion and transfer (85% and above), then the entire membership is converted to the new DC fund.

PERCEIVED SUCCESSES

The success rate is gauged differently by the funds, focusing on the conversion or the implementation or both, depending on whether a phased approach was adopted or both processes occurred simultaneously.

Success of the conversion processes is assessed on the volume of members who transferred or converted. Where positive responses were obtained, it was usually due to enhancements to actuarial reserves given to entice members to convert, for example as with Nedcor, or where the company itself contributed additional amounts to the transfer value where insufficient surplus existed in the fund.

Transnet provided R700 million as an incentive for members to convert from DB to DC which led to an 83% conversion rate. In the short term this is extremely costly, however, it has already had positive spin-offs for Transnet. Jan-Willem Plantagie, infrastructure finance ratings associate at Standards and Poors, in an interview with Business Day on 5 Feb 2001, indicated that the Transnet Amendment Bill was a positive move. "A defined contribution fund for existing members also reduces the risk for Transnet as it is transferred to its members, who will also share the benefits." This "vote of confidence" from Standards and Poors will assist them greatly in improving Transnet's financial reputation.

Success in IMIC is difficult to assess. However, the following areas can be targeted in order to identify changes in behaviour over a period:

- The number of people who have chosen "suitable" portfolio options i.e. one that matches their risk portfolio in terms of age and other personal retirement arrangements. Depending on the options, this may take the form of the default (life stage model) or a specific choice (risk model).
- The number of people utilizing the option to change their portfolios, especially where their altered choices are the best matches for their age and risk profiles. The funds investigated allow on average two moves a year, so members would be unable to speculate.
- Increased interest in improving investment knowledge following IMIC implementation. Initially interest peaks just before "switch dates" when members can make a choice to switch. Ultimately, one would aim for an ongoing interest, which can be fed through regular report-backs to members regarding how particular portfolios are faring.
- The ability of the systems to calculate correctly the unit prices and transfer to the correct member accounts.

PERCEIVED FAILURES

Areas indicated in the responses where funds require additional focus are:

- Lack of knowledge of members regarding investment risk and its consequences both from the point of view of being too risk-averse and too adventurous risk-wise. This would imply that the object of IMIC, to allow members to match their risk profile to associated investment choice, has failed. Nedcor realizes that significant funds will have to be spent on member education to encourage better utilization of available options. Mike Tait, Principal Officer of the Nedcor Defined Contribution Pension and Provident Fund sees a great need for members to be educated in a "classroom situation", in order for them to be able to make informed decisions.
- Moving towards default options which would automatically place members in the portfolio which best suits their lifestyle and follows best practice principles, like that of I&J. Nedcor is also moving towards implementing a "life stage product" to ensure this.

5.2.3 Forces leading to decisions and processes

It was previously mentioned that Chris Bosenburg recommends that before any changes are undertaken in the fund, one must ask the question why we want to change and whether there is a need or a want by the members to change. This could be extended to ask whether there is a need for change from the employer's point of view.

From this it is evident that forces or pressures leading to change can either be fueled from the employer or from the employees/unions. In the funds that were investigated, both were found. It is important to take note of the number of people that have led to the implementation of IMIC, for example a handful of people can convince an entire membership that a particular change is what is required, for their own personal gain.

FORCES ORIGINATING FROM THE EMPLOYER

The main force from an employer's perspective would be the need or want to reduce the open-ended liability, which is found in a DB fund. In Nedcor, this was the reason for the move towards converting to a DC fund and simultaneously implementing IMIC. Where this occurs, a Board decision would normally be taken, whereafter discussions would be held with the unions and members or directly with the members where they are non-unionised. In Nedcor, no negotiations occurred with the unions. However, the members and unions were kept fully informed and received education throughout the process. This aspect is still considered critical by Nedcor.

Transnet was faced with a R17 billion deficit in the fund when it was commercialized in 1990, as government did not accept responsibility for existing Transnet pensioners. Transnet has managed to reduce the deficit substantially, culminating in the splitting of the old DB fund into three components: a closed DB fund for pensioners, a DB fund for those who preferred not to transfer and a defined contribution fund for "convertors" and new active members. Linda Ensor of Business Day, on May 9 2000, said that Transnet was attempting to "free itself of any possible future responsibility for the deficits of the funds" by converting to a DC fund. Esmarie Strydom, Investment Manager for the new funds says that it was not only for the betterment of the employer. Members were given the choice to cross over. In addition, the employer was cognisant of detrimental withdrawal benefits in the DB fund, which due to the nature of a DC fund will improve with conversion. Note must be taken that the move to a DC fund, in addition, removed an obstacle to the privatization of the parastatal. In order for the conversion to occur, however, an act of Parliament was required to allow for the transfer of assets.

FORCES ORIGINATING FROM THE EMPLOYEE

In Denel, the move towards IMIC was led by the "Divisional Investment Committee", which was driven by a handful of members. Road shows were held by management, after it was accepted as the "route to go". Member investment choice booklets were distributed to members, explaining the details of the investment channels offered by the fund.

5.2.4 Costs involved with conversion and implementation

The majority of the respondents indicated the following areas as being the highest cost accumulators:

- Design, printing and distribution of reading material in the form of member packs or brochures, CDs, etc.
- Cost of major road shows and presentations by senior staff and union representatives.

This can be understood, as the majority of the funds investigated have depots and plants throughout South Africa, requiring much travel and organization in order to reach the entire staff in the company.

Transnet undertook a massive education campaign to cover 87 000 members of the fund. This included the training of 400 trainers, printing of member packs, involvement of the company, starting with a letter from the MD detailing the process, followed by ongoing involvement of the Human Resource Departments to deal with any other queries from members during the process, and once the conversion and IMIC had been implemented. The road shows included presentations using visual aids such as slides and CD roms. This was followed by general discussion. Four languages were used (English, Afrikaans, Zulu and Sotho), depending on the specific group of members addressed, in order to provide maximum understanding by all members.

Additional areas raised were:

- Outsourcing of the new fund administration.
- Upgrading of information technology/systems.
- Cost of collating the returns regarding fund choice and investment choice.

Ongoing expenditure:

- Month to month costs of running the project e.g. administration costs

5.2.5 Options for investment choice

Fifth Quadrant, in an Investment Choice Strategy document prepared for I&J, indicates that there are three main investment choice models, which are not mutually exclusive:

- The **market model** which allows members a wide choice using a unit trust product provider to gain access to the entire spectrum of unit trusts,
- The **life stage** model formulated on the basis of a person's age, and
- The **risk profile** model where the member is given the choice between options with different risk/return profiles.

The last two are utilized in many funds as can be seen in table 2, below. The first option, from a member education and fiduciary duty of the Board of Trustees' point of view, is often seen as too risky to implement.

With the **life stage model**, the current age of the member is used to determine the "time before using the benefit" i.e. the member's retirement age. It is common to find three life stage portfolios.

First, the growth portfolio, is appropriate for members aged 45 and younger, where the main risk is the risk of inflation. This will be high in equities (up to 75%) with bonds being the second largest contributor (+- 25% including

cash). A benchmark for the performance of this portfolio would be to beat inflation by 6 to 7% per annum (after tax and investment manager fees) over a five year rolling period.

Second, the moderate portfolio, is appropriate for members between age 45 and 55, where inflation risk is still paramount, but where volatility risk also needs to be addressed. Compared to the growth portfolio it will be lower in equities (+-60%) and higher in bonds (+- 40% including cash). A benchmark for the performance of this portfolio would be to beat inflation by 4,5 to 5,5% per annum (after tax and investment manager fees) over a five year rolling period.

Third, the secure portfolio, is appropriate for members over 55 years of age, where the main concern is volatility risk. This is made up of approximately 45% equities, but which are covered by insurance to prevent capital loss, and 55% of bond type investments of short duration. A commonly used product for the secure portfolio is a "guaranteed fund".

With the life stage model, it is easy to allocate members to suitable portfolios using their ages as the basis.

The **risk profile model** is very similar to that of the life stage model. The main difference is that with the life stage model, the member is allocated, as the default, to a portfolio on the basis of his age. The member has to make a positive election only if he does not want to be placed in this default portfolio. With the risk profile model, the member must make a positive election as to which portfolio he would like to be placed in. The risk profile model also allows a greater choice of investment channels e.g. a money market option for those who are risk-averse or a more aggressive option for those wanting a high risk/reward option.

Table2: COMPARISON OF ORGANIZATIONS: INVESTMENT PORTFOLIOS

RESPON-DENTS	NO OF OPTIONS	BASIS FOR OPTIONS	COST PER CHANGE	NO OF SWITCHES ALLOWED
NEDCOR	5	Risk Profiles and Market Model (unit trusts)	Unit trusts – cost per switch Other options – currently no cost[13]	Daily and monthly[14]
AMPLATS	3[15]	Risk Profiles	R250 per switch	Twice annually
DENEL	4	Risk Profiles	R250 per switch	Twice annually
TRANSNET	4	Life stage	First free, thereafter increased % on the amount being switched	4 times per annum
I&J	3	Life stage	R200 + 1% of amount being switched	4 times per annum

Denel designed the various options around the ages of their members (risk profile model):

Growth – designed for members younger than 45 years of age

Moderate – for members between 45 and 50 years of age

Secure – designed for members 50 years and older

[13] Unit trust switches would be charged based on buying and selling costs. For the balance of the options, the rules of the fund allow for a minimal charge per switch (R500 maximum). This has not, however, been implemented as yet.

[14] Daily switches are allowed for unit trusts. Month end switches are allowed for the other four options.

[15] Multi-managers are used for the aggressive portfolio

I&J's default option is based on term to retirement (life stage model):

High Growth Portfolio - > 10 years to retirement

Moderate Growth Portfolio - 10 to 6 years to retirement

Phased-in approach - 6 to 3 years to retirement. Every quarter, 1/12 of the fund credit is moved from the moderate growth to the capital protection option, minimizing volatility risk. Transnet has a similar phased approach when nearing retirement.

Capital Protection Option - < 3 years to retirement

Where individuals choose from the available options for themselves, they must specifically instruct the fund to implement the phased approach.

Table 3: OPTIONS PROVIDED FOR MEMBER CHOICE

RISK	NEDCOR	AMPLATS	DENEL	TRANSNET	I&J
Aggressive	High risk segregated portfolio	Aggressive (using multi managers)	Growth (69% equity)	Aggressive	High Growth (70% equity)
Middle	Medium risk segregated portfolio	Balanced	Moderate (60% stocks)	Moderate	Moderate Growth (50% equity)
Low	Low risk Capital protected (Guaranteed Fund)	Low volatility guaranteed.	Secure (Guaranteed fund of an Insurer (Metlife)	Guaranteed	Capital Protection option (75% local structured products)
Other	Cash Portfolio		Money Market	Money Market	
Other	Whole RSA unit trusts via linked product house				Default option based on term to retirement

5.2.6 Change in focus of the fund, Board of Trustees and the members

When converting and implementing IMIC, a change of focus is required by all involved; the members, the Board of Trustees, the employer and the unions. The full implications need to be taken into account before agreement is reached on the processes to be followed. The amount of change also depends on how effectively the Board was performing prior to the conversion.

The case studies highlighted the following major areas which need to be taken into account in the process:

INVESTMENTS:

- Requires greater understanding of investment risk by all parties.
- Less focus on fund administration and more focus on investment performance.

INVESTMENT CHOICES:

- Members' ability to switch investment options as their needs change.
- Too many investment choices may be confusing and lead to incorrect choices being made by members.
- Investment choice appears to be based on "follow-the-herd" principles in some funds where specific default portfolios do not exist. e.g. in the Nedcor fund, too many of the members below the age of 40 years old are in the safe, guaranteed fund product which will not provide sufficient returns in the long term to provide adequately for old age.

SYSTEMS AND ACCESS TO INFORMATION:

- The need for members to easily gain access to benefit values, unlike laborious DB fund administrative processes.

- Systems that allow timeous, correct transfers of "units" to individual member accounts.
- Transnet's systems allow for more transparent access to information and are required to provide daily data. A call centre has been established manned by Bachelor of Commerce graduates to assist with general advice as well as information relating to the fund, the processes etc. The web site also gives additional ongoing information, for instance quarterly investment reports. Approximately half of the total staff have access to the Internet. Those who do not have can make use of computers at the regional offices to access the information.

COMMUNICATION:

- The overarching process required is ongoing education of and communication with members and the Boards of Trustees in order to improve the level of understanding.
- More interaction between administrator/consultants and the board is required.

Boards of Trustees of DC funds, in order to avoid disgruntled members or, in some cases legal tussles with members in later years, need to address certain areas in a more focused manner than when dealing with a DB fund:

- Vested interest implies greater attention is given to fiduciary responsibilities.
- Greater awareness of cost e.g. operating expenses.
- Greater interest in information flow between the company and the administrators, as well as appropriate "service level agreements".
- Ongoing review and education of Board members regarding legislation and adjudicator's findings which should serve as a benchmark to compare the functioning of the particular fund.
- Ongoing review of other administrators/ service providers in the market to ensure the particular fund provides good service to its members.

5.3 Conclusion

When comparing the outcomes of the case studies to what had been espoused through the literature review, the trends and advice gleaned from experiences in the USA, Australia and the UK have been closely followed.

Two examples of good practices, or learning from the experience of others, which should be taken forward when deciding on whether to implement individual member investment choice in public sector funds are :

- The extensive process followed by Transnet with regard to educating and communicating with their members can be used as a benchmark to test other funds' communication and education drives. However, with the conversion and implementation of IMIC having happened relatively recently, it may not be possible to ascertain long term benefits and whether the drive will continue in this fashion or lose its momentum. By setting up the call centre and the website, this should maintain communication to the higher level staff. The process to maintain contact with the remainder of the members will be the crucial success factor.
- Other funds which had not originally adopted a life stage model are moving in this direction. This takes tremendous burden off members as they would automatically be placed in the default option that would best suit their age and normal risk profile. They would still, however, have the right to choose another option where required.

The elements necessary for the implementation of individual member investment choice as well as the forces leading to a conversion to a DC fund, which have become evident in the literature review as well as the case studies will be addressed when ascertaining the current situation with regard to the GEPF and local government retirement funds. This will be used to support the proposition of the researcher as to the optimal future solution for public sector funds.

CHAPTER 6 – Current Reality: Public Sector Funds

6.1 Introduction

The public sector retirement funds which will be covered in this section are:

- the Government Employees' Pension Fund (GEPF), and
- a myriad of local government retirement funds.

In order for the researcher to address the main question dealt with in this research i.e. whether a defined contribution pension fund offering individual member investment choice is the optimal solution for the public sector, it was essential to have an intricate knowledge of the processes, problems, solutions to problems and other issues relating to the conversion to a DC fund and the implementation of IMIC. This, gleaned from the literature review, participant observation as well as case studies, sets the base for exploring the current reality of public sector retirement funding, taking cognisance of the steps taken to modernize and consolidate the funds, and for ascertaining the optimal solution for the public sector in the future.

The Government Employees' Pension Fund is a DB scheme with a membership of approximately 1,1 million, including pensioners. Over the last eight years the government fund has been the topic of much debate owing to archaic benefits, the need to amalgamate it with the old TBVC (the old "homelands") retirement funds and to transform the fund in general. Many changes have occurred in modernizing the rules and reducing the burden on the state by for example reducing the contribution rates.

The Local Government retirement fund arena is riddled with a plethora of different retiremen[illegible]overing the spectrum from DB to DC, with a joint membership [illegible] 216 000. The majority of the funds are still DB in

nature, however many of them have converted to DC, allowing, in most cases, the right to remain in the DB fund if a member so wishes. The most modern of the funds, from the point of view of having followed the international trend of conversion to DC and having implemented individual member investment choice, is the Cape Municipal Pension Fund. Amongst the most archaic of the large funds, and yet two of the most beneficial to members, are those of the old Johannesburg City Council, being the City of Johannesburg Pension Fund and the Johannesburg Municipal Pension Fund, both DB in nature.

6.2 Government Employees' Pension Fund (GEPF)

Currently there is only one Government fund, the Government Employees' Pension Fund (GEPF), which resides under the auspices of the Department of Finance. This came into effect from 1 May 1996 and amalgamated ten retirement funds from within South Africa and the old TBVC states. It has membership of approximately 1,1 million, of which 230 000 are pensioners. However, in order to arrive at a single fund, tremendous effort has been made by Government and the Unions to negotiate an acceptable retirement arrangement for public servants.

A series of Committees was established over the years to deal with the rationalization and modernization of the retirement fund industry in South Africa, including public sector funds. These include the Mouton Committee (1992) and the Smith Committee (1995).

THE MOUTON COMMITTEE REPORT

Mouton, in the Committee's final report, emphasized the complexity of the total retirement provision system. The need for change was highlighted. However, due to the high possibility of undesirable, unintended consequences following changes introduced, he suggested that broad consensus from major stakeholders was required before the changes were implemented. He described the provision of

retirement benefits in South Africa as "implicit, buried in a plethora of legislation, regulation and practice notes". The Committee suggested that a National Retirement Forum be established in which retirement matters could be debated and discussed leading to broad consensus on the issues.

THE SMITH COMMITTEE

The Minister of Finance appointed the Smith Committee on Strategy and Policy Review of Retirement Provision in South Africa, in June 1995 with the following mandate:

> *"Having regard for the profound changes brought about by the democratisation of South Africa and the present transformation affecting virtually all aspects of society, the Committee is to enquire into the efficacy and efficiency of the present retirement arrangements and to make recommendations for improvement."*

Thereafter a Joint Standing Committee on Finance (JSCOF) was requested to subject the Smith Committee's report to public hearings within May 1996 and report back to the Minister of Finance. The JSCOF attacked the Smith Report due to its lack of representivity, its bias towards industry and its failure to consult more broadly. This led to strong opinion that a more inclusive representative process should be followed by government in the compilation of its retirement policy, which is still evident in the latest round of discussions relating to fund surpluses and transfer values. These processes had looked at the entire scope of retirement funding within both the private and public sector.

NATIONAL RETIREMENT CONSULTATIVE FORUM (NRCF)

The string of committees culminated in the formation of the National Retirement Consultative Forum (NRCF) in 1997, made up of theme committees. One of the themes was "Public Sector Retirement Provision" and was convened by Peet

Maritz, the current Chief Director: Pensions Administration. It was not the intention of the Public Sector Theme Committee to act as a negotiating committee, but as a forum for consultation and debate in order to move forward with solid proposals to Government on issues of critical importance. The report compiled by the National Retirement Consultative Forum highlighted the major areas of change within the public sector retirement arena and the areas of agreement on 19 April 1996, between the State as employer and the union, to restructure pension benefits within the public sector:

- Revised final salary definition to mean the last two years of service;
- Amendment of the Public Service Act to allow employees to retire early, from the age of 55, but with a reduction in benefits of 4% per year for each year before the age of 60;
- Enhanced cash resignation benefits to allow for more mobility of civil servants;
- Transfer of accrued pension benefits (full actuarial value) to other approved retirement funds on resignation; and
- Reduction of employer's contribution rate from 18% to 17% from 1 July 1996.

The recommendations of the Public Sector Theme Committee of the NRCF went further in the transformation process and included the following:

- Total equity between public (funds established by law) and private sector retirement funds from a tax perspective, as recommended by the Katz Commission as from 1 March 1998;
- Establishing a technical committee, appointed by the Finance Minister, including all stakeholders, to investigate a pay-as-you-go funding arrangement and the conversion from the DB to DC fund structure;
- A further lowering of the employer's contribution rate from 17% to 15%;
- That individuals previously deprived of membership be given access to the fund; and

- The appointment of an Investment Policy Committee for the GEPF by the Minister of Finance.

CURRENT REALITY

When considering the current situation, equity between public and private funds has occurred as from 1 March 1998, the employer's contribution rate has been reduced to 15% and access to the GEPF for those previously deprived of membership has been implemented. The possibility of introducing the pay-as-you-go funding has been investigated and has been discarded as being too costly in the long run as well as being problematic overall as can be seen from experiences in Europe. Peet Maritz[16], Chief Director: Pensions Administration indicates that this type of system is "flawed by design." Greg Morris[17] of NBC Employee Consultants, sees the fact that it does not satisfy accrual accounting principles as being extremely problematic. The liability is incurred at the time the person works and should be accounted for in these periods and not only on retirement.

The Financial Mail, in an article termed "Public Sector Pensions – Footing the Bill" (9 February, 1996) reflected on a World Bank report on pay-as-you-go schemes:

> *"These schemes obscure the real state of public finance. The condition of the scheme always deteriorates as the system matures. The system tends to be regressive because the first workers covered tend to be the higher income workers, whose generous returns are paid for by the lower income workers who enter late. Labour market distortions and incentives to evade increase as contribution rates rise in later stages...Pay-as-you-go schemes are easy to put together but difficult to take apart"*[18].

[16] Interview with Peet Maritz in February 2001.
[17] Interview with Greg Morris in February 2001.
[18] Financial Mail, 9 February 1996.

The matter regarding conversion to a defined contribution fund has been discussed and the fund, in some ways, is moving towards implementing systems that could accommodate the introduction of a defined contribution scheme. Within the last couple of months three tenders have been issued for:

- Information technology infrastructure;
- Application software; and
- Investment Administration Accounting.

The first two will be fully outsourced. The third tender is for a twelve month contract involving advice, human resources and knowledge transfer.

The current pension fund is covered by the Government Employees' Pension Law (1996) and the rules of the fund. It is envisaged by Maritz, however, to move towards compliance with the Pension Funds Act (1956), as well. The main obstacles which have prevented the government fund from registering in terms of the Pension Funds Act and obtaining approval by the Commissioner for Inland Revenue have been:

- The funding level. This has improved fundamentally over the last five years moving from 60 to 70% funding to the current state of 95% funding, allowing the fund to now consider registration. It is anticipated that the fund will be fully funded within a three year period[19].
- The composition of the Board of Trustees. Currently the Minister of Finance is the sole interim trustee of the fund. To comply with the PFA, a minimum member representation of 50% of the Board is required . This is especially relevant if there is a chance of moving towards a defined contribution fund, as members would then want a say in the running of the fund and the investment strategy. Unions have been requested to supply names of their members for representation on the Board of Trustees, but this has not been forthcoming. It is the opinion of Maritz[20] that the status quo suits the unions as they do not want to be held accountable or accept

[19] Interview with Kobus Reineke in February 2001.
[20] Interview with Peet Maritz in February 2001

responsibility for any pension fund issues. If the Minister continues as sole interim trustee, he can be held operationally and politically accountable and responsible.

In addition, other areas of improvement being considered for urgent implementation are:

- Greater independence of the fund from Government i.e. Moving it out of the ambit of the Department of Finance to become an arms-length agency structure, similar to the South African Revenue Services (SARS) or the office of the Auditor General.
- Professionalisation of the administration of the GEPF with administrative costs recovered from the fund and not from the fiscus.
- Financial management of the GEPF based on responsible and accepted business and actuarial principles in consultation with the Minister of Finance.
- Modernisation of the manner in which the investment strategy of the fund is dealt with to consider, amongst other issues, diversification of the asset base to include offshore investments and increasing the allocation to equities and property. Currently a miniscule amount of the total investment is to be found in Eurobonds. An increase in offshore exposure, to close to the limit of 15%, should be considered. The percentage found in equities is also extremely low, compared to private sector funds. This process, however, needs to be addressed with extreme care as the shift out of gilts, currently making up the lion's share of the fund's investments, could cause a financial "earthquake".

FUTURE POSSIBILITIES

The three options which require to be considered as the optimal solution for the GEPF for the future are the following:

1) Maintaining the status quo i.e. a defined benefit fund
2) Converting to a defined contribution fund
3) Converting to a defined contribution fund which offers individual member investment choice.

In addition to this, questions posed which the research report should answer are:

- What pressures are evident requiring adaptations to the form of the fund?
- What are the demographics of the members (age, level of education) as well as the geographical location of members' working environments?
- How sophisticated are current administrative processes and systems?
- Are the additional costs required for a conversion to a DC fund and implementation of IMIC affordable to the fund?

In discussions with the senior management of the fund, the researcher discovered that, even though the fund was moving towards implementing systems which could cater for the conversion to defined contribution, and improving practices in order to move more in line with what is required from private funds in terms of the Pension Funds Act, major pressure to convert, not to mention to implement individual member investment choice, is not present in the fund nor from either government or the unions' side. This has been further reduced by improving the resignation benefit within the existing DB fund, as the factor of poor resignation benefits is often a strong motivator towards implementing a DC structure, which is considered more flexible for a highly mobile workforce. Evidence is however available that the fund is extremely costly to government and thus ultimately to the taxpayer, which requires action. Possible means of arriving at savings are: streamlining the functioning of the fund, inculcating a more professional service and thereby reducing (and ultimately eliminating) administrative costs to be borne by government. The fund has identified these as areas for urgent attention. In addition, the investment strategy and asset allocation is not allowing the fund to benefit from high interest investments which, through better returns would allow

the under-funding to be reduced as well as the administration costs born by the State. This requires urgent attention, though will not provide a short term solution.

The fund currently does not conform to the norms of private sector funds and the Pension Funds Act. Though the fund is controlled by its own act, the Government Employees' Pension Law (1996), it would be prudent to follow the basic principles set down by the PFA such as the fund striving to become fully funded and the introduction of a fully representative Board of Trustees.

In considering a conversion of the GEPF to a DC fund and the implementation of individual member investment choice, the ability of adjusting the asset allocations and investment strategy to one which matches the profile of the fund's members, would be extremely difficult, if not impossible. Presently less than 40% of the investments lie in equities. Offshore investments only make up a small percentage. The remainder is found mainly in government bonds and cash. In order to adjust this, to move closer to the norm of private funds, and in line with prudent investment guidelines, and to allow members to choose where they wish to invest, a major "shake-up" would be required. It would not be easy in the short to medium term to convert gilts to equities without affecting the overall investment patterns of the country and ultimately the economy. The researcher, therefore concludes that the implementation of IMIC, at present, or within a five year period, is not possible.

In addition, before such a conversion is considered, the fund should aim towards becoming fully funded. This is especially relevant taking into account the proposed Pension Funds Second Amendment Bill, which sets out minimum levels for transfer and conversion values amongst other set minimums. This has the potential of pushing the fund back into a situation of under-funding, thereby requiring additional funding from government.

The administrative systems would also have to undergo a major overhaul in order to cater for individual member accounts. Account credits would have to be transferred to individuals' accounts monthly. The GEPF is in the process of undertaking such an upgrade of its systems, but Kobus Reineke[21], Deputy Director: Pensions Administration feels that the systems will only be ready for this eventuality in three years time.

If all of the above areas were addressed and finalized, and the conversion to a DC fund was then considered, a tremendous burden would still be placed on the fund and on the then representative Board of Trustees, regarding member education and ongoing communication. With the government workforce spread over every corner of South Africa and having a vast amount of the staff at lower levels, communication would be a nightmare, to say the least. This does not even take into account the logistical problems of having to deal with eleven official languages. The cost of implementation and ongoing extensive communication and education of almost 900 000 members would put tremendous strain on the finances of the pension fund.

The above points support the assertion of the researcher, that it is not feasible to covert the GEPF to a DC fund, with or without IMIC in the short term, or even within the next three to five years.

What may be possible, in line with the move of senior management staff out of the bargaining council arena, with the introduction of the Senior Management Service (SMS), is for pressure to be placed on the fund from the Department of Public Service and Administration, to implement a new defined contribution component of the fund with individual member investment choice, for the SMS level staff. The level and education of these members is high and numbers are greatly reduced from the 1,1m members of the entire fund, and would allow for easier communication and education of the SMS members. This could also be

[21] Interview with Kobus Reineke in February 2001.

used as a means of attracting superior senior staff into the public sector. The remuneration package, presently indicating a fixed pensionable portion, could become even more flexible, allowing SMS staff to increase their contribution to the fund taking into account individual retirement planning needs. This "project" could be used as a pilot to establish the possibility of conversion to a DC fund once the new systems are implemented and have been fully tested.

In the interim, for the balance of the fund, the move towards a more prudent administration of the fund and a modernization of the investment strategy can only improve the financial viability of the fund in the medium to long term.

6.3 Local Government Retirement Funds

Retirement funding in Local Government has been a hotly contested issue for quite some time. Debate and arguments relating to the level of employer contributions is the topic of arbitration in the South African Local Government Bargaining Council (SALGBC) between the South African Local Government Association (SALGA) and the two main local government unions, SAMWU[22] and IMATU[23]. The employer is arguing for a reduced level of contribution standardized over all funds at 13,5%. Unions are demanding a minimum contribution rate of 18%. With many of the existing funds having employer contribution rates below the level of 18%, it would place additional financial burden on an already strained local government financial situation.

[22] SAMWU is the South African Municipal Workers' Union and represents pproximately 60% of the local government workforce, mainly the black employees at lower levels. It is affiliated to COSATU which is an alliance partner of the governing ANC party.
[23] IMATU is the Independent Municipal Association of Trade Unions and is another key trade union (along with SAMWU) operational in Local Government, representing approximately 40% of the employees at middle and upper management levels.

AUDIT OF LOCAL GOVERNMENT RETIREMENT FUNDS

During March 1999, SALGA approached NBC to conduct a retirement fund audit within local government in order to ascertain the current status of local government retirement funding. This was in order to assist SALGA in playing a major role in the restructuring of the retirement funds led by the then Chairpersons of SALGA's Executive Committee, Councillor Colin Matjila and the Labour Relations Committee, Councillor Patrick Flusk. Other intended outcomes of the report were:

- *"To assist trustees of funds and the participating local government authorities in their financial planning;*
- *To afford SALGA and the trustees of the funds an opportunity to consider the appropriateness of the investments and the structure of the investments of the funds;*
- *To assist SALGA and the local government authorities to provide benefits that are valuable to their employees at a reasonable cost; and*
- *To assist the local government authorities to align the provision of retirement benefits with that of its employment policy."*(NBC, 1999)

At the time of this audit, ten defined benefit and six defined contribution funds were investigated, with the Cape Municipal Pension Fund consisting of both DB and DC structures within the same fund. These made up the largest funds within the local government sector covering the majority of all local government retirement fund membership.

The rules of the DB funds define the benefits to the members. The employer pays all contributions, after taking members' contributions into account, in order to meet the costs of these benefits. In the DC funds, the employers' contributions are capped at a set level, allowing accurate financial planning and members' benefits are no longer pre-defined.

CONVERSIONS FROM DB TO DC

In general, the benefits of local government funds are more generous than the private sector as well as the Government Employees' Pension Fund and parastatal funds. These massive benefits result in the high contribution rates, which in most cases, the employer still has to subsidise. The funds with the highest cost to employer regarding benefits are those that remain DB in nature. In some of these funds it is due to the granting of service bonuses as well as the purchase of service at favourable rates, which leads to large amounts being paid by the employer on retirement.

This, amongst other pressures, has led to the trend of conversion from DB to DC happening steadily within the local go' .nment funds, if not at the same pace as private funds within South Africa.

- 18 000 members converted from the Cape Joint Pension to the Cape Joint Retirement Fund.
- 14 000 members transferred from the Joint Municipal Pension to the Municipal Employees Gratuity fund. Both of these funds are known as the "Benoni funds".
- As early as 1994, the DB portion of the Germiston fund was closed and all active members were transferred to the DC section in the Germiston Municipal Retirement Fund.
- In Natal, the option was given to members to transfer from the old Natal Joint Superannuation Fund (DB) to either another DB fund, the Natal Joint Retirement Fund, which had a lower rate of contribution to assist members with affordability problems, or to a new DC fund, the KwaZulu-Natal Joint Municipal Provident Fund. Members were given the right to transfer between funds with the proviso that they stay in a particular fund for a minimum of five years.
- Members of the Cape Municipal Pension Fund were given the opportunity to transfer to a defined contribution fund within the same fund.

Though the transfers followed the trend from DB to DC, the processes and the negotiations that took place did not always lead to the improvements normally expected in a DC fund. In order to obtain the unions' backing for such changes and to entice members to covert, the contribution rates were often kept at the original high levels found in the "old" DB funds. The employer contribution rate for the Germiston defined contribution fund stands at a staggering 25,6% followed closely by the Municipal Employees' Gratuity Fund (one of the "Benoni" funds) at 22%. This does not take into account the cost to convert with regard to communication, systems etc. The only fund that was able to reduce the employer contribution rate was the Natal Joint Provident Fund, in which the rate is 9,75%. By comparison, a typical private sector fund has an employer contribution rate of between 10 and 14%. The one benefit to the employer from the conversion is that the rate in a DC fund is fixed and no additional costs should require to be funded on retirement.

Another area where the new DC funds have not embraced the philosophy of a DC fund as yet is in respect of risk benefits. These are still treated in the same way as in a defined benefit fund, which could lead to additional financial burden for the employer, especially with the problem of HIV/AIDS increasing by the day.

AREAS OF "BEST PRACTICE"

Given a fairly archaic history within local government funds, the following areas within the specified funds can be used as a guide to best practice within local government funds as a whole. This does not, however, mean that the entire fund, its rules and administrative practices are of a superior nature:

- The Cape Municipal Pension Fund is the only local government fund which has implemented individual member investment choice. They have implemented a "life plan" default option, previously referred to as the "life stage" in chapter five. This automatically matches the individual to the "best fit" for the age of the person, whilst allowing individuals to amend this default

option to another investment portfolio if they wish. This will allow individuals to best maximise their investment potential.

- The Cape Joint Funds have an informative website at http://www.capejoint.co.za. This gives access to the rules of the fund, the trustees, the investment strategy, valuation report, audited financial statements to mention but a few items. This is moving in the right direction in improving communication with its members, especially where followed up with interactive areas within the local authorities provided for employees who do not have the privilege of having their own computers to access the site.

CURRENT REALITY AND AREAS TO BE ADDRESSED

Currently it is extremely difficult to compare the various funds within local government, however, the following areas are of concern:

- Many of the sets of rules are extremely complex and difficult for the members, and in some cases even the employer, to understand.
- Many "hidden" or additional costs exist for which the employer has to pay, such as administration costs, bonus service (granted after serving a certain time as well as the employer having to match additional service which has been purchased by the member), 13th cheques for pensioners. Just taking these into account, the employer's contribution can be increased by as much as 5% of the salary bill.
- Suitable investment policies are not in place in certain of the funds. In addition, not all funds have representative Boards of Trustees as yet. This is, however, improving.
- The administrative cost per member in local government funds is exceptionally high compared to the private sector benchmark of R11 to R18 per member. At year end 1997, the rate per member of the Potchefstroom fund was R43 followed by the "Transvaal" Joint Funds ("Benoni" Funds) at R38 per person. If the funds were rationalised, the possibility of introducing

economies of scale could occur leading to enhanced administration at a lower cost.

There is an urgent need to rationalise retirement funds within the local government sector. This would cover various areas such as the number of funds, the rules (which need to be standardised and simplified), corresponding benefits and contribution rates, to allow for more equitable treatment of local government employees across the country and across race and gender. Bargaining issues are discussed in a central forum, the South African Local Government Bargaining Council, which is complicated with the myriad different rules of funds, contribution rates and additional, often unquantified, costs attached to the administration of the funds, retirement and retrenchment rules.

As this process is certain to take some time, in the interim, the following should be ensured in all funds:

- Representative Board of Trustees should be put in place.
- Detailed investment strategies must be developed including investment performance measurement and monitoring, asset monitoring in terms of Regulation 28 of the Pension Funds Act, taking into account the proposed amendments to the manner in which this is dealt with.
- Employees who previously did not have access to retirement funding should be assisted in obtaining this benefit.

FUTURE POSSIBILITIES

Arriving at the optimal solution for local government retirement funding is a daunting task. Insufficient evidence exists at present in order to assess the best option and a process is therefore proposed in order to reach a stage where further research can be undertaken in order to take local government retirement funding forward.

As a start, SALGA needs to agree on a structured approach in order to deal with the restructuring and rationalization of local government retirement funding. The arbitration case relating to the contribution rate is still outstanding and needs to be finalised as soon as possible. According to the Chief Executive of SALGA, Thabo Mokoena[24], an in-principle agreement has been reached with the majority union, SAMWU, that a single fund be instituted. The basis of this single fund and the manner in which to achieve it, has however not been agreed on. This is a start, but the researcher sees a need for setting up of a consultative retirement fund forum in which the issues can be discussed and debated, similar to the National Retirement Consultative Forum (NRCF), which was established to deal with issues at a national government level. The Minister of the Department of Provincial and Local Government (DPLG), Sidney Mufamadi, has been approached by the Department of Finance, to establish a task team including SALGA, DPLG, the GEPF and the Department of Finance. This could be expanded into the larger forum including the local government retirement funds themselves as well as the unions. Lessons learned from the national experience can be shared with local government in attempting to find the best solution for the future of retirement funding within local government. In addition to this, bilaterals are being held between the unions and senior SALGA officials as well as local government councillors in order to reach an agreeable solution from the employer as well as the unions' point of view. A "champion" needs to be identified within the SALGA Executive to take this process forward i.e. a political nomination. Presently, neither the employer nor the unions are pushing for any finalisation of the rationalization process. If the Minister of DPLG sets a deadline for the submission of a report on the Local Government Pension Fund restructuring process, this will lend some urgency to the process. There has been talk of the necessity to transfer staff between the different levels of government (including all three spheres), in order to address skills shortages in certain areas. This would be simplified if benefits at the different levels of government were also similar, the most problematic of all being retirement benefits.

[24] Interview held with Thabo Mokoena in February 2001.

CHAPTER 7 – The Future of Public Sector Retirement Funds: A Conclusion

7.1 Introduction

The object of this research report is to disprove the contention that a defined contribution pension fund offering individual member choice is the optimal solution for the public sector. In order to do this, it was necessary to trace the development of retirement funds, following the international trend of converting from a defined benefit to a defined contribution fund and the implementation of individual member investment choice. The main research and literature review covered private and parastatal funds, which have implemented individual member investment choice, in order to ascertain problems encountered in the processes as well as areas of best practice, which could be used in the context of the public sector retirement funds. Though the above trends can be seen in the public sector, they have not occurred to the same extent as in the private sector, with only one local government fund having implemented individual member investment choice. The South African context also includes the increase in member participation, partly due to the legislative changes which have occurred as well as greater democratization within the workforce.

The report highlights the complications which can be experienced on conversion from a DB to a DC fund as well as issues the warning that Boards of Trustees must ensure that members are fully educated and full details of options are communicated to all members prior to them having to make any decisions. If this does not occur the Board of Trustees may be held liable for future losses of members due to the choices they had to make on conversion or relating to individual member investment choice.

When considering both a conversion to DC as well as implementation of IMIC, parties should be cognisant of the relationships, patterns of influence and potential problems that may be experienced in order to make informed decisions regarding the future of a particular fund. The two questions to be addressed most rigorously when considering conversion to a DC fund are firstly, the degree of cost control required from an employer's point of view, and secondly, the extent to which members bear the risk and take responsibility for the outcomes of their retirement funding. Consideration should be given to the employee profiles, education levels, culture and employment patterns. It should be clear as to the "real" reason for the proposed changes. In the communication it is better to be totally transparent, making members aware of all the pros and cons, as this will avoid problems at a later stage.

It has become apparent from the report that there is no consensus on many of the retirement fund issues, both within the ranks of specialists in the field, as well as between employer and employees or members. An example of this is the question of whether a defined contribution fund or a defined benefit fund is the most suitable option. Employers, in general, prefer a defined contribution fund as this limits their liability in terms of contributions and allows them to budget for retirement fund costs with greater certainty. Retirement specialists do not agree as to whether a DB or a DC would provide a greater benefit on retirement for an individual. Fifth Quadrant's MD, Anthony Lester and Dave Thompson of Alexander Forbes prefer the DC option because of the likelihood of a better pension on retirement. Anthony Asher, Professor of Actuarial Science at the University of the Witwatersrand, however does not believe that a DC fund would accumulate to a sufficient level in order to meet members' realistic benefit expectations. In general DB fund rules still reward long service and unduly penalize early leavers, giving strong motivation for conversion to a DC fund in the case of a mobile workforce.

The debate on transfer values continues, with various actuaries performing calculations for transfer values between funds in different ways. The Pension Funds Second Amendment Bill of February 2001 is the culmination of many months' negotiation, argument and eventual compromise between government, employers and unions. If the Bill is approved it specifies:

- Minimum values in circumstances which involve transfers, conversions and retrenchments;
- Minimum levels for pension increases; and
- Minimum levels of interest to be added to member contributions in respect of early leavers.

These minimum values include investment and contingency reserves which have accumulated in a fund. The object of the Bill is to ensure that surpluses are not built up in future at the expense of members leaving the fund.

Along with the transfer of risk from employer to employee on DB/DC conversion should go the right for members to have a greater say in their investment rights. Some feel that this can be met sufficiently by a representative board of trustees, but the researcher personally feels that an individual has the right to be able to choose for himself, if he has the wish to do so. This does, however, lead to additional costs in terms of administrative systems to ensure timeous and correct information, and requires ongoing communication and education of members. In the current research, the diversity of public sector staff with regard to levels of education and financial acumen, geographical spread as well as the total membership of 900 000, would require extensive communication and education exercises having to be embarked on. Implementation in the short to medium term is therefore not considered feasible.

An alternative to moving to IMIC is to share the risk within a DC fund by implementing a smoothing of investment returns. Strong proponents for this method are the unions, in keeping with the "all for one and one for all" focus. This uses cross subsidization across decades and could cause inequities over time.

In general, it is not beneficial for a specific member where a fund has a "global investment strategy" i.e. one strategy for all members of the fund. The main rationale for the implementation of individual member investment choice is to assist an individual to best match his risk profile, given his length of service to retirement. This would take into account the two main investment risks, inflation and volatility, but is against the socialist ideals of the unions. However, for a member to get the benefit of IMIC, he should be best matched to his specific risk profile. He will not be attaining his optimal return if he remains in a "stable guaranteed fund" if he is below the age of 45 years or if he constantly switches in order to chase "hot" equities.

7.2 Reflecting on the Initial Research Problem and Questions: Some Recommendations

The research divided retirement funding within the public sector into two areas: the Government Employees' Pension Fund and local government retirement funding. Investigations into the two areas led the researcher to assert that a dual approach is required in optimizing overall public sector retirement funding.

GOVERNMENT EMPLOYEES' PENSION FUND

In assessing the optimal solution for the GEPF, the research discards the two options regarding conversion to a DC fund for the following reasons:

- The fund is currently 95% funded. It is recommended that the fund should be fully funded before any such conversion is considered.
- The systems do not currently conform to the requirements for the implementation of a defined contribution fund. The conversion could only be considered once the systems have been tested and it is ensured that they are capable of accurately, timeously and securely dealing with 900 000 individual accounts. This is, however, in the process of being addressed and should be

ready for conversion to occur within about three years, according to Kobus Reineke[25], Deputy Director: Pensions Administration for the GEPF.

- The investment strategy and asset allocation does not allow for the transfer of investment risk to be placed on the shoulders of the member as yet. The asset allocations are far from being comparable to the norm of private sector funds and the prudent investment guidelines. Attention to shifting the allocations to a more prudent mix, which will enable improved returns, will require patience, as bonds make up a large percentage of the overall investment which would need to be converted into equities.
- In addition, there is no sense of urgency on the side of the fund to change from a DB fund. The issue of a conversion was raised by the Public Sector Theme Committee of the National Retirement Consultative Forum, however no pressure currently exists to move hastily in this direction, as the unions appear satisfied with the current DB arrangement, especially since previously disadvantaged individuals have been given the option to join the fund as well as the withdrawal benefit for early leavers being improved.

The researcher supports the proposition that the fund should remain DB in nature, for the short to medium term at least. It would not, however, mean that the fund remains static. It is the intention to continue with the modernization, bringing it up to the standards of private sector funds, in line with the Pension Funds Act, ultimately reducing the burden on the State. A steady range of issues is currently being addressed. These include:

- Improving the funding level: Currently it is 95% funded, showing a tremendous improvement from a couple of years ago.
- Introducing a representative Board of Trustees: Currently no union representatives have been put forward by the respective organizations.
- Modernising the investment strategy to allow for greater offshore investment and other possible ways of increasing the return on investment and thus reducing the burden on the state.

[25] Interview with Kobus Reineke in February 2001.

- Streamlining the administration of the fund through improving the systems.
- Promoting a professional organization, at an arm's length from government.

In addition, the researcher recommends that a pilot project be undertaken, involving the Senior Management Service (SMS) within Government. Once the new systems are functioning optimally in the GEPF, the SMS could be offered the opportunity of converting to a DC fund. This project could be led by the Department of Public Service and Administration and the Department of Finance. The SMS (consisting of staff on a Director level upwards) has been removed from the Public Service Bargaining Council and is governed by a separate set of regulations. The reduced number of members which the SMS covers, as well as higher education levels, allow for greater ease of communication and education. This is also enhanced due to this level of staff all having access to the inter- and intranet allowing cost effective communication. This opportunity of joining a DC fund as well as the possibility of having flexible contribution levels could be utilized to encourage a greater number of high calibre candidates to apply for government sector senior posts.

LOCAL GOVERNMENT RETIREMENT FUNDS

The local government retirement fund arena consists of a myriad of funds, all with different rates of contribution, sets of rules, investment strategies with varying representivity on their Boards of Trustees. Presently only one fund has implemented individual member investment choice, the Cape Municipal Pension Fund. It is the assertion of the researcher that the evidence as to which form of fund would provide the optimal form for local government, is currently inconclusive. Furthermore, it would serve no purpose to target certain other funds within the local government sphere to either convert from DB and DC and simultaneously implement individual member investment choice or for an existing DC fund to implement IMIC. Rather, the entire local government retirement fund arena should be rationalized and standardized. Once this has been

accomplished, IMIC can again be considered. In the interim the Cape Municipal Pension Fund, having already converted and implemented individual member investment choice should be monitored and evaluated in order to establish the added benefit to members.

The researcher recommends that a consultative forum be established, similar to the National Retirement Consultative Forum, in order to discuss and debate the retirement fund issues within local government and greater government as a whole. Parties to be represented on the forum should include SALGA, national government (DPLG, Department of Finance, DPSA), local government retirement funds and the unions. The lessons learned from the government amalgamation processes as well as the regional amalgamations of retirement funds which have occurred within local government should be taken forward in order to place a final proposal on the table for discussion as to the rationalization and restructuring of local government retirement funding. The Minister of the Department of Provincial and Local Government (DPLG) has been approached to set up a task team to include the representatives from the GEPF, the Department of Finance and DPLG in order to take the matter forward. This task team could feed into the broader forum, assisting with technical expertise. The debate has previously lacked a sense of urgency, with the arbitration regarding employer contribution rates taking years to be finalized. The researcher proposes that a retirement fund "champion" be chosen from the SALGA Executive who will be tasked with the duty of ensuring that the matter be addressed and concluded. Even though an in-principle agreement has been reached between SALGA and the majority union, SAMWU, on the implementation of a single local government retirement fund, the process to reach this ultimate goal is a long and rocky one, and will need much debate and argument before a way forward will be reached. However, any journey has to start with a single step, and SALGA's "champion" will have to take this step. It is proposed that the Minister of DPLG be the overseeing individual and decree a "due date" for the submission of a report, lending some urgency to the debate.

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