

**ANALYSIS OF SOUTH AFRICAN PENSION FUND CONVERSIONS: 1980–2006;  
DEVELOPING A MODEL FOR DEALING WITH ENVIRONMENTAL CHANGE**

by

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## **DEDICATION**

To all stakeholders in the retirement funds industry.

## ABSTRACT

Between 1980–2006, thousands of South African pension funds converted members from defined benefit to defined contribution structures. This research set out to answer the questions of why this phenomenon occurred and whether peculiar environmental circumstances influenced the outcome.

The research framework identified various stakeholders in the retirement fund industry – government; regulator; pension fund adjudicator; ombudsman for long term insurance; trade unions; members; trustees; business; employers and service providers – and isolated the elements to be considered in the research. Industry experts were interviewed to obtain a macro view of the phenomenon and specific manifestations of the phenomenon were also considered in case studies.

The purpose of the research was to develop a model for managers to assist them in dealing with environmental change. Qualitative research methodology was utilised and feedback from semi-structured interviews was categorised into several emergent themes. Within-case and cross-case analyses were conducted.

Research results indicate that the conversion phenomenon occurred in two waves – one initiated in the 1980s and driven by the trade unions and a second in the 1990s, driven by employers, often at the advice of their consultants. Evidence of the start of a third wave also emerged. Results indicate that an environmental shock exerted a substantial influence on the course of events. Under these:

- \* Various factors combined to drive organisational evolution (i.e. adaptation to the environment).
- \* Adaptation speed was inappropriate and exceeded that which was required for sufficient thought.
- \* Uncertainty and vacuum circumstances arose leading to consequences that require redress.
- \* The power of the relative stakeholders changed and influenced the strategic outcome.

- \* An imbalance in stakeholder interests arose and ethical factors became consequential.
- \* Business acted to restore certainty for itself.

Existing literature explained organisational behaviour in environments of competitive shock and high turbulence, but not in circumstances of environmental shock. A model emerged to assist managers to deal with environmental change, which was applied to an analysis of pension fund reform. It was also applied to the pension fund perspective on Broad-Based Black Economic Empowerment. This model may also be applied in analysis of land redistribution, sanctions and constitutional development.

**Key terms:**

Broad-based black economic empowerment; Environmental shock; Ethical considerations; Inappropriate speed; Organisational evolution; Pension fund conversions; Pension fund reform; Pension fund surplus; Redress; Rules of the game; Unintended consequences; Vacuum circumstances

# CONTENTS

GLOSSARY OF TERMS i

LIST OF TABLES v

LIST OF FIGURES v

## SECTION ONE: THEORETICAL CONTENT

### CHAPTER ONE: ORIENTATION 1

#### 1.1 BACKGROUND 1

1.1.1 Nature of the retirement funding system 1

1.1.2 Retirement funds in South Africa 2

1.1.2.1 Pension fund development 3

1.1.2.2 Growth and structuring 3

1.1.2.3 Defined contribution structures 5

1.1.2.4 Conclusion 6

1.1.3 The metal industries environment in South Africa 7

1.1.3.1 War – a catalyst for development 7

1.1.3.2 Post-war boom 8

1.1.3.3 International isolation 9

1.1.3.4 More restrictive legislation 10

1.1.3.5 International pressure 11

1.1.3.6 An opening economy 13

1.1.3.7 Metal Industries Pension Funds 13

1.1.4 The South African economy 18

1.1.4.1 Introduction 18

1.1.4.2 Business at the heart of the post-1994 economy 18

1.1.4.3 Business as a driver of change in South Africa 19

1.1.4.4 Conclusion 23

#### 1.2 OBJECTIVES OF THE STUDY 23

1.3	SCOPE OF THE STUDY	24
1.3.1	Research framework	24
1.3.1.1	Environmental shock	25
1.3.1.2	Government	25
1.3.1.3	Regulator	26
1.3.1.4	Members	26
1.3.1.5	Employers/business	26
1.3.1.6	Trade unions	26
1.3.1.7	Trustees	26
1.3.1.8	Service providers	27
1.3.1.9	Adjudicator	27
1.3.1.10	Ombudsman for long term insurance	27
1.3.2	De-limitations of the study	27
1.3.3	Assumptions	27
1.4	IMPORTANCE OF THE STUDY	28
1.5	STUDY ENVIRONMENT	29
1.5.1	Current affairs in the South African pension funds industry	29
1.5.1.1	Revised Pension Funds Act	29
1.5.1.2	Rulings of the pension funds adjudicator	29
1.5.1.3	Institute of Retirement Funds (IRF)	29
1.5.1.4	Broad-Based Black Economic Empowerment	30
1.5.2	Impact of market performance	30
1.6	CLARIFICATION OF CONCEPTS	31
1.6.1	Defined benefit and defined contribution structures	31
1.6.2	Conversion mechanisms	31
1.6.3	Actuarial valuations and the “surplus issue”	32
1.6.3.1	Investment reserves	33
1.6.3.2	The “surplus issue”	33
1.7	FRAMEWORK OF THE STUDY	35

## **CHAPTER TWO: LITERATURE REVIEW 36**

### **2.1 THEORY OF EVOLUTION 36**

2.1.1 Natural selection **38**

2.1.2 Relevance to the research problem **39**

### **2.2 WELFARE ECONOMICS 39**

2.2.1 Nature of welfare economics **39**

2.2.2 Social choice **41**

2.2.3 Pensions as social security **42**

2.2.4 Relevance to the research problem **43**

### **2.3 THEORY OF FINANCE 43**

2.3.1 Market efficiency and risk **43**

2.3.2 Theory of saving **45**

2.3.3 Pension savings **46**

2.3.4 Relevance to the research problem **47**

### **2.4 THEORY OF THE FIRM 47**

2.4.1 Resource-based view **47**

2.4.2 Stakeholder theory **48**

2.4.3 Evolution of the firm **49**

2.4.4 Relevance to the research problem **52**

### **2.5 ETHICS 52**

2.5.1 Utility and sanctions **52**

2.5.2 Ethics in business **53**

2.5.3 Ethical organisations **54**

2.5.4 Relevance to the research problem **56**

### **2.6 DECISION-MAKING 57**

2.6.1 Liberalism **57**

2.6.2 Decision-making process **58**



2.6.3	Decision criteria	59
2.6.4	Relevance to the research problem	61
2.7	STRATEGY	61
2.7.1	Strategic development	61
2.7.2	Game theory	62
2.7.3	Competitive shock	63
2.7.4	Relevance to the research problem	65
2.8	LEADERSHIP IN TURBULENT TIMES	65
2.8.1	Turbulence	65
2.8.2	Strategic leadership	66
2.8.3	Conceptual complexity	68
2.8.4	Relevance to the research problem	69
2.9	ORGANISATIONAL CHANGE	70
2.9.1	Organisational evolution	70
2.9.2	Time pacing	73
2.9.3	Organisational transformation	74
2.9.4	Relevance to the research problem	75
2.10	ANSWERS FROM THE LITERATURE	76

## **SECTION TWO: RESEARCH DESIGN**

### **CHAPTER THREE: PROBLEM STATEMENT, PROPOSITIONS AND RESEARCH METHODOLOGY 77**

#### **3.1 RESEARCH PROBLEM 77**

#### **3.2 RESEARCH PROPOSITIONS 78**

3.3	RESEARCH DESIGN	78
3.3.1	Research method	78
3.3.1.1	Qualitative research	79
3.3.2	Case study	81
3.3.2.1	Definition of research questions and constructs	82
3.3.2.2	Selecting cases and sampling	83
3.3.2.3	Crafting instruments and protocols	85
3.3.2.4	Data collection	86
3.3.2.5	Data analysis	86
3.3.2.6	Shaping hypotheses	87
3.3.2.7	Enfolding literature	88
3.3.2.8	Reaching closure	88
3.4	REASONS FOR USING THE METHOD	88
3.5	LIMITATIONS OF THE STUDY	88
3.6	GENERALISABILITY	89
3.7	RELIABILITY AND VALIDITY	90
3.8	NATURE OF THE RESULTS	91

### **SECTION THREE: CONTRIBUTION TO KNOWLEDGE**

## **CHAPTER FOUR: RESEARCH RESULTS AND ANALYSIS 92**

4.1	ANALYTICAL PROCESS	92
4.2	RESEARCH RESULTS	93
4.2.1	The regulatory framework	93
4.2.2	Trade unions	116

4.2.3	Members and Trustees	131
4.2.4	Business and Employers	141
4.2.5	Service providers	151
4.3	ANALYSIS OF RESULTS	185
4.3.1	Key elements	185
4.3.1.1	Environmental factors	185
4.3.1.2	Forces for change	186
4.3.1.3	Pace of change	190
4.3.1.4	Uncertainty	191
4.3.1.5	Consequences	195
4.3.1.6	Redress	201
4.3.1.7	Relative power of stakeholders	205
4.3.1.8	Ethical considerations	209
4.4	CONCLUSION	214
 <b>CHAPTER FIVE: DISCUSSION, RECOMMENDATIONS AND CONCLUSION 217</b>		
5.1	Discussion of research propositions	217
5.1.1	Environmental shock	217
5.1.2	Proposition one: Factors combine to drive evolution (i.e. adaptation to the environment)	218
5.1.3	Proposition two: Organisational evolution speeds up	219
5.1.4	Proposition three: Uncertainty and vacuum circumstances arise, leading to unintended consequences that require redress	220
5.1.5	Proposition four: relative power of stakeholders changes and determines the strategic outcome	221
5.1.6	Proposition five: An imbalance in stakeholder interests arises and ethical considerations become more consequential	222
5.1.7	New proposition six: Business seeks certainty	223

5.2	ENFOLDING LITERATURE	223
5.2.1	Conversion decisions by boards of trustees	223
5.2.2	Existing theory	223
5.2.2.1	Competitive shocks	223
5.2.2.2	High turbulence	225
5.2.2.3	Organisational evolution	225
5.2.2.4	Decision-making speed	226
5.2.2.5	Strategic outcome	226
5.2.2.6	Ethical considerations	227
5.2.2.7	Theory of the firm	227
5.2.3	What the literature does not explain	228
5.3	CONTRIBUTION TO THEORY	228
5.3.1	Definition of environmental shock	228
5.3.2	Under environmental shock, organisations seek certainty	229
5.3.3	Fast decision-making is essential, provided it does not exceed the thought process	229
5.3.4	Guidelines for managers to deal with fundamental environmental change	230
5.4	AN EMERGING MODEL	231
5.4.1	Recognising an environmental shock	231
5.4.2	Factors driving organisational adaptation	231
5.4.3	Appropriate speed	232
5.4.4	Determining what is uncertain	232
5.4.5	Potential consequences and redress	233
5.4.6	Change to relative power and impact on the strategic outcome	233
5.4.7	Code of conduct	234
5.5	RECOMMENDATIONS	234
5.5.1	Pension fund industry	235
5.5.1.1	Application of the model to pension fund reform	236

**5.5.2 Managing a country or a business 241**

**5.5.2.1 Application of the model to a pension fund perspective on  
broad-based black economic empowerment (B-B BEE) 242**

**5.6 CONCLUSION 252**

**REFERENCES 254**

**BIBLIOGRAPHY 261**

**APPENDICES 276**

8.1 Appendix 1: List of experts initially interviewed **276**

8.2 Appendix 2: Interview guide – industry experts **277**

8.3 Appendix 3: Contact summary form **280**

8.4 Appendix 4: Document summary form **281**

8.5 Appendix 5: Case analysis form **282**

8.6 Appendix 6: Case analytical framework **283**

8.7 Appendix 7: Macro-view industry expert interviews **286**

8.8 Appendix 8: Case studies **289**

8.9 Appendix 9: Case analysis Fund A and Fund B **290**

8.10 Appendix 10: Case analysis Fund C **299**

8.11 Appendix 11: Case analysis Fund D **305**

8.12 Appendix 12: Case analysis Fund E **310**

8.13 Appendix 13: Case analysis Fund F **317**

8.14 Appendix 14: Case analysis Fund G **322**

8.15 Appendix 15: Case analysis Fund H **328**

8.16 Appendix 16: Macro case analysis **332**

8.17 Appendix 17: Cross-case analysis **333**

## **GLOSSARY OF TERMS**

**Actuarial liability:** The present value of an amount, as determined by the fund actuary, that the fund will be required to pay to members at retirement.

**Actuarial reserve:** The value of the assets of a fund, as determined by the fund actuary, plus any investment reserve.

**Annuity:** An annual payment to retired members, that can be paid in monthly installments.

**Board of Management:** Also known as the Board of Trustees, these are member elected and employer appointed individuals who are accountable for the effective management of a pension fund.

**Certificate of existence:** A document submitted by pensioners on an annual basis to certify that they are still alive.

**Codes of good practice:** Rules drafted by the Department of Trade and Industry (DTI) for the implementation of Broad-Based Black Economic Empowerment.

**Consultant:** A person or entity that provides services to a fund for a fee.

**Contribution holiday:** Where defined benefit funds were in surplus, the sponsoring employer stopped contributing to the pension fund for a period of time.

**Conventional annuity:** An annuity that provides a set, guaranteed, monthly or annual payment for life.

**FAIS:** The FAIS Act, 2002, became fully operational in 2004. All intermediaries now have to be licensed in terms of the Act in order to sell financial products and have to comply with the requirements of the Act in order to do financial planning and to furnish advice.

FAIS ombud: The FAIS Act created the position of FAIS ombud who is invested with jurisdiction over complaints against insurers and intermediaries in respect of advice given after 1 October 2004.

Financial Sector Charter: A voluntary agreement among stakeholders in the financial sector that constitutes a framework and establishes the principles upon which Broad-Based Black Economic Empowerment (B-B BEE) will be implemented in the financial sector.

Financial Services Board (FSB): A statutory body that regulates the provision of financial services in South Africa.

Fund actuary: An individual, appointed by the Board of Management, responsible to perform a fund valuation on a tri-annual basis.

Independent trustees: Trustees who are not members of the fund.

Investment risk: Exposure to market volatility.

Linked investment service provider (LISP): An administration service that provides access for members to invest in a wide range of investment options offered by various asset managers.

Living annuity: A flexible annuity where pensioners can select to draw a specific percentage of the asset value per annum. Returns are not guaranteed and are dependent on investment returns.

Means test: Applied to determine whether a pensioner qualifies to receive the State Old Age Pension (SOAP).

Pension: An amount paid to a member at retirement on an annual or monthly basis.

Pension fund: In the Pension Funds Act, pension funds are also referred to as pension fund organisations and are defined as: “any association of persons established with the object of providing annuities or lump sum payments for members or former members of such association upon their reaching retirement dates, or for the dependants of such members or former members upon the death of such members or former members”.

Pension funds adjudicator: Established in terms of the Pension Funds Act to adjudicate complaints lodged against funds.

Pensioners: Members of a pension fund who have retired and are in receipt of a pension.

Preservation: Where a member withdraws from a fund and the proceeds are invested into another fund, rather than taken as a cash payment.

Principal officer: Appointed by the fund in terms of the act, and is a fund’s official representative with the FSB for the purposes of compliance with the Pension Funds Act.

Provident fund: A pension fund that pays a lump sum at retirement.

Regulation 28: Issued in terms of the Pension Funds Act and sets out investment limits for funds, e.g. 75 per cent can be invested in equities.

Retirement Annuity Fund (RA): A pension fund that is not sponsored by an employer and provides a maximum benefit of a third in cash at retirement with the balance paid as an annuity.

Retirement funds tax: A 9 per cent tax payable by pension funds on interest and rental income.



Rule amendment: A change to the rules of a fund, registered by the registrar of pension funds and approved by the South African revenue services.

Top-hat fund: An additional fund offered over and above the fund that employees are required to join when they commence employment at a sponsoring employer.

Trustees: See Board of Management.

Section 14: This section of the Pension Funds Act provides for regulatory control over amalgamations and transfers of business involving registered funds.

SOAP: State Old Age Pension, currently R820 per month.

Surplus: An amount, as determined by the fund actuary, by which the actuarial value of a fund exceeds the actuarial liability.

Surplus apportionment: In terms of the Pension Funds Second Amendment Act, all funds that identify a surplus must draw up a surplus distribution scheme, which sets out to whom and how the surplus must be distributed.

Sweetener: An amount promised to members to encourage them to transfer from defined benefit to defined contribution structures.

Umbrella fund: A pension fund whose rules permit any employer to become a participating employer.

Vesting rights: A benefit to which members are entitled.

## **LIST OF TABLES**

Table 1: Relative power of stakeholders **204**

## **LIST OF FIGURES**

Graph 1: Relative stakeholder power 1980s **206**

Graph 2: Relative stakeholder power in the mid-1990s **207**

Graph 3: Relative stakeholder power in 2006 **208**

Graph 4: Power dynamic between 1980–2006 **209**

# **SECTION ONE: THEORETICAL CONTENT**

## **CHAPTER ONE ORIENTATION**

### **1.1 BACKGROUND**

#### **1.1.1 Nature of the retirement funding system**

In 1994 the World Bank distinguished three separate pillars of a retirement funding system: the first is public benefit programmes funded from general government revenue and aimed at redistribution; the second is mandatory savings (such as company sponsored retirement funds); and the third is voluntary savings.

In South Africa, the first pillar comprises the social old age grant. It is the main source of income of over 75 per cent of women over the age of 60 and men over the age of 65. The old age grant is a means-tested payment of R820 per month administered by central government. The second pillar comprises the various pension fund arrangements associated with formal sector employment in either the private or public sectors.

The Pension Funds Act, promulgated in 1956, codifies the second pillar of the retirement funding system. There have been a number of ad-hoc amendments to the Act and a number of commissions have assessed retirement funding. These include the Mouton Commission (1992), Katz Commission (1995), Smith Commission (1995), National Retirement Consultative Forum (1997) and the Taylor Committee (2002). The National Treasury (2004) issued a discussion paper on retirement fund reform stating that the government seeks to build on the strengths of the established retirement funding environment, while progressively addressing its deficiencies.

According to the National Treasury (2004), the 1980s and 1990s saw a dramatic transfer of employees from defined benefit to defined contribution funds. Under

defined benefit arrangements, members were guaranteed a specific benefit at retirement, based on years' service, with employers funding any shortfall. Under defined contribution arrangements, members received a benefit at retirement based on contributions made to the fund and investment growth. Members thus carried the investment risk and benefit of defined contribution funds.

The National Treasury (2004) indicates that the South African environment has also seen considerable growth of multi-employer or "umbrella" funds. Such funds offer ease of access (especially for the employer), usually have lower unit costs than stand-alone retirement funds (which are to the advantage of the member), and frequently offer improved communication and administration facilities. Most of the large trade unions have established national defined contribution funds and have negotiated an option for their members to belong to such funds, as opposed to membership of an employer-sponsored fund.

After the initial transfer of most of their in-service members to defined contribution funds, some defined benefit funds shrunk in membership to the extent that they were no longer financially viable. Collapsing them into the new defined benefit contribution funds, but preserving features of the defined benefits that the member enjoyed, has given rise to hybrid arrangements, which therefore have features of both defined benefit and defined contribution funding. Consequently, the South African retirement funding system hosts a variety of funds, from defined benefit and defined contribution, to hybrid funds and multi-employer funds.

### **1.1.2 Retirement funds in South Africa**

The Pension Funds Act of 1956 defines a pension fund as:

any association of persons established with the object of providing annuities or lump sum payments for members or former members of such associations upon reaching their retirement dates or for the dependants of such members or former members upon the death of such members or former members.

Pension funds provide a maximum of a third cash payment on retirement, the balance must purchase an annuity for life. A provident fund is a pension fund that allows 100 per cent cash payment on retirement.

#### **1.1.2.1 Pension fund development**

Joubert (1999) states that: "In society, retirement represents the creation of an economically non-productive role for large numbers of people who have reached a certain age and whose labour is not considered essential to or necessary for the functioning of the economic order". He suggests that retirement is a consequence of industrialisation and therefore a creation of modern society. Before industrialisation, people worked until they had to stop working as a result of age or illness.

The earliest record of pension provision in South Africa, according to Ponting (2000), is in 1837 when pensions were paid by the British to some of their military staff. Legislation in the form of the Pension Funds Act 24 of 1956 formalised the pension fund industry. In 1956, South Africa was the first country to have a comprehensive act to regulate retirement funds. In other countries, the behaviour of retirement funds was regulated through a number of laws and legal principles, such as the law of trusts, but was not governed by any specific Act. South Africa was therefore a pioneer in this field.

#### **1.1.2.2 Growth and structuring**

Ponting (2000) states that retirement funds are the biggest institutions of social ownership in South Africa and over the years a number of theories have been developed which look at the level of state involvement in the retirement industry. The main elements of the framework can be briefly summarised as follows: there have been significant changes in the policy environment in which the state is located (political, economic and normative); the state adjusts to these changes in its environment by introducing pension reforms; the enterprise/occupational pension system primarily adjusts to the changes in its own product market, production regime shaped by changes in technology, and in internal labour market requirements.

Goodhind (1981) suggests that there are three principal sources of income for the individual in old age: from his own savings (i.e. accumulated wealth); from a pension scheme related to former employment; and from the government. Government pensions are minimal and cannot be regarded as adequate except for a very low standard of living. Lund (1999) argues that there is a structural problem in the South African social security system, a crack between the pillars of private retirement and assistance. It is possible for people to contribute to a private retirement or provident fund, draw the fund early if retrenched or in the case of early retirement, and then the state old age pension (SOAP) may be awarded with no reference to past savings and awards.

According to Ponting (2000), in addition to helping employers cope with the problem of their older staff retiring, a retirement fund also enables them to offer benefits that will attract and keep the staff they need in their organisation. This explains why defined benefit funds were geared towards providing benefits for employees who stay with the company until they retire. Employees lost a substantial amount of their expected retirement benefits when they resigned or were retrenched before retirement. Robinson (2001) states that dual employer/employee representation became compulsory from 15 December 1998 in both defined benefit and defined contribution 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.

Petersen (2001) suggests that the pension fund has traditionally been seen as a benefit for “good and faithful” employees, to enable them to enjoy their retirement or to provide for their dependants in the event of premature death or disablement. The pension fund provides financial support to allow the employer to discharge his moral obligation to employees or their dependants. Sher (1994) states that a defined benefit scheme refers to a retirement fund in which the benefit obligations are defined in terms of the member’s salary at retirement. These benefits are

promised to the member and guaranteed by the employer. The employer's contribution varies according to the actual performance of the fund (investment income, salary escalation and staff turnover) relative to the assumptions used when determining the actuarial value of the fund liabilities.

A defined contribution benefit design refers to a retirement fund in which the fixed regular contributions paid on behalf of the member are accumulated with interest until the member's retirement. At retirement the benefit paid is based on the accumulated proceeds. This contrasts with the defined benefit design wherein the retirement benefit is fixed and the contribution varies.

### **1.1.2.3 Defined contribution structures**

Stafford (1993) found that the following factors caused the move towards employees demanding defined contribution funds: extremely high levels of unemployment and uncertainty regarding job security; low levels of financial literacy that make defined contribution funds easier to understand; no adequate social security net; benefits not adequately explained to members – unions used the issue of retirement funds to further their own aims.

Murphy (2001), the first pension funds adjudicator, states that:

partly in anticipation of these changes and partly in response to them, employers, relying on the advice of consultants, began a process of redefining their liabilities towards their employees. Consistent also with international practice, the industry therefore has commenced a process of restructuring, with many employers moving from defined benefit arrangements to defined contribution schemes. Unfortunately, this has happened with inadequate supervision, under legislation conceptualised and enacted in 1956 and updated minimally on a piece-meal basis. With the wisdom of hindsight, it is fair to say that the regulatory framework has not been up to the task.

The defined benefit structure fueled conflict between employers and employees. During the 1980s, in the wider context of South African politics at the time, control over retirement funds became part of the broader liberation struggle (COSATU, 1992).

Cameron and Heystek (1998) listed union concerns at the time to be:

- \* Where union members were retirement fund members, the employer had total control of the vast sums of money saved.
- \* Trade union members, even though they were full-time employees of companies, were often excluded from retirement fund membership if they fell into the blue collar worker job classification.
- \* Withdrawal benefits under defined benefit funds were regarded as penal because workers generally only received a return of their contributions together with interest. Defined contribution funds facilitated the return of employer contributions as these were easily quantifiable.
- \* Members who retired to remote rural areas often did not receive their pensions because of lack of infrastructure.
- \* The concept of defined benefits was too complex and members believed that the actuarial principles involved in these schemes were not fair.

Defined contribution funds were considered to be a solution to problems experienced with defined benefit funds (Sephton, 1990). In terms of this fund structure, members receive an amount equal to their fund value at retirement, usually in the form of a lump sum payment. Withdrawal benefits on these funds are generally far more generous, and more transparent, than those received from the defined benefit fund. Horlock (1982) found that a defined contribution fund was perceived by members as a means of gaining more control over their retirement funds.

#### **1.1.2.4 Conclusion**

It was inevitable that pension fund structures would evolve. Defined benefit pension funds were established by employers to reward their employees' loyalty. They did not, however, fit the reality of employment mobility. Over time they grew to become strong financial institutions in their own right. As such, they became players in the provision of social security and several stakeholders emerged. Pressure to restructure from defined benefits to defined contributions came from various sources and for various reasons. There is no indication, however, of other alternatives being considered or of a measured conversion process being applied.



### **1.1.3 The metal industries environment in South Africa<sup>1</sup>**

#### **1.1.3.1 War – a catalyst for development**

At the outbreak of World War II, South Africa's engineering sector was, for the most part, concentrated on repair and maintenance work. The urgent demands of war brought massive expansion and technological development in the metal and engineering industry. Behind this revolution was a giant Pretoria steelworks that had started in 1934 – ISCOR.

Faced with a cut-off in the overseas supply of production equipment and finished articles, South African industry rose to the challenge and converted its engineering workshops into efficient munitions factories and began turning out a range of wartime equipment and spares comparable in quality with munitions produced in Britain and the United States.

Industrial relations were also becoming more organised. In 1944, the National Industrial Council for the Iron, Steel, Engineering and Metallurgical industries were formed – and the first national wage agreement for the industry was forged.

Peace brought an explosive increase in South Africa's metal and engineering industry. In the second half of the 1940s the number of metal and engineering undertakings grew by many hundreds and employment increased from 76 000 to 110 000. On the political front a minority Nationalist government had been voted into power in 1948. A policy of apartheid followed.

#### **1.1.3.2 Post-war boom**

Contrary to expectations, the South African economy did not follow the post-World War I pattern, and the long-awaited depression anticipated by many economists did not eventuate. As the post-war recovery continued, South Africa spent freely. Imports were stepped up without regard to the balance of payments. A drain on

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<sup>1</sup> This section draws heavily from the "Strength in Diversity" brochure issue by the Steel and Engineering Industries Federation of South Africa (SEIFSA) on its 60th anniversary in 2003. It provided the contextual background within which pension fund conversions in the metal industries were evaluated.

foreign reserves developed and it was necessary to introduce drastic exchange control measures. Many existing plants were expanded, affiliations established with overseas interests, and new plants came into existence to produce a wide variety of articles that had previously been imported.

In his 1950 presidential address, the President of the Steel and Engineering Industries Federation of South Africa (SEIFSA) reported that industrial relations were “amicable and constructive”. The industrial council system was working well, he said, “because of the fair-minded and intelligent perception brought to its administration by the representatives of both employer associations and trade unions”. Despite an enduring shortage of skilled labour, prices in the metal industry were internationally competitive – and South Africa started looking to export markets.

After the Korean War, strategic non-ferrous metals were in freer supply. The metal industry continued to expand and several hundred new firms opened for business and the workforce grew to more than 140 000. Output increased significantly. Two influential developments were the introduction of import restrictions in 1949–50 and the opening of a second Iscor steel works, at Vanderbijlpark, in 1952.

In the mid-fifties the industry’s Sick Pay Fund and Group Life and Provident Fund were established, mainly for skilled (white) workers. Meanwhile the Nationalists had been imposing a stream of laws and regulations designed to keep white and black South Africans apart. The Black Labour Relations Regulation Act of 1953 was aimed at creating a separate labour relations system for black workers. The fundamental difference was that black trade unions could not take part in centralised collective bargaining or make use of the industrial council system. Black workers’ interests would be dealt with through a central board – controlled by whites.

The Industrial Conciliation Act became the core of South Africa’s labour relations. Apart from covering trade union, industrial council and centralised bargaining agreements, it introduced far-reaching racial discrimination into labour affairs.

Notably it prevented black workers from forming registered trade unions and barred “mixed” unions. These two laws entrenched racial division in the conduct of labour relationships. They were supported by other separatist legislation such as the Group Areas Act and the Influx Control Act. Before the end of the decade the Industrial Conciliation Act was amended to introduce “job reservation” calculated to protect white workers. Employers protested that “such matters are foreign to the successful system of collective bargaining and are detrimental to the harmonious working of the industrial council system”. Job reservation also denied blacks technical training at a time when the country was experiencing a shortage of all kinds of technical skills.

### **1.1.3.3 International isolation**

Several events occurred in the 1960s that divided South Africans even more deeply, alienated world opinion and led to intensified international pressure.

First came the massacre of 69 blacks by police at a demonstration against the pass laws. The world was appalled and the government responded by banning the African National Congress (ANC) and the Pan Africanist Congress (PAC). A year later South Africa withdrew from the Commonwealth and became a republic. In 1963, at the Rivonia Trial, Nelson Mandela was sentenced to life imprisonment and, Transkei became the first “independent Bantustan”. The following year government walked out of the International Labour Organisation (of which South Africa had been a founder member), and the country’s team was excluded from the Tokyo Olympic Games. Other sport protests and boycotts followed.

All this led to a flight of money. Thousands of whites emigrated, and property prices plummeted. But these events also demonstrated two things: the country still had considerable financial resources to invest in new productive capacity and its people were extraordinarily resilient and innovative as they sought to survive the increasing isolation. Fundamental to “Fortress South Africa” was government’s support of local industry. High level investigations took place to find ways of replacing imports with local products. The economy boomed and gross domestic product (GDP) rocketed from R5 billion in 1960 to R13 billion in 1970.

The “build the economy” policy brought unprecedented spin-offs for the metal and engineering industry, which forged ahead at an average 12 per cent during the mid-sixties. The workforce burgeoned to 265 000. In 1965 the Metal Industries Medical Aid Fund was launched mainly for skilled employees, and in the following year the Metal Industries Group Pension Fund was established as a non-contributory scheme mainly for unskilled employees.

The shortage of skilled labour was an abiding problem. With the formation of the National Industrial Council for the industry, control of apprenticeship training became a national function under the National Apprenticeship Board. Trade union and employer representation on the board was bolstered by members with special expertise. By the end of 1966 some 28 000 artisans and 6 000 apprentices were at work in the industry.

#### **1.1.3.4 More restrictive legislation**

At the beginning of the seventies, business concerns began to emerge about the way the Physical Planning and Utilisation of Resources Act was being applied. The aim of this Act was to limit the number of black workers in specified areas without the prior approval of the Minister of Planning. Furthermore, the Act inhibited the progress of black workers into more skilled categories in an industry which had long been inhibited by a shortage of skilled white workers. In 1972 an agreement was reached with the industry’s trade unions to allow black workers to advance into higher skilled (previously white) operative jobs.

In Soweto, resentment towards government was rising. On 16 June 1976, thousands rioted. Rioting spread across the Rand and to the Western Cape and by early 1977 more than 500 people had died. Government responded with more bannings. Many young blacks went into exile to fight the system – and world hostility mounted. In 1977 the Wiehahn Commission was appointed to enquire into labour legislation. Its key recommendations were:

- \* full freedom of association must be granted to all employees;
- \* trade unions must be allowed to register, irrespective of composition; and
- \* statutory job reservation must be phased out.

Government responded to township unrest and violence, boycotts and burnings, with one state of emergency after another. Media censorship was tightened. At the same time it sought to bolster the economy by funding ambitious infrastructure development and import replacement projects and through high tariffs and generous export incentives. Many of these projects helped sustain the industry during a stagnant global economy. In the early 1980s the production in the industry was more than R10 billion, or about a third of the country's manufacturing output.

On the industrial relations front in 1980, two registered black trade unions became fully-fledged members of the industrial council. The next year they were joined by two more. Unemployment remained a serious problem, particularly among blacks in metropolitan areas, and inflation, though lower than in some of South Africa's trading partners, was still eroding living standards and raising the cost of corporate finance.

#### **1.1.3.5 International pressure**

In 1981 the new black unions were beginning to show their muscle. Strikes broke out throughout the metal and engineering industry of black workers saying that they wanted nothing to do with a pension fund for black workers introduced by the Industrial Council. It had been negotiated with unions in the council at the time, not with the black unions.

The workers' view was that the "preservation principle" – that employees leaving one company could not get their contributions back until retirement age – was unacceptable. The employers agreed to change it, but not to abandon or break up the fund. The change was crucial in persuading the black unions to stay with the idea of an industry-wide pension fund.

By 1983 the recession in the metal industry internationally was being called the worst since the Great Depression half a century earlier. Even South Africa's distant and isolated industries were caught in the contagion.

In the second half of the 1980s pressure on the Nationalists intensified, within and outside the country. Demonstrations and riots continued to wreak havoc in the townships. Troops moved into areas where rampaging youths were burning schools and shops believed to be supporting the system. Government sought to appease an increasingly hostile world by pulling down long-standing pillars of social apartheid. "Mixed marriages" and sex across the colour line were no longer outlawed. Public amenities were opened to all, and influx controls – the hated pass laws – were abolished. A tricameral parliament was established, with separate Houses for Whites, Indians and Coloureds.

State President P.W. Botha declared that these reforms showed that South Africa had "crossed the Rubicon". Yet the ANC, PAC and other black resistance organisations remained banned, their leaders in jail or in exile. South Africa's key trading partners, the European Economic Community and the United States, introduced formal sanctions. The Comprehensive Anti-Apartheid Act, signed into law in the USA in October 1986, was seen by many as the final blow that would break apartheid in South Africa. Industrial unrest and intimidation continued. Reports streamed in of illegal strike action, overtime bans and factory occupations. Union members gave their support to sanctions and disinvestment. In 1988 NUMSA (the National Union of Metalworkers of South Africa) triggered the industry's first national strike by 25 000 members at 120 companies. It lasted three weeks. President Botha bowed out and was replaced by F.W. de Klerk.

In February 1990, banned political parties – notably the ANC – were unbanned. The state of emergency was lifted and the first moves were made towards a negotiated constitution. In 1990 the rules of the Metal Industries Group Pension Fund were amended to allow members to pledge pension contributions as security for home loans.

In a climate of tough economic conditions, escalating retrenchments and employer-union confrontation, NUMSA held a controversial strike ballot. On 31 July 1992 the industry's last big national strike of the century began. By the following week, some 80 000 NUMSA members were on a strike that would last a month. Recessionary

conditions in the following year saw employment in the industry drop to well below 300 000, from 454 000 in 1981.

#### **1.1.3.6 An opening economy**

Historic elections swept the ANC and its COSATU and SA Communist Party allies to an overwhelming victory and Nelson Mandela to the Presidency.

The world had been through tumultuous times with Gorbachev and *perestroika* and *glasnost* – and had witnessed the crumbling of communism and the Soviet Union. Now, also freed from apartheid and sanctions, South African business began to look outward. Those entrusted by government with driving the economy forsook the short-term populist path of socialism for the richer rewards of free market pragmatism.

Fundamental changes took place in business, labour and skills development. The National Economic Forum and the National Manpower Commission were merged to create the National Economic, Development and Labour Council (NEDLAC). The new Labour Relations Act was implemented, transforming labour law and industrial relations. The South African Qualifications Act (SAQA) introduced a National Qualifications Framework, which was followed in 1998 by the Skills Development Act, and a system of sectoral education and training authorities, known as SETAs.

Since 1994 the industry unions have had equal representation with employers on the Board of Management of the Metal Industries Benefit Funds Administrators (MIBFA), a Section 21 company controlling the industry's pension, provident, sick pay and permanent disability funds. The combined market value of the funds is around R25 billion. Previously the funds were managed by the funds division of SEIFSA.

#### **1.1.3.7 Metal Industries Pension Funds**

Various industry funds exist, some of which are mentioned in the research analysis.

➤ **Engineering Industries Pension Fund (EIPF)**

This is a defined benefit pension fund. The Metal Industries Group Life and Provident Fund was established by way of an Industry Council Agreement concluded on 2 May 1957, and established on 29 July 1957, in accordance with the provisions of the Labour Relations Act 28 of 1956 (the old LRA). It was converted from a provident fund to a pension fund, without a name change, in 1975. Its name was changed to Engineering Industries Pension Fund on 31 March 1990. With effect from 1 January 1995, the Metal Industries Group Pension Fund was merged with the fund. The Metal Industries Group Pension Fund was formed in 1966. It was agreed in 1990 that the fund should be terminated and a provident fund should be established in its place.

In terms of its constitution and rules, the EIPF is a body corporate which has the capacity to sue and be sued in its own name. The constitution of the EIPF makes provision for the appointment of a board of management which is vested with the power of management of the fund. As at 31 July 2004, the EIPF had 30 434 members.

➤ **Metal Industries Provident Fund (MIPF)**

The MIPF is a defined contribution provident fund. The MIPF was established by way of an Industrial Council agreement concluded during 1991 with the effective date being 22 March 1991 in accordance with the provisions of the old LRA.

In terms of its constitution and rules, the MIPF is a body corporate which has the capacity to sue and be sued in its own name. The constitution of the MIPF makes provision for the appointment of a board of management which is vested with the power of management of the fund. As at 31 July 2004, the MIPF covered 208 017 members.

➤ **Surplus issues**

Former members of both funds total approximately 995 000. Both the EIPF and the MIPF have significant actuarial surpluses amounting in total to approximately R9 billion. The funds' administrator, the Metal Industries Benefit and Fund



Administrators (MIBFA), and the bargaining council have obtained a number of legal opinions on this issue, all of which conclude that the provisions of the Pension Funds Act (PFA) 24 of 1956 are not applicable to the funds. The PFA 1956 came into operation on 1 January 1958. The registrar, NUMSA and the member trustees maintain that the funds are obliged to comply with the PFA, including the provisions of the surplus legislation.

SEIFSA trustees, in their capacity as trustees of both the EIPF and MIPF, owe fiduciary duties to the funds and to their members. The outcome of the disputed issues will have significant consequences for the funds, existing members, former members, pensioners and employers. If the provisions of the PFA do not apply to the funds, then there is no lawful basis on which the trustees may effect a surplus distribution consequent upon these provisions. Similarly, if the surplus legislation is binding, then the funds are obligated to comply with these provisions and any failure to do so could give rise to claims by dissatisfied stakeholders (as defined in the PFA) or by the registrar to enforce compliance therewith. The registrar has already indicated that if the funds do not submit the statutory surplus apportionment scheme required by Section 15B of the PFA he will take steps to constitute a special tribunal under Section 15K of the PFA to compile a scheme on the funds' behalf.

On 4 May 2000 the pension funds adjudicator issued a "practice note" in which he expressed the opinion that the provisions of the PFA are applicable to certain funds established in terms of industrial council or bargaining council agreements, but were not applicable to others. On 9 June 2000, and in response to a complaint against the EIPF lodged with the adjudicator in terms of the PFA, the adjudicator declared that the Act conferred upon him the jurisdiction to determine the dispute. However, in a decision handed down on 6 May 2002 the adjudicator reversed his position and determined that the PFA did not apply to the MIPF.

The amendments to the PFA comprising the surplus legislation had come into effect on 7 December 2001. Since the funds were registered in terms of the PFA and since the adjudicator had declared that he had jurisdiction to determine the

complaints against the funds in terms of the PFA, the trustees proceeded as though the PFA was applicable to the funds. To that end the funds established special sub-committees to investigate a surplus apportionment under the PFA. These sub-committees performed extensive work in pursuance of their task. In the latter half of 2003 and early 2004 the funds' administrators MIBFA and the bargaining council procured a series of separate opinions concerning the question of whether the PFA applied to them. These opinions were brought to the attention of the boards of management of the funds.

Pursuant to the opinions received, the EIPF and the MIPF notified the registrar that they had been advised that the PFA was not applicable to them. On 24 May 2004 the registrar responded that the Pension Funds Act 24 of 1956 applies to all funds that are registered in terms of Section 4 of the Act. At a special meeting of the board of management of the EIPF on 13 May 2004, employee representatives expressed the view that the surplus subcommittee should begin distribution of the surplus without further delay. An employer representative responded that the distribution cannot take place until such time as clarity had been received as to the governance of the funds and suggested that the declaratory order from the High Court should be obtained. After a trade union caucus, labour declared their intention to request the Financial Services Board (FSB) to make a ruling on the matter.

A delegation of the EIPF and MIPF met with the registrar on 2 August 2004 to explain to him the legal dilemma that they find themselves in and to ask for the registrar's assistance in obtaining clarity on the matter. On 8 August 2004 the registrar wrote to the funds and stated that the MIPF was registered in terms of the PFA in April 1991; that it must submit a surplus apportionment scheme by 30 September 2004; if the scheme was not submitted a specialist tribunal would be convened.

At a meeting of the board of management on 11 August 2004, the employee nominated and employer appointed trustees could not agree on the way forward. Although the funds had been operated under the impression that they were subject

to the PFA, opinion had indicated otherwise. The employer appointed trustees subsequently agreed to apply for a declaratory order at the High Court of South Africa.

There are numerous occupational funds, other than funds established in terms of industrial agreements, to which the PFA does not apply by virtue of Section 4 of the PFA. These funds represent a significant portion of the pension funds industry which is not subject to regulatory oversight by the registrar. They include:

- \* The Government Employees Pension Fund maintained in terms of the Government Employees Pension Law, 1996.
- \* The Temporary Employees Pension Fund established in terms of the Temporary Employees' Pension Fund Act, 1979.
- \* The Associated Industries Pension Fund established in terms of the Associated Institutions Pension Fund Act, 1963.
- \* The Associated Institutions Provident Fund established in terms of the Associated Institutions Provident Fund Act, 1971.
- \* The Members of Statutory Bodies Pension Scheme established in terms of the Members of Statutory Bodies Pension Act, 1969.
- \* The Members of Parliament and Political Office-Bearers Pension Scheme established in terms of the Members of Parliament and Political Office-Bearers Pension Scheme Act, 1984.
- \* The Closed Pensions Fund, established in terms of the Closed Pension Fund Act, 1994.
- \* The SA Public Library Provident Fund established in terms of the SA Public Library (Pension and Provident Fund) Act, 1924.
- \* The Transnet Pension Fund, the Transnet Retirement Fund and the Second Defined Benefit Fund established in terms of the Transnet Pension Fund Act, 1990.
- \* The Post Office Pension Fund (formerly the Postal Pension Fund) established in terms of the Post Office Act, 1958.
- \* The Telkom Pension Fund (formerly Telecommunications Pension Fund) established in terms of the Post Office Act, 1958.

If the PFA does not apply to the EIPF and MIPF the applicants will nonetheless be willing to participate in an exercise involving the apportionment of actuarial surpluses in the EIPF and MIPF by agreement between the trustees and the industrial council provided that nothing in the conduct of that exercise would require them to breach their duties to the MIPF and EIPF or their members. The registrar is concerned, however, that this will not take place in terms of the PFA (which sets out specific rules for the apportionment).

#### **1.1.4 The South African economy<sup>2</sup>**

##### **1.1.4.1 Introduction**

Since 1994, the South African economy and its management have changed dramatically, and for the better. As South Africa re-entered the global economy, the level of external and internal competition faced by South African private businesses has intensified. Amidst these events, the traditional look and attitudes of South African business became increasingly out of step with the vibrant multi-racial and multi-cultural society which it serves and on which it depends. Changing the face of South African business firms – to make them more balanced, in terms of race and gender, but also more innovative, flexible and responsive – has become a prerequisite for success. Business is at the heart of the post-1994 economy, as is evident from business's growing share of output, investment and growth. In many areas business is a driver of change and complements reforms undertaken by the public sector.

##### **1.1.4.2 Business at the heart of the post-1994 economy**

With an estimated gross domestic product in excess of a trillion Rand in 2003, the South African economy is now some 30 per cent larger than it was in 1994. The private sector, which accounts for more than three quarters of the economy, was responsible for 24 out of the 30 percentage points of growth since 1994. Much of this growth took place in manufacturing, finance and communications – in other

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<sup>2</sup> This section draws heavily from *Business in South Africa in 2003*, published by the South Africa Foundation in Johannesburg: South Africa. It provided the contextual background within which pension fund conversions were evaluated.

words, outside of the historical mainstays of the South African economy. This growth reflects South Africa's increasing integration into the world economy.

Between 1994–2002, exports of goods by South African firms increased by some 50 per cent in real terms – the South African economy has become an export economy. At the same time, imports have increased markedly, providing South African households and firms with more choice, and South African producers with more competition.

Since 1994, corporate sector savings has equalled 87 per cent of South Africa's cumulative gross domestic savings, compared to 13 per cent for the household sector and dis-saving by the state. At 17 per cent of GDP per year, South Africa's gross domestic savings rate is low compared to other middle income countries with an average rate of 25 per cent. Corporate savings is defined as net profit that has been retained for internal use plus whatever amount was reserved for the replacement of worn capital stock. This means that South Africa relies heavily on corporate savings to fund all forms of investment, as well as government deficits. In 2002, the net value added of corporates was estimated at R626 billion. This was shared between employees (61 per cent), government (21 per cent), lenders, reinvestment in the business and dividends.

#### **1.1.4.3 Business as a driver of change in South Africa**

Business in South Africa has a chequered history when it comes to change, and in some areas business is still changing more slowly than circumstances demand. In the last few years, though, the business sector has accelerated change in five important areas. These frontiers of change are: success in global markets; empowerment; innovation; contribution to society; and investment in Africa.

##### **➤ Success in global markets**

Three factors have set the stage for South Africa's export boom:

- \* South Africa's re-entry as a full member of the global economy;
- \* South Africa's trade policy liberalised; and
- \* the Rand's weakness.

## ➤ **Empowerment**

Including black South Africans (who have been excluded through the decades of apartheid) in the economy is a critical national imperative. This change needs to be accelerated in the ranks of shareholders, on boards and in the management cadres of South Africa's private business firms. The short-hand for this process is the word "empowerment".

Foreign investors own an estimated 36 per cent of the market capitalisation of the JSE. Some 38 per cent of JSE market capitalisation is held by South African institutional investors on behalf of millions of beneficiaries. This pattern is a sign of a mature and sophisticated market, but it tends to shield the identity of the ultimate beneficiary. This type of institutional capitalism also tends to blur the ultimate locus of control. There is still an element of corporate cross-holding in our market, with an estimated 19 per cent of the market owned by other corporates. That leaves direct retail investors (and company founders and their families) with an estimated 5 per cent of the market. Due to the dispersed nature of power as sketched above, establishing the racial composition of control of a company is often complicated. It is easy where investors have direct stakes; more difficult as institutional capitalism becomes more prevalent. It would be inadvisable to create a regime where direct ownership is favoured over indirect ownership, given the advantages of the latter (particularly for investors other than the super-wealthy). Both forms of ownership have a role to play.

Given the predominance of institutional savings in South Africa, it is likely that black ownership (in terms of ultimate beneficiaries) will steadily increase to normal levels, but data on black control may remain low, given the dispersed nature of control of institutional capitalism. Normalisation in terms of influence and control will therefore be achieved by direct black control, but more so by black representation throughout the various levels of institutional decision-making. This includes more representative investment teams in the institutions, and ultimately culminates in greater black participation at corporate boards (the means by which shareholders oversee the company they own).

The government released its Black Economic Empowerment (BEE) strategy in March 2003. The strategy signalled that government would not set universal BEE requirements, but would use its role in the economy as a procurer of goods and services and an issuer of licenses and certain rights to create an incentive for companies to empower. The government has endorsed the use of a scorecard to measure the extent of empowerment achieved and the development of industry sector charters. The Financial Services Charter was released by the financial sector on 17 October 2003 and sets measurable goals in six areas for achievement over the next ten years: employment equity and skills; procurement; access to financial services; empowerment financing; ownership and control; and corporate social investment.

In 2003 organised business achieved unity with the merger of the Black Business Council and Business South Africa. The new body, Business Unity South Africa, represents business in NEDLAC and is charged, along with government, labour and the community, with the implementation, inter alia, of the Growth and Development Summit Agreements as well as the roll-out of the Accelerated and Shared Growth Initiative for South Africa (ASGISA). This includes a major infrastructure and development initiative aimed at raising GDP growth to 6 per cent per annum and halving unemployment by 2014.

➤ **Innovation and invention**

South African firms play an important role in making the benefits of innovation and technological progress available to the country's people. There are instances of novel approaches by South African firms benefiting society on a large scale, such as Sasol's GTL (gas-to-liquids) technology which expanded the world's energy resources and Pay-as-you-go telephony from MTN, Vodacom and Cell-C which created a social revolution.

➤ **Contribution to society**

On 7 June 2003, organised business, organised labour, government and the community constituency in NEDLAC signed an agreement marking the 2003 Growth and Development Summit hosted by President Thabo Mkebi. The GDS

Agreement focused on four themes: employment; investment; advancing equity – including skills development, extension of economic opportunity and expanded access to services; and local action and implementation. The overall aim of the Agreement is to halve unemployment by 2014. Business made various commitments in this regard.

As South Africa's political landscape has changed and, at the same time, corporate profit margins have come under pressure from increased domestic and foreign competition, companies have sought to improve the effectiveness of their Corporate Social Investment (CSI) spending. Companies have over the past year pursued the following strategies:

- \* focusing on fewer and larger projects;
- \* consciously linking the CSI programme to national priorities;
- \* actively seeking partnerships in CSI work;
- \* supporting programmes with a national spread;
- \* focusing CSI to communities where business operations are; and
- \* aligning CSI programmes to the nature of the business.

Over the past year, CSI has been characterised by three trends: increased partnering; pilot and replication; and employee involvement.

### ➤ **Investment in Africa**

South African companies have recognised the value of investing in Africa and have made significant efforts in the continent since 1994. South African firms contribute to the development of the region in the following ways:

- \* by increasing trade from and within the region;
- \* by providing skilled inputs into African projects; and
- \* by way of direct investment in productive capacity in the region.

South African companies have invested in a range of industries, most notably cell phones, banking, retail and food and mining.



#### **1.1.4.4 Conclusion**

Business exists to generate value for society. When it succeeds, it generates employment and wages, as well as profit and taxation revenues. At this moment in South Africa, business is called upon to help construct a new, inclusive South African society.

## **1.2 OBJECTIVES OF THE STUDY**

In the 1970s, most retirement funds in South Africa were defined benefit funds, managed by employers or employer-appointed boards of management. Under these arrangements, members received a guaranteed benefit at retirement based on years' service. Employers funded any shortfall, thus carrying investment risk.

In the early 1980s, trade unions agitated for the establishment of defined contribution retirement funds. Their reasons included:

- \* The mortality rate for the black population is higher than for whites, and trade unions felt their members were subsidising the whites in defined benefit funds.
- \* Once members retire, they moved back to their rural homes, and drawing a pension at the end of each month was difficult for members in these rural areas.

In the early 1990s employers began to express a need to limit their open-ended liability. This led to members of defined benefit funds being given an option to transfer to defined contribution funds. Employers preferred a defined contribution arrangement, where members received a benefit at retirement based on contributions made to the fund plus investment growth, since it provided for the capping of their personnel expenses and it transferred the investment and expense risks to the employee. After the 1994 elections, the trend became more pronounced and in the late 1990s employers began providing inducements to members to transfer to defined contribution funds by paying across a portion of the surplus.

Today, the vast majority of employees in the private sector are members of defined contribution funds, while public sector funds are still largely defined benefit arrangements.

The Pension Funds Second Amendment Act of 2001 was retrospective legislation that requires pension funds to distribute any surplus held in the fund to current and former members who were members of the fund at any time since 1980. This legislation appears to be an attempt to ensure that where a majority of members of a defined benefit fund had converted to defined contribution arrangements, the few remaining members could not unfairly benefit from the remaining surplus.

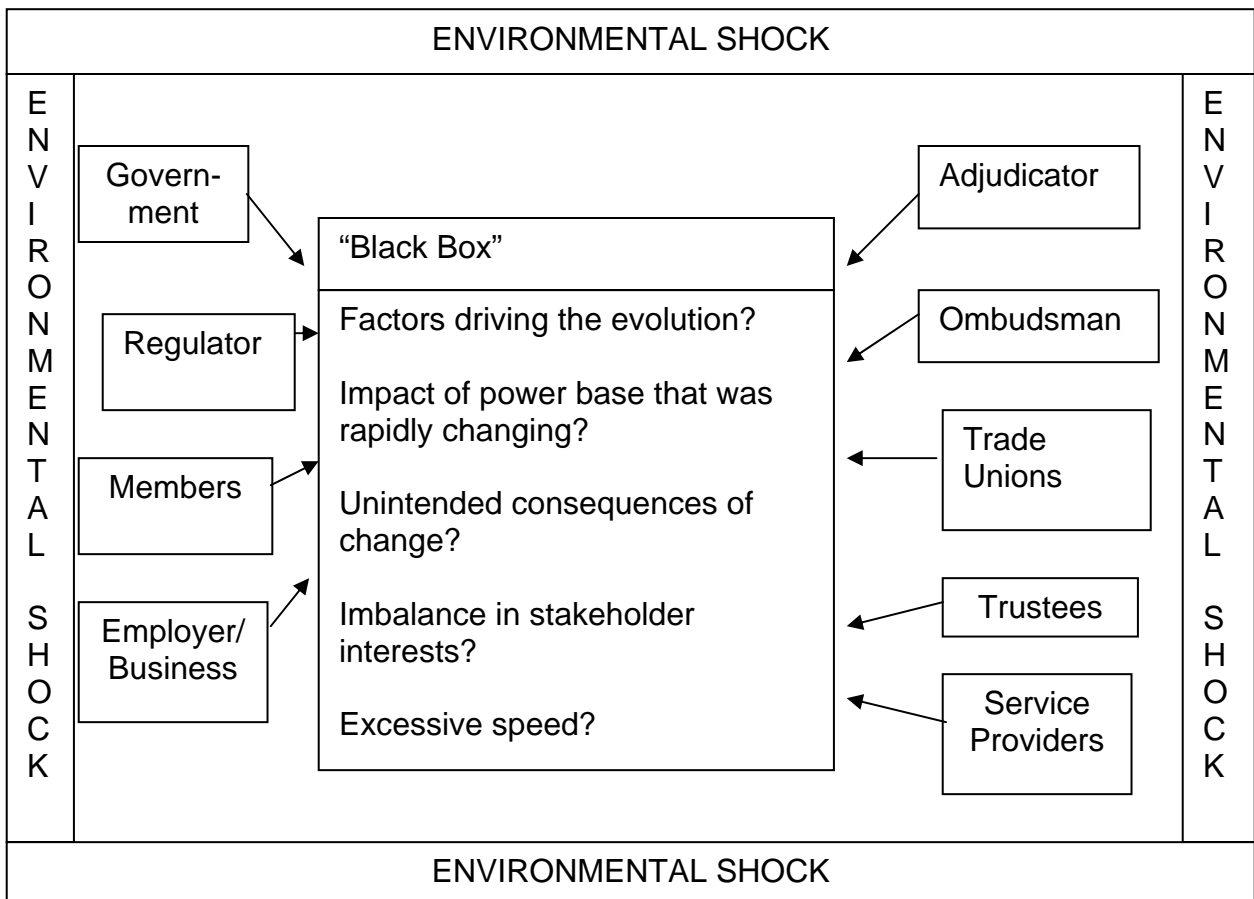
The objective of this study is to analyse the phenomenon of South African pension fund conversions and develop a model for management to apply in dealing with fundamental environmental change.

### **1.3 SCOPE OF THE STUDY**

The possible research outcome is a model for application in times of fundamental environmental change to equip decision-makers to take appropriate strategic action. Decision-makers will be equipped to recognise “environmental shock” that changes the rules of the game.

#### **1.3.1 Research framework**

Pension fund conversions are contextualised as follows:



The various elements of the model are detailed below.

### 1.3.1.1 Environmental shock

In the context of pension fund conversions, the economic restructuring and transition to democracy in South Africa is an environmental shock of significant political, economic and social magnitude that changed the game.

### 1.3.1.2 Government

Government passes legislation that serves as the rules of the game. When the majority of pension fund conversions occurred, the National Party government had other, more significant matters of concern and the ANC “government-in-waiting” was not entirely clear on how it proposed to close the gap between social insurance and social assurance. It is interesting to note that the government employee pension fund has retained a defined benefit structure.

### **1.3.1.3 Regulator**

The regulator, the Financial Services Board (FSB), was experiencing a transition of its own.

### **1.3.1.4 Members**

Members appear to have welcomed the conversions and were either unaware of or unconcerned about investment risk moving from employers to members. Financial literacy may have been absent. Members who converted and remained with the same employer are in many instances significantly worse off.

### **1.3.1.5 Employers/business**

Pension fund deficits were considered to be a significant threat given that contingent liabilities were required to be reported in financial statements. Many funds were open only to white members. After the transition to democracy they would of necessity be opened to black members. It is possible that employers considered this to be a possible threat in the belief that this would increase their contingent liability through increased exposure to AIDS and its financial implications for the fund.

### **1.3.1.6 Trade unions**

Trade Unions agitated for the conversions claiming that members would be better off under “more transparent” and easier to understand defined contribution structures. They may have been considering their power position within the new political dispensation.

### **1.3.1.7 Trustees**

From 15 December 1998, at least 50 per cent of trustees must be member elected and the balance appointed by the employer. They were required to make the various decisions regarding the conversions. There is, however, a critical lack of education, especially among member elected trustees, and so it is possible that they did not fully understand the implications of the changes that they were resolving to make, or they had vested interests.

### **1.3.1.8 Service providers**

The conversions provided significant business opportunities for consultants who advised trustees on how to action the conversions. Brokers now have vast amounts of pension fund assets available for them to provide advice to members. Other service providers include: actuaries, administrators, umbrella fund sponsors, life offices and lawyers.

### **1.3.1.9 Adjudicator**

The office of the pension funds adjudicator was established on 1 January 1998 to investigate and decide on complaints received from members. The adjudicator only acts if complaints are received from members.

### **1.3.1.10 Ombudsman for long term insurance**

The ombudsman provides a voluntary arbitration service that resolves disputes between policy holders and the life offices. Under defined contribution arrangements, members who retire and purchase pensions from life offices cease to be members of the fund.

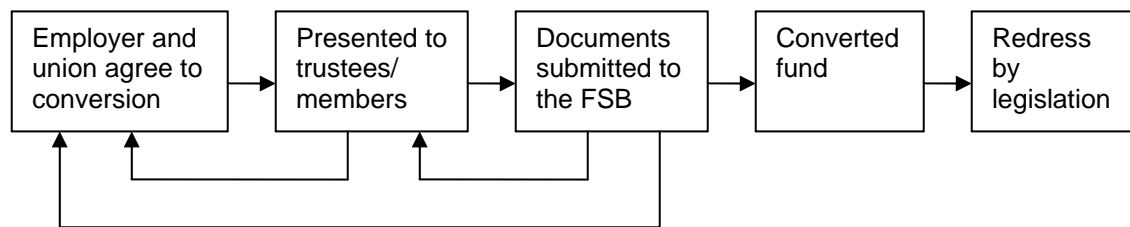
## **1.3.2 De-limitations of the study**

The study considers pension fund conversions as represented in the research framework, and focuses only on the conversions from defined benefit fund structures to defined contribution fund structures. It specifically does not consider the development of umbrella funds, nor does it offer any solutions to the societal problem of pension provision.

## **1.3.3 Assumptions**

Defined benefit funds rewarded long service and were designed to make provision for retirement. They did not reflect the reality of employment mobility and were not compatible with the remuneration concept of “cost-to-company” – it was inevitable that their structure would change.

The conversion process operated as follows:



Under usual circumstances, mechanisms would exist to balance stakeholder interests. The FSB would ensure that members were protected and/or members themselves would have applied pressure to employers for an alternative outcome. Now that the conversions have occurred, the government is implementing “redress” in the form of the Pension Funds Second Amendment Act (known as surplus apportionment legislation) to address one of the unintended consequence of the conversion – a surplus in the fund that cannot be accessed.

#### **1.4 IMPORTANCE OF THE STUDY**

The phenomenon of pension fund conversions is a manifestation of organisational behaviour during fundamental environmental change.

It is certain that environmental change will continue to occur and that change drivers will emerge. If decision-makers in business are equipped to recognise that prevailing circumstances are not “business as usual” and that the rules of the game are changing, they would be enabled to take appropriate strategic action.

An infrastructure should be available to guide managers in these circumstances. They should be able to consider the circumstances and identify the mechanisms that may be failing or stakeholders that are reacting differently. This would then provide an opportunity to take defensive action, or to take advantage of the environmental influences. During such circumstances, arbitrage opportunities increase and ethics becomes a key consideration in order to restrain exploitation of an unfair advantage. Various examples exist where challenges to business have arisen as a result of environmental change, such as:

- \* Black economic empowerment and employment equity.
- \* Sector charters (e.g. mining and financial services).
- \* Land re-distribution.
- \* Sanctions.

Therefore the results of this study may well assist management to cope with the challenges these phenomena present.

## **1.5 STUDY ENVIRONMENT**

### **1.5.1 Current affairs in the South African pension fund industry**

#### **1.5.1.1 Revised Pension Funds Act**

The existing Pension Funds Act came into effect on 1 January 1958. This legislation was subsequently amended on an ad-hoc basis, but does not provide a suitable framework for the retirement fund industry. A white paper on pension fund reform has been issued for comment and it is anticipated that revised legislation will be promulgated in 2008.

#### **1.5.1.2 Rulings of the pension fund adjudicator**

Several rulings of the pension funds adjudicator indicate that the retirement fund industry has failed to serve the best interests of members. In reaction to these findings, service providers have agreed with the Minister of Finance to set aside R3 billion to refund members who were subjected to unfair confiscatory penalties.

#### **1.5.1.3 Institute of Retirement Funds (IRF)**

The Institute of Retirement Funds was established to serve the interests of pension funds and their members. This body was, however, dominated by service providers rather than fund trustees. In 2005, after considerable pressure from the trade union movement (especially COSATU) and the Financial Services Board, members of the IRF agreed to split the IRF into two distinct bodies: an Institute of Retirement

Funds, to represent fund trustees, and the Institute of Retirement Industry, to represent all other players in the industry.

#### **1.5.1.4 Broad-Based Black Economic Empowerment (B-B BEE)**

Pension funds form the broadest base for black ownership. Codes of Good Practice issued by the Department of Trade and Industry (DTI) in November 2005, however, do not specifically refer to pension funds. Thus companies cannot obtain credit for black ownership via pension funds. In effect, this means that where a company is 100 per cent owned by a retirement fund with predominantly black membership, that fund would be required to sell part of the company to other black individuals in order to obtain credit for black ownership.

The industry is not legally bound to comply with the Financial Sector Charter, which was signed by the IRF. There are indications, however, that stakeholders will apply pressure on funds to comply with its various provisions.

#### **1.5.2 Impact of market performance**

Given that members bear the investment risk under defined contribution structures, the perceived benefit of defined contribution structures is that members can benefit from superior market performance. During the conversion period under review (i.e. 1980–2006) the market has, as would be expected, experienced periods of relatively poor and relatively strong market performance.

Since late 2005, early 2006, market performance has been outstanding. Prices on the Johannesburg Stock Exchange reached an all-time high and fund values of members invested in equities via defined contribution pension funds have experienced phenomenal growth. The all-share index is up 40 per cent. This recent market improvement is now being cited to encourage remaining members of defined benefit funds to convert to defined contribution structures.

In periods such as these, defined benefit funds appear less attractive, given that retirement benefits are limited to a specific formula – but members also tend to



forget about market risk. In a defined contribution structure, values in a members' investment account can range from astronomical to abysmal within a very short period. Members of defined benefit funds are not faced with this risk.

## **1.6 CLARIFICATION OF CONCEPTS**

### **1.6.1 Defined benefit and defined contribution structures**

A defined benefit fund is structured to provide members with a benefit on retirement as set out in the rules of the fund. This benefit is set out in a formula, usually in the form of a percentage of final salary for each year of service. For example, if the member is entitled to 2 per cent of final salary for each year and completes 40 year's service, the member will receive a pension of 80 per cent of his or her final salary. This benefit is guaranteed in terms of the rules of the fund and the sponsoring employer is responsible to fund any shortfall the fund may experience in meeting this liability.

A defined contribution fund provides a benefit on retirement that is determined by the amount invested into the member's individual investment account and investment growth. If investment return is good, a member will receive a higher benefit than if investment return is poor.

A pension fund pays an annuity to members on retirement, usually in the form of a monthly payment. A provident fund is a pension fund that pays a lump sum at retirement. Pension and provident funds can be structured either as defined benefit or defined contribution structures or as a combination, known as a hybrid structure.

### **1.6.2 Conversion mechanisms**

In instances where members converted from defined benefit to defined contributions structures, the process could be actioned through a transfer of members to another fund in terms of Section 14 of the Pension Funds Act, or an amendment to the rules of the existing fund to change its structure.

### 1.6.3 Actuarial valuations and the “surplus issue”

Defined benefit funds usually required a tri-annual actuarial valuation. At this time, the fund actuary considered funding levels and determined whether the fund had sufficient assets to meet its liabilities on an on-ongoing basis. Various reserves were also set aside. In particular, investment reserves were often held to protect the fund from adverse market conditions. In the event of these conditions arising, liabilities would be met from the investment reserve.

The Pension Funds Act refers to regulations which, while separate, forms part of the main Act. Regulation 15 defines requirements and assumptions for establishing the valuation bases. An extract of the regulation follows:

15 (2) The report referred to in subsection (7) of Section 16 of the Act shall include, where applicable, the following particulars:

- (2) (a) The number of persons in respect of whom liabilities have been calculated, subdivided into active member, deferred pensioners and vested pensioners...
- (b) (i) a description of the classes of assets held by the pension fund;  
(ii) the fair value of the net assets of the pension fund...  
(iii) the actuarial value of these net assets, for the purpose of a comparison with the pension fund’s accrued actuarial liabilities; and  
(iv) a description of the bases employed in calculating the actuarial value of each of the classes of assets together with adequate particulars of each basis to enable an independent valuator to judge the financial soundness of such basis;
- (c) (i) the value of the pension fund’s accrued liabilities, with the same subdivisions as that contemplated in paragraph (a)... and for the purpose of this subparagraph “accrued liabilities” means -
  - (aa) the actuarial liabilities in respect of past service benefits (including accrued bonus service) of active members, with due allowance for future salary increases where these...
  - (bb) the actuarial liabilities in respect of pensions in course of payment and deferred pensions...
- (ii) a description of the basis employed in calculating the actuarial value of the accrued liabilities together with adequate particulars of the bases to enable an independent valuator to judge the financial soundness of such bases....

In terms of Regulation 15, the value placed on the various classes of assets (e.g. stock market shares, property, etc) is directly related to the value of the members' liabilities.

The usual method described in many 1990s actuarial reports is to use the "dividend yield" of a share as the valuation basis. This is a formula, e.g. 2,5 per cent dividend yield.

#### **1.6.3.1 Investment reserves**

Stockmarket values constantly fluctuate. To compensate, actuaries usually place a lower value on shares than the market value. This ensures that, should the stockmarket drop, there remain sufficient funds to fund pensions. The difference between the actuarial value of assets and the market value of assets is called an investment reserve.

South African actuaries started referring to the investment reserve as a "market value surplus". On transfer out of the fund, this "surplus" was included with the actuarial surplus. However, if members and pensioners remain in the fund, this reserve or surplus, regardless of what it is called forms part of the total assets reserved to fund the liabilities of the fund. This value is included in the funding requirements as reported to the FSB in the valuation reports.

#### **1.6.3.2 The "surplus issue"**

Wellsted (2000) states that many employees who transferred from traditional defined benefit pension funds to defined contribution provident funds left behind huge portion of assets previously reserved for them. He argued that lack of governance in South Africa allowed reserves to be stripped out of members' benefits on transfer. Professor John Murphy, the former pension funds adjudicator, supported the South African practice of declaring investment reserve as surplus. Murphy defined the South African pension fund surplus as the difference between the market value of the assets in the fund and the value of the liabilities. In British actuarial practice, a surplus is clearly defined as the difference between the actuarial value placed on the assets and the liabilities of the fund. Wellsted (2000)

argues that this subtle difference in terminology makes a huge difference in the value of the funds transferred for employees and pensioners. Depending on the stockmarket, this difference could be up to 40 per cent of the value of the actuarial reserve.

In a transfer from one fund to another, British law requires the transfer value to take into account the market value of the assets. According to Murphy, South African practice need only take into account the notional value placed on the assets by the actuary. As a result, members who transferred from one fund to another left behind a large part of the reserve, which was converted to surplus. The result was a “surplus” of R80 billion in South African pension funds and companies rushing to liquidate their pension funds to realise the profits.

Andrew (2000), Chief Actuary, FSB, stated that:

Despite this information being available, perhaps as a result of tough bargaining, in the early transfers members often moved with only their cash resignation benefits, usually a refund of their own contributions accumulated with a modest rate of interest. They left behind excess investment earnings and the employer contributions. Later they moved with their accrued liability, representing the present value of benefits expected to be paid in future as a result of service prior to the date of transfer.

Seldom were members given the benefit of any provision held within the fund to protect the fund against a fall in the stockmarket, or of any actuarial surplus.

There was a lack of understanding on the part of the members and their trade unions of how defined benefit funds were financed. In particular, the union negotiators may not have appreciated that a provision against the possibility of a fall in the stockmarket may have existed on top of the declared actuarial surplus... I hope this will reassure your readers that, while we may have been slower in South Africa than we should have been to react to the trend that was emerging around us, we are aware of the problems and are seeking to address them.

The Pension Funds Second Amendment Act came into effect in 2000. It set out minimum withdrawal benefits and a process for surplus apportionment. Wellsted (2000) argues that it is not possible to separate the value of the investment reserve from the rest of the actuarial valuation when negotiating a transfer – because members have no power to give away a portion of their pension benefits other than

for property loans. Many people forget Regulation 15 when arguing about who owns the investment reserve on transfers of pension members. Mr Andrew has acknowledged that the portion of the actuarial valuation was separated and treated as a surplus in funds, claiming that union negotiators may not have realised they had not asked for it. It would be a bit like selling a motor car for a negotiated price and then after agreeing the sale, removing the bumpers and mudguards before handing over the car to the new owner.

In the 1990s, when employers actively encouraged members to convert from defined benefit to defined contribution structures, they determined the fund's actuarial liability to the member and then offered to increase the value by a specific percentage if the member converted. This increase in value was known as a "sweetener" to encourage members to convert.

## **1.7 FRAMEWORK OF THE STUDY**

The study is presented in three sections: the first provides a theoretical basis, the second details the research design, and the third records and analyses interviews with industry experts and case studies, and sets out conclusions and recommendations for a model for dealing with fundamental environmental change.

The structure is as follows:

- **Section One: Theoretical content**  
Chapter One: Orientation  
Chapter Two: Theoretical foundations and literature review
- **Section Two: Research design**  
Chapter Three: Problem statement, propositions and research methodology
- **Section Three: Contribution to knowledge**  
Chapter Four: Research results and analysis  
Chapter Five: Discussion, conclusions and recommendations

## **CHAPTER TWO**

### **THEORETICAL FOUNDATIONS AND LITERATURE REVIEW**

#### **2. LITERATURE REVIEW**

The following literature review considers the theoretical foundations of the study. It aims to determine whether existing literature could explain or shed some light on the fundamental changes that occurred in the South African pension fund industry between 1980–2006.

#### **2.1 THEORY OF EVOLUTION**

Evolution by natural selection is the central concept of Charles Darwin's (1859) work. It is a theory about the origin of adaptation, complexity and diversity among the earth's species (Young, 2002; Dugger & Sherman, 1997). Two major issues are: the evolution of all species as a historical phenomenon; and natural selection as the main mechanism that causes the phenomenon. Darwin (1859) noted that the Madagascar orchid *Angraecum sesquipedale* had an 11-inch-long nectar receptacle and predicted that a moth must exist with a proboscis 11 inches long. This mutual adaptation came to be known as co-evolution. It refers to successive changes among two or more ecologically interdependent but unique species such that their evolutionary trajectories become intertwined over time. As these species adapt to their environment, they also adapt to one another. Darwin (1859) analysed the differences among pigeons and concluded that, if domestic breeding could yield changes, natural selection over millions of years could do more. He noted clusters of closely allied species that suggested common ancestors.

In common usage from 1647, according to Gould (1977), "evolution" was a concept of progress; the idea that things develop from simple to complex in an orderly manner. Victorian biologists used the term "evolution" to describe the theory of embryological development. Their view was that genetic development and change was pre-ordained. Jones (1999) suggests that the Latin root of the word "evolution" referred to the unfolding of a scroll. The word was first used in biology to describe

the changes in shape of an embryo as it developed. Not until much later did “evolution” begin to suggest the gradual transformation of one form into another. Now its definition has come together and the study of development is unrolling the scroll of biological history. Darwin (1859) did not use the term “evolution” and preferred his own term “descent with modification”. His view was that natural selection was not pre-ordained or orderly.

Darwin (1859) states that a struggle for existence inevitably follows from the high rate at which all organic beings tend to increase. Darwin (1859) applied the work of population theorist, Thomas Malthus – who wrote about human society that more individuals are born that can survive and reproduce – to all species. There is no exception to the rule that every organic being naturally increases at so high a rate that if not destroyed, the earth would soon be covered by the progeny of a single pair. Darwin (1859) suggests that every single organic being around us may be said to be striving to the utmost to increase in numbers; that each lives by a struggle at some period in its life. What checks the natural tendency of each species to increase in number is, however, most obscure. He concludes that the vigorous, the healthy, and the happy survive and multiply. Darwin contended that his theory led only to improved adaptation, not to any other sort of progress, although other Victorian biologists popularised the idea that natural selection would lead to progress, to bettering of the species.

Jones (1999) suggests that the Industrial Revolution was a test of the theory of evolution. Its results were often unexpected, sometimes unwelcome and always unplanned. He suggests that the testimony of natural selection is so familiar that we do not recognise the proof of its power: the fit of life to where it lives. Jones (1999) states that critics of evolution argue that it is not a real science because it cannot predict the future and suggests that evolution favours youthful vigour at the expense of later decline.

Hayden, Ruvinsky, Gilgoff and Sobel (2002) state that many creatures still appear quite suddenly in the fossil record, and the growing suspicion is that evolution sometimes leaps rather than crawls. Scientists have learned that our planet has

been rocked periodically by catastrophes. Once conditions improved, the survivors found a world of new opportunities. They were freed to fill new roles, “experimenting” with new body plans and evolving too rapidly to leave a record in the fossils.

### **2.1.1 Natural selection**

Darwin (1859) suggests that individuals who have any advantage, however slight, over others, would have the best chance of surviving and of procreating their kind. Natural selection (the principle of preservation) will modify the structure of the young in relation to the parent, and of the parent in relation to the young. In social animals it will adapt the structure of each individual for the benefit of the community; if each in consequence profits by the selected change. Darwin (1859) suggests that isolation is an important element in the process of natural selection. Isolation, by checking immigration and consequently competition, will give time for any new variety to be slowly improved; and this may sometimes be of importance in the production of a new species.

Darwin (1859) states that natural selection will always act with extreme slowness. It inevitably follows that as new species in the course of time are formed through natural selection, others will become rarer and rarer, and finally extinct.

Atkins (2004) suggests that the mechanism of biological evolution lies in the DNA and that natural selection depends on three principles: there is heritable genetic variation; parents over-proliferate and successful offspring are the ones best adapted to the environment. He states that success is more than just survival, it is the ability to go on to reproduce. Atkins (2004) argues that Herbert Spencer’s phrase “the survival of the fittest” is misunderstood and debases the subtlety of the underlying idea. Natural selection, according to Atkins (2004), is totally committed to the present and is wholly without foresight. Natural selection cannot anticipate that it may be driving a species into an evolutionary cul-de-sac.



Atkins (2004) states that, in natural selection, an individual competes with other individuals and is driven to seek its own success regardless of the good of the aggregation of organisms that constitute the species. Natural selection needs to account for terrestriality (migration of life on the ground), bipedality (walking upright on two feet, leaving the hands available for manipulation), encephalisation (expansion of the brain relative to the size of the body), and the emergence of culture.

### **2.1.2 Relevance to the research problem**

Pension funds evolved to survive in their environment. The ability to adapt to the environment is vital for survival. Organisations that were able to off-load contingent liabilities may well have obtained an advantage over those that retained the liability. The nature of the environment did not provide the isolation necessary for slow improvement or the production of a new type of fund – by implication the speed of the process did not facilitate the development of an optimal outcome. Also, the theory of natural selection can be applied to pension funds because they “evolved” without consideration of the long term implications – various individual parties to the pension funds investment evolution were only acting in their own best interests. Evolution implies reaction to the environment. The pension fund investment evolution was a reaction to the environment, but also a decision of various players that this was in their own best interests.

## **2.2 WELFARE ECONOMICS**

### **2.2.1 Nature of welfare economics**

Price (1977) states that welfare economics is concerned with the effect of economic policies on the level of welfare of individuals or groups of people. According to Johansson (1991), societies must make choices of how to use their scarce resources. Trade-offs must be made – if we ask for more of one thing, it usually means less of something else. He suggests that the basic value judgement used in welfare economics is known as the Pareto principle. This principle says

that a change is desirable if it makes some individual(s) better off without making any others worse off.

Fazeli (1996) states that the modern welfare state is a product of capitalism. The objective of the welfare state is to provide a security net for individuals to cope with the unpredictability of the market system, but not to challenge its legitimacy. Fazeli (1996) argues that governments initially became concerned with the lot of the poor not for purposes of relieving suffering, but for the maintenance of law and order.

Hill (1997) states that “social policy” is primarily used to define the role of the state in relation to the welfare of its citizens. Social policy is seen as concerned with the alleviation of social ills; incremental social change to create a more equal society. Social policy is concerned with housing, social security, education and health. “Social security” falls into three categories: contributory benefits; non-contributory benefits which are not means-tested, but are contingent upon the individual being in some specific category (a child or disabled); and means tested benefits.

Johansson (1991) states that a policy change is socially desirable if everyone is better off (the weak Pareto criterion) or at least some are made better off while no one is made worse off (the strong Pareto criterion). There is a close correspondence between an allocation of resources that satisfies the Pareto condition and the allocation that results from a perfectly competitive price system. When a competitive equilibrium exists, it attains Pareto optimality – this is known as the First Theorem of Welfare Economics. It is by no means optimal in any other ethical sense, since the market equilibrium may be very unfair.

O’Connell (1982) suggests that the evaluation of economic policies involves some relative assessment of the benefits to those who gain and the losses to those who suffer. Generically, a surplus is a return or benefit above economic or opportunity cost. “Consumer surplus” arises when the utility or satisfaction derived from consumption of goods exceeds the price of the goods. In a competitive economy with a downward-sloping demand schedule, consumers pay for all commodities the value of the last unit to them. The value of units consumed prior to the last unit

exceeds the price, thus generating a surplus. He argues that goods can be divided into groups on the basis of the number of individuals that can consume the goods without adversely affecting the ability of others to consume the same goods.

### **2.2.2 Social choice**

Mueller (2003) states that one of the most influential studies of the first stages of the social choice process has been Rawl's *A Theory of Justice* (1971). Rawl focuses on the process or context in which decisions are made as much as, if not more than, on the outcomes of this process. The goal is to establish a set of just institutions in which collective decision-making can take place. No presumption is made that these institutions or the decisions emerging from them will in any sense maximise the social good. Rawls sets out to develop a set of principles to apply to the development of the basic structure of society. They are to govern the assignment of rights and duties and regulate the distribution of social and economic advantages. These principles form the foundation of the social contract.

In Rawls's theory, Mueller (2003) suggests, life is a game of chance in which Nature deals out attributes and social positions in a random or accidental way. This natural distribution of attributes is neither just or unjust. But it is unjust for society simply to accept these random outcomes, or to adopt institutions that perpetuate and exaggerate them. Thus, a set of just institutions is one that mitigates the effects of chance on the positions of individuals in the social structure. Rawls argues that the following two principles will be chosen as the pillars of the just social contract: each person is to have an equal right to the most extensive basic liberty compatible with a similar liberty for others; and social and economic inequalities are to be arranged so that they are both reasonably expected to be to everyone's advantage and attached to positions and office open to all.

Fazeli (1996) suggests that the liberal legitimization of the welfare state has been associated with a functionalist approach toward the role of the state in society. The market system was seen as unable to perform certain necessary functions required for economic and social stability. The role of the state was, then, to correct the

imperfections of the market mechanism. Various studies indicate that there is some redistribution of income from the richest households to the poorest households. However, we have to pay attention to the fact that the net tax paid by higher income households is not entirely used to finance welfare and public assistance and other benefits received by the poor. It is also used to finance some general expenditures of the state, such as defence, police, judiciary system, administration, and some other public goods, such as highways, parks, libraries and museums.

### **2.2.3 Pensions as social security**

Esping-Andersen (1990) argues that neither state nor market was predestined as a locus of welfare provision. He argues that in all advanced countries we find some blend of private and public welfare provision and it is in this relationship that we will uncover some of the most important structural properties of welfare states. He suggests that states created markets and markets created states. For pensions, it required the application of state power to build and nurture a viable private market.

According to Barr (1993) the purpose of pensions, from the viewpoint of the individual, is to make it possible to transfer consumption over time, i.e. to consume less than he/she produces during working life so that consumption can continue after retirement. In principle there are two (and only two) ways in which an individual can achieve this: by storing current production during working life; or by acquiring a claim on output produced after his/her retirement by the next generation. Barr (1993) suggests that storing current production is valid in limited circumstances. The second option comes in the form of funded schemes and pay-as-you-go (PAYG) schemes. Under the PAYG scheme the state taxes the current generation of workers and uses the proceeds to pay pensions to the retired generation. PAYG is thus a simple tax-transfer scheme. Barr (1993) suggests that government can adopt policies to reduce pensioner demand by paying lower pensions; reduce worker demand by maintaining real pensions financed out of higher contributions or, the only complete solution, increase output so that a constant contribution rate can finance an unchanged real pension. It can also introduce later retirement dates.

Myles (1995) suggests that the first issue in the analysis of social security is its effect upon the equilibrium of the economy and, particularly, upon the level of the capital stock. A second major issue that arises is the effect of demographic change upon the social security programme. Present trends are for the proportion of retired consumers to increase and for the retired to live longer. At a practical level, this raises the question of whether the working population can continue to fund social security. The financing of social security can have important implications for the economic effects of the programme and for its sustainability in the face of demographic change.

#### **2.2.4 Relevance to the research problem**

Pensions form part of the social security framework and it is imperative that government establishes a framework within which they should operate. The state old age pension (SOAP) is a means tested social assistance benefit and exists alongside the social insurance private pensions. Government should take a keen interest in the pension fund investment evolution to ensure that the social security net is not eroded and an additional burden is not placed on the state.

### **2.3 THEORY OF FINANCE**

#### **2.3.1 Market efficiency and risk**

According to Ross et al (1996), the efficient markets hypothesis asserts that well-organised capital markets, such as the New York Stock Exchange are efficient markets, for all practical purposes. All investments in an efficient market are expected to be zero net present value investments at the time the investment is made. Levich (2001) states that we do not assume a perfect capital market setting because we believe this is an accurate picture of the world, but because it eases the analysis and provides a useful benchmark for comparison with other, more realistic assumptions.

The Markowitz Portfolio Selection Model, as quoted by Bodie, Markus and Kane (1999) suggested that diversifying investments leads to portfolios with higher expected returns and lower standard deviations. To find the optimal risky portfolio, the capital allocation line (CAL) with the highest reward-to-variability ratio (i.e. slope) is identified. The optimal risky portfolio lies where CAL is tangent to the efficient frontier. This model is precisely one of portfolio management: the identification of the efficient set of risky portfolios, often called the efficient frontier of risky assets. The principle idea behind the frontier set of risky portfolios is that, for any risk level, an investor is interested only in that portfolio with the highest expected returns.

The most striking conclusion from the model was that a portfolio manager will offer the same optimal risky portfolio to all clients regardless of their risk aversion. The degree of risk aversion of the client comes into play only in the selection of the desired point on the CAL. Thus, the only difference between clients' choices is that the more risk-averse client will invest more in the risk-free asset and less in the optimal risky portfolio than will a less risk-averse client.

Pozen (2004) states that most companies are still looking to equities to stop the pension-fund hemorrhage over the long term. How do companies seek higher returns from an asset mix that includes equities, without assuming unacceptable risk? The answer is: through wise allocation of assets across both stocks and bonds. That may seem obvious, but, surprisingly, it's the exception, not the rule. In most defined benefit plans today, trustees, who often have little experience in pension investing, set the mix of equities and bonds.

There are eight key types of risk: capital risk; credit risk; inflation risk; interest-rate risk; liquidity risk; market risk; repayment risk and reinvestment risk. The concept of risk aversion is linked with the idea of a fair bet (Biswas, 1997). A fair bet is an uncertain prospect whose expected yield is zero. A person is risk averse if he never accepts a fair bet. A person is called a risk lover if he always accepts a fair bet. If a person is always indifferent between accepting a fair bet and rejecting it, he is called a risk neutral person. Biswas (1997) argued that in most traditional

literature dealing with risk and uncertainty, economic agents are assumed to be risk averse. He suggested that answers should be sought in the context of non-expected utility theory. Non-utility theories have attracted the attention of many behavioural psychologists.

### **2.3.2 Theory of saving**

Juster and Taylor (1975) state that the behaviour of personal saving in the USA economy has long held a fascination for economists. The earliest consumption functions indicated that richer households save more relative to income than poorer ones, leading to the Keynesian speculation that secularly rising income would result in higher saving rates. A study of USA capital formation of Simon Kuznets indicated, however, that this attractive theory did not square with the facts. This apparent contradiction led to the formulation of three new theories of the consumption function: the relative income hypothesis of Duesenberry, the life-cycle hypothesis of Modigliani and Brumberg, and the permanent-income hypothesis of Friedman. Taylor's work has been on the role of income composition in determining the behaviour of aggregate saving, while Juster has concentrated on the role of uncertainty.

Juster and Taylor's (1975) approach takes into account two types of uncertainty that are expected to influence saving behaviour. The first type is the conventional kind of uncertainty regarding income. If consumers become concerned that money income may fall, they can be expected to react by trying to build up cash balances via increased saving. If money income actually falls, the fixed cost elements of consumption expenditures can be expected to result in lower saving. The second, less conventional, dimension of uncertainty has to do with the effects of price inflation on saving. In a world where money wage rates cannot fall, uncertainty about the change in real income is limited to uncertainty about how large an increase in money wages will be forthcoming. However, when prices are rising, real income can fall if money wages fail to rise as rapidly. Saving may be more influenced by judgements about plausible upper limits of future price increases than by estimates of the most probable changes in price. They conclude as follows:

results strongly support the conclusion that uncertainty regarding the future course of real and money income leads to an increase in saving; the strongest statistically is the impact on saving of uncertainty regarding plausible upper limits to the amount of price inflation.

Green (1991) states that mainstream economics explains the individual's division of income between saving and consumption on the basis of given preferences and exogenous constraints. Institutionalists have rejected the hedonistic calculus that underlies the lifetime utility function. According to Green (1991), the inclination to save was traced by Adam Smith to a basic propensity in human nature, the desire of bettering our condition, which overall is expected to prevail over conflicting motives.

### **2.3.3 Pension savings**

Katona (1965) researched the effect of pension savings plans on saving behaviour. The neoclassical position is that if individuals are forced to save through a pension plan, their other savings will be appropriately reduced. Katona's research found the opposite. He argues that pension savings are complementary to other forms of saving. Katona theorises that participation in a compulsory pension scheme would lead people to raise their savings goal so that "even if the retirement income provided by a pension plan seems to suffice for one's needs prior to participating in a plan, it may not appear so after the pension has been assured". This is reinforced by behaviourist psychology which is that the closer the goal, the greater the effort. The idea is that if attaining a reasonable target level of retirement income seems remote, little effort will be made to approach this level, but that if the goal comes into sight and appears both concrete and attainable, then people are stimulated to save in order to achieve it.

Kuehlwein (1993) concludes that the life-cycle model of saving in the presence of lifetime and other forms of uncertainty provides several verifiable conditions for the consumption behaviour of the elderly. Altmann (2003) discusses management of an individual's savings over the life cycle. He states that, as the UK population



ages and increasing numbers of people are living longer, the cost of supporting older members of society are rising. If society wishes to avoid a substantial rise in the number of older people living in poverty, policy aims must focus on a number of issues: ensuring individuals save more while they are economically active; encouraging employers to provide higher contributions to occupational pensions; spending more public money on pensions and pensioners; encouraging individuals to remain in the labour force for longer.

The UK has a higher level of retirement savings per individual than most of the rest of Europe and has built up a successful pension savings culture. This may be because of the low level of the UK state pension. Much of these pension savings is in defined benefit occupational pension schemes. Many employers are switching to money purchase pension provision, and are taking the opportunity of this change to lower their contributions. In addition, there has been a general movement in social policy away from collectivism and towards individualism.

#### **2.3.4 Relevance to the research problem**

Prior to the evolution, members' financial literacy was not essential. Under defined contribution structures, however, members are required to understand several complex financial concepts, especially that of the risk associated with various asset classes. A defined contribution structure, especially where individual investment choice is permitted, implies that members need to take more responsibility for their pension investments and need to understand their own risk profiles and savings behaviour. The financial outcome of the evolution is that firms off-loaded contingent liabilities and members acquired investment risk.

### **2.4 THEORY OF THE FIRM**

#### **2.4.1 Resource-based view**

Penrose (1959) saw the firm as the organised combination of competences. It is more than an administrative unit – it is also a collection of productive resources the

disposal of which is determined by administrative decision. A firm needs a variety of reserves for its operation, whether they be financial, inventory, or labour reserves. Implicitly, such reserves are required in order to cope with uncertainty. Penrose gave stress to the tacit and elusive nature of skills. Her theory was also built on the tacit or unteachable nature of much of the operational knowledge within the firm.

Estola (2000) states that although equilibrium means a balance-of-forces situation, in economics the balancing forces have not been defined. Most theories of economic growth concentrate on steady-states. The neoclassical theory of a firm assumes that firms' productions in a given time unit are the profit maximising ones. If we now replace the assumption that firms produce in a profit maximising way by assuming that firms like to better their situation if possible, with this principle we can model the adjustment of production so that the modelling covers also possibly steady-states as well as changes in demand and costs. To understand the growth of production, we have to understand why individual firms increase their production. A natural explanation is that this increases their profitability.

#### **2.4.2 Stakeholder theory**

According to Key (1999), it was Freeman (1984) who most clearly and graphically modelled the concept of stakeholders as those impacting on the firm and on whom the firm impacts. Freeman defined a stakeholder as any group or individual who can affect or is affected by the achievement of an organisation's objectives, and suggested that firms should identify their direct and indirect stakeholders.

Kochan and Rubinstein (2000) suggest that the first task in developing the positive features of a stakeholder theory is to define who stakeholders are and how a stakeholder firm differs from a conventional American-style shareholder-wealth-maximising firm. The question of who or what constitutes a stakeholder is perhaps the most frequently debated issue in the literature on this topic. Kochan and Rubinstein (2000) identify propositions of the general stakeholder theory. For stakeholder firms to emerge, stakeholders must hold assets that are critical to the

firm's success, put their assets at risk in the firm and have sufficient power to compel influence, and sufficient trust must be present among shareholder and stakeholder leaders to believe in a partnership. Incentives under which leaders are employed must motivate them to be responsive to the interests of all the stakeholders. Stakeholders need to add value to ongoing operations and stakeholder interests must be aggregated and conflict managed effectively. Resistance to the legitimacy of stakeholders other than shareholders participating in corporate governance processes needs to be overcome.

Boatright (1996) states that the modern theory of the firm, which is central to finance and corporate law, views the corporation as a nexus of contracts among the various corporate constituents. Upon this foundation, finance theory and corporate law postulate shareholder wealth as the objective of the firm. Philosophers generally regard the contractual theory of the firm primarily as a subject for criticism (using the resources of philosophical ethics). In particular, stakeholder theory, which stresses the importance of all groups that affect or are affected by a firm, has been proposed as a more adequate theory of the firm for studying business ethics.

### **2.4.3 Evolution of the firm**

Ramamohan Rao (1989) states that the theory of the firm acknowledges that as a firm grows in size there will be an emergence of: diffused ownership and separation of ownership and control; nonprice competition dominating the operation of the market mechanisms and price strategies; and a complex internal organisation supplementing the market mode as a management structure. He concludes that a welfare analysis of nonprice competition and internal decisions of the firm can be summed up in the form of three propositions: there cannot be any organisational inefficiency so long as the firm has the internal pressure to maximise profits and internal decisions do not have the effect of reducing external pressure; so long as an internal decision has the effect of reducing external pressure there will be inefficiency even if the firm is a profit maximiser; and the absence of internal pressure can, in general, create inefficiency.

Harrison (1994) suggests that rather than dwindling away, concentrated economic power is changing its shape, as the big firms create all manner of networks, alliances, short- and long term financial and technology deals – with one another, with governments at all levels, and with legions of generally smaller firms who act as their suppliers and sub-contractors. According to Hodgson (1988), the evolutionary theory of the firm is largely a post-1945 phenomenon. In part it emanates from a famous controversy about the assumption of profit maximisation in economics. Alchian (1950) contended that, for the purposes of the debate, it did not matter whether firms were trying to maximise profits or not. Market competition created an environment akin to natural selection where the more efficient would win out. Although individual behaviour cannot be predicted, evolutionary processes ensure that patterns of development can be observed in the aggregate.

Rein and Wadensjo (1997) state that there have been significant changes in the policy environment. The new environment is characterised by the perception that pensions will not be affordable in the future, and that the existing system of pensions is not fair in terms of generation or gender. Pension reforms have included: raising the pension age; recalculating pension benefit entitlements; introducing quasi-funded pensions to replace pay-as-you-go; legislation to reduce access to pension-like benefits; tax incentives to encourage the development of occupational and personal pensions. The general trend, they argue, is towards a more diversified welfare state.

Kimura (1997) states that in 1994, amid the financial crisis, the Japanese government decided to reform the public pension system. The reform consisted of three main parts: a rise in the pension age; a rise in the contribution rate; and a reduction in the level of public pension benefits. The impact of raising the pension age on private arrangements for retirement income is far-reaching. Since the salary and position of employees rise in accordance with length of service in many companies, the extension of the retirement age increases the financial burden for companies and also prevents the promotion of younger people. Thus, most companies have altered their personnel management, the wage systems and

retirement pay. Japanese companies encourage employees to invest in personal pensions.

Valle (2002) says that organisational evolution broke into economic studies with the work of Alchian (1950) who, based on the principles of biological evolution, pointed out the process of natural selection which the environment imposes on firms and the relevance of organisational adaptation as a survival guarantee. With respect to the phenomenon of organisational evolution, there are three key elements: variety, selection and retention or heredity. Valle (2002) concludes that organisational evolution is directed by a process of adaptation to the environmental evolution. For evolutionists, the evolution of the firm is sketched as a path which runs parallel to the path describing environmental evolution. Organisational change is then presented as the mechanism which allows adaptation to the environment and that, in turn, guarantees organisational survival.

Salvato (2003) states that evolutionary models envisage an organisation as a collection of routines, providing a robust micro-level unit of analysis to address adaptive processes. Over time, variations occur in the routines and in the ways in which they are recombined. Some of the new routines and recombination patterns are selected and incorporated into the ongoing practices, thus shaping new strategic configurations. The concept of routine as the main replicator of organisational phenomena is currently being reappraised. Few studies have systematically traced the patterns of recombinations through which existing routines lead to higher-level strategic efforts, leaving the field open to such contributions. Evolutionary theories have not provided coherent guidance on the interplay between managerial agency and organisational or environmental structure. Variations in organisational routines are depicted as being either intentional or unintentional; the selection of new routines or routine recombinations can occur at either the environmental level, or within the organisation; the retention of new routines and practices can be the result of managerial choice or of blind external forces.

#### **2.4.4 Relevance to the research problem**

Firms were initially considered to be a combination of resources that were as effective as the competencies that they possessed. Profit maximising was their most important function. It is recognised that firms evolve parallel to environmental evolution and that there are various stakeholders whose interests need to be considered. It can be argued that underwriting pension funds was a valuable contribution of the firm to several stakeholders.

### **2.5 ETHICS**

#### **2.5.1 Utility and sanctions**

Mill (1863) states that the creed which accepts utility or the greatest happiness principle as the foundation of morals, holds that actions are right in proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness. By “happiness” is intended pleasure, and the absence of pain; by “unhappiness” pain and the privation of pleasure. According to the greatest happiness principle the ultimate end, with reference to and for the sake of which all other things are desirable (whether we are considering our own good or that of other people), is an existence exempt as far as possible from pain, and as rich as possible in enjoyments, both in terms of quantity and quality.

Mill (1863) asks: What is the sanction of the moral standard and the motive to obey it? He suggests that there are internal and external sanctions. The external sanctions are the hope of favour and the fear of displeasure from our fellow creatures or from the Ruler of the Universe. The internal sanction is duty, the ultimate sanction of all morality being a subjective feeling in our own minds. The idea of justice supposes two things – a rule of conduct and a sentiment which sanctions the rule. Mill (1859) states that the struggle between liberty and authority is the most conspicuous feature in early history, particularly in that of Greece, Rome and England. Civil or social liberty considers the nature and limits of the

power which can be legitimately exercised by society over the individual. By liberty is meant protection against the tyranny of the political rulers.

### **2.5.2 Ethics in business**

Trevino, Weaver and Brown (2000) suggest that, given the importance of senior leadership to the success of ethics management, it is important that executives be in touch with the organisation's ethical pulse. But, they argue, a number of factors may conspire to keep senior managers out of touch. Upward communication in organisations is frequently filtered and distorted, with information gaps growing larger as the number of intervening hierarchical levels increases. When it comes to ethics and compliance programmes, senior managers will tend to see themselves and their organisations in a favourable light.

Schroeder (2002) states that Milton Friedman's view was that the social responsibility of business is to increase its profits. At the other end of the spectrum, Marx considered all private business and enterprise to be incompatible with the good of society. Schroeder (2002) identified companies in the middle of this continuum:

- \* companies that make profits, but subsequently donate parts of the profits to charity, e.g. Microsoft;
- \* companies that integrate social values into day-to-day business activities ("caring capitalism"), e.g. Ben & Jerry Ice-cream; and
- \* companies that produce or provide ethical products and services, e.g. Trevor Bayliss's wind-up radio and wind-up torch.

According to Toenjes (2002) the issue of moral motivation – Why be moral in business? – spans both the empirical and the philosophical work in business ethics. His argument is that in a contractualist paradigm of business ethics, philosophic issues and motivational issues coalesce into one focal concern. This is the concern to justify actions to others in terms that all can accept. The desire to justify involves more than the psychological question of whether individuals who tend to think in terms of agreements and contracts will be less likely to act

unethically. We can distinguish two fundamentally different approaches in business ethics. The more traditional one involves the application of principles, rules and maxims to cases. The other approach seeks to demonstrate that the goals of business include or somehow coincide with the goals of ethics.

According to Toenjes (2003), ethics in business is seen as a win-win proposition. A major weakness of this approach is that it begs the motivational question in just those circumstances where it is in most need of an answer. These are situations in which it appears that business interests and ethical interests conflict. The contractualist desire is a desire to cooperate with other persons according to principles that all can accept. It is a desire to be able to justify our conduct and the principles governing our conduct. The desire to justify is quite common and familiar. It is involved in attempts to make excuses and attempts to get others to cooperate. The desire to justify is seen in the lengths to which people will go to avoid admitting the unjustifiability of their actions and institutions, including attempts to discredit or even dehumanise those who might reasonably reject the justification offered, as is often done in war, colonialisng, and slavery. The desire to justify is the desire for it to be reasonable for others to accept what you are doing or at least for it not to be reasonable to reject what you are doing.

### **2.5.3 Ethical organisations**

According to Verschoor (2003), there are eight traits of an ethically healthy organisation:

- \* openness and humility from top to bottom of the organisation;
- \* an environment of accountability and personal responsibility;
- \* freedom for risk taking within appropriate limits;
- \* a fierce commitment to “do it right”;
- \* a willingness to tolerate and learn from mistakes;
- \* unquestioned integrity and consistency;
- \* a pursuit of collaboration, integration and holistic thinking; and
- \* courage and persistence in the face of difficulty.



Craig-Smith (2003) states that the idea that business has societal obligations was evident at least as early as the nineteenth century. In Britain, visionary business leaders in the aftermath of the Industrial Revolution built factory towns – such as Bourneville (founded by George Cadburg in 1879) and Port Sunlight (founded by William Lever in 1888) – that were intended to provide workers and their families with housing and other amenities when many parts of the newly industrialised cities were slums. A similar pattern also emerged in the United States. This was a form of paternalistic capitalism. Craig-Smith (2003) states that corporate social responsibility (CSR) refers to the obligations of the firm to society or, more specifically, the firm's stakeholders – those affected by corporate policies and practices.

According to Craig-Smith (2003), the urgency stems from a realisation that the criticism of business is more far-reaching than ever before. This is in part because, with globalisation, business itself is more pervasive and more powerful. Criticism of business is also more far-reaching because more is expected of business today, with the growing recognition of the failure of governments to solve many social problems and, for this and other reasons, the diminished scope of government (at least in the United States and Europe). Most large corporations now at least espouse a commitment to CSR and in some cases their initiatives appear to go substantially beyond corporate philanthropy and corporate communications that attempt to defend the firm's societal impacts. Craig-Smith (2003) suggests that the right CSR strategy should reflect the individual company's mission and values – what it stands for – and thus be different from the CSR strategy of even its closest competitors. Developing the right CSR strategy requires an understanding of what differentiates an organisation – its mission, values, and core business activities. Stakeholder engagement must be at the core.

Mintzberg, Simons and Basu (2002) state that, within hours of the events of 11 September 2001, obsession with self gave way to serving others. They argue that the role of management is to balance between these two extremes. They suggest that a syndrome of selfishness has taken hold of our corporations and that massive and dangerous legal corruption is taking place below the surface – behaviour that,

while technically allowable, corrupts our leadership, our organisations, our society and ourselves as human beings. They suggest various “fabrications” upon which the syndrome of selfishness is built. They conclude that a series of damaging wedges have been driven into our societal fabric and that they will harm us more severely – all of us – if they are not soon removed.

Zalewski (2002) states that employer sponsored pensions were an important way in which firms shared the economic gains of the managerial capitalism period. Most firms offered defined benefit programmes during the managerial capitalism era, which paid an annuity whose value was determined by factors such as wages and years of service. Partly because of stockholder pressure, many firms switched to defined-contribution plans. In addition to their positive impact on corporate profits, mainstream economists also favoured defined contribution plans because they provide freedom of choice. He suggests that many executives, who decided to shift retirement-income risk to employees by terminating defined benefit pension plans, are still covered by high-quality retirement plans. Because this disparity enriches managers at the expense of more economically vulnerable employees, it is morally objectionable and thus requires corrective action.

Pollard (2003) suggests that it is the spiritual side of our humanity that influences our character, our ability to determine right or wrong, to recognise good or evil, to make moral judgments, and to develop a philosophy of life – a world view that can provide and lead with a moral and ethical standard that is not relative and cannot be waived even by action of a Board of Directors.

#### **2.5.4 Relevance to the research problem**

There is a strong argument for business to behave in an ethical manner. In pursuing the pension fund investment evolution, firms off-loaded substantial contingent liabilities, but they may well have neglected to consider or be concerned about the impact on members, who acquired investment risk. Benefit from the evolution was not equal. The relative power positions of the various parties was relevant to the outcome. Now that the evolution has occurred, a new set of ethical

obligations should emerge – such as sponsoring trustee training, development of members' financial literacy or consideration of an alternative to defined contribution arrangements with employers perhaps underwriting some of the risk.

## **2.6 DECISION-MAKING**

### **2.6.1 Liberalism**

McKinlay (1996) identified liberalism – or neo-liberalism – as the dominant ideology informing globalisation. Liberalism profiles a set of core values, essentially a commitment to individual freedom. In terms of liberalism, the market is justified and rationalised in terms of its capacity to maximise individual choice. A significant international economic trend is increased focus on individualism and the right of the individual to pursue his or her own destiny. “Paternalistic” defined benefit retirement funds are being replaced by defined contribution retirement funds. Members are demanding the “financial freedom” to choose where their assets should be invested.

According to Arrow (1984), the individual has a mental ordering of the possible consequences of all actions, saying, for each pair of consequences, either that he prefers one or that he is indifferent to them. These relations of preference and indifference have the property (known as transitivity) that if consequence A is preferred to consequence B and B to C, then A is preferred to C, and similarly with indifference. In a given situation, the range of action open to an individual is limited in some way – thus, in the theory of consumers' demand under perfect competition, the actions possible are the purchase of bundles of consumers' goods whose cost does not exceed the available income. In the theory of consumer's choice it is not customary to differentiate between actions and their consequences, since the two go hand-in-hand. In the theory of choice under risky conditions, one of the chief problems is the description of uncertain consequences and therefore not uniquely related to the actions.

## 2.6.2 Decision-making process

A decision is defined as the selection process leading to a particular action (Gregory, 1988). In terms of a model developed by Gregory (1988), a decision has the following components:

- (a) A list of alternative actions to be considered in the decision sequence.
- (b) A list of all possible outcomes which can result from actions under (a).
- (c) Data on the consequences of all feasible combinations of actions and outcomes.
- (d) Assessments of the likelihood of the various outcome possibilities listed in (b). Sometimes this can be done by examining data from previous similar experiences. Sometimes we have to rely on expert opinion backed by results of sampling from the market. Sometimes we have only the views of experts and they themselves might have difficulty in rationalising the way in which they came to their opinion.
- (e) A decision criterion. Components (a)–(d) have described the structure of the decision, but they have not told us what to do.

The action to take may by now be obvious, but it is more likely that, because of the outcomes beyond our control, all we shall be able to do is to confine the consequences to one of a set whose relative likelihoods are known. Some sets may have consequences which have little variation, but are generally at a relatively low level. These correspond to low risk categories. Other sets may offer the opportunity of very attractive returns, but also include some which would create serious problems for the decision-maker. If he is a gambler he may be prepared to take such actions. There are, of course, other possibilities, but in order to make his mind up, the decision-maker is being influenced by some outlook or attitude towards what could happen when he decides which action to take.

The rational model of choice under uncertainty, as described by Arrow (1984), can be summarised as follows: There are a number of possible states of nature and a number of possible actions we can take. We do not know which state of nature, among a certain class, is the true one. We have to take an action of which the

consequences will depend upon which state of nature is the true one. The problem is to choose which action to take among those which satisfy the constraints of the situation. The consequences are completely determined by the action and the state of nature, and presumably are ordered as in the case of certainty. Broadly speaking, utility theory is concerned with the problem of choice by an individual from a set of alternative possibilities available to him (Arrow, 1984). The utility theory of choice states that the choice in any given situation depends on an interaction of the externally given obstacles with the tastes of the individual, and that the obstacles and tastes can be thought of as independent variables.

Biswas (1997) argues that one of the problems with expected utility theory is that it ignores the role of framing in the process of decision-making under uncertainty. In making a decision in uncertainty, the subjective perception of the status quo plays an important role. According to Simon (1976), human beings have limited information-processing capabilities, and because of this they are prepared to sacrifice the benefit of a comprehensive survey of the alternatives with all their information requirements and analysis. Instead, he suggests, they look for an alternative which is better than their current method of operation and settle for that. This involves consideration of all alternatives in some depth, but it avoids consideration of all the alternatives, all but one which will, of course, be discarded. Simon (1976) calls this satisficing.

### **2.6.3 Decision criteria**

The following decision criteria have been suggested by Gregory (1988):

- **The maximin criterion**

Suppose that the decision-maker has to select from  $m$  actions  $a_1, a_2, \dots, a_m$ ; Nature has  $n$  actions  $b_1, b_2, \dots, b_n$ ; the payoff when actions  $a_i$  and  $b_j$  respectively are taken is  $r_{ij}$ . When action  $a_i$  is taken by the decision-maker, his payoff will be one of the values  $r_{i1}, r_{i2}, \dots, r_{in}$ . If  $r_{i0}$  is the smallest of these, then clearly he will always obtain a return which is no less than this value. If he chooses the action which has the largest minimum or guaranteed payoff, he will

have the satisfaction of knowing that whatever happens, that is whatever Nature does, his return will be at least this maximum of the minima.

The maximin criterion arises from a very pessimistic or conservative attitude on the part of the decision-maker. It assumes that Nature is likely to take a most uncooperative action and that the decision-maker therefore has to counter this approach as well as he can. This conservatism of the maximin criterion is its main drawback. Each action is judged solely on its worst payoff, other payoffs being ignored. An investor who makes use of this criterion is considered to be low risk tolerant and will be inclined to select an investment that offers guarantees and the minimal possibility of loss.

- **The minimax regret criterion**

This criterion is similar to the first, but it argues that the “correctness” of a decision should be measured not by the actual payoff received, but by the amount by which the payoff could have been increased, had the decision-maker known what the state of Nature was. It is a criterion which has in mind judgement by hindsight. For each action of Nature and of the decision-maker we can calculate what is known as the regret. This is the difference between the maximum payoff for Nature’s action and the particular payoff for the decision-maker’s action and this same action by Nature.

Applying an approach which, like maximin, guards against the worst action by Nature, we now determine for each of the decision-maker’s actions the largest regret. Having done this we select the action with the smallest value, and term this the minimax regret action.

The minimax regret criterion has some of the disadvantages of the maximin criterion, but often to a lesser extent. This criterion suggests that investors will look back and argue that they “would have been better off invested elsewhere”.

- **The maximax criterion**

The maximax criterion presents a means of selecting an action which is in direct contrast with minimax. The procedure in full argues that for each of the decision-maker's actions, the largest payoff is noted. The action is then selected which has the largest of these values. It is a totally optimistic criterion, ignoring all other payoffs and taking no account of the probability that Nature will take this particular favourable action. It is very much the approach of the desperate gambler. An investor applying this criterion will chase the best performing investment at the time (i.e. "the flavour of the month").

#### **2.6.4 Relevance to the research problem**

Boards of Trustees made the conversion decision, yet effective decision-making requires information. In the absence of information and a proper understanding thereof, members cannot make an informed decision.

## **2.7 STRATEGY**

### **2.7.1 Strategic development**

Ghemawat (2002) suggests that the traditional concept of strategy is phrased in terms of the resource position (strengths and weaknesses) of the firm. Adherents to what has come to be called the resource-based view (RBV) of the firm argue that market positions based on superior products rest on the ownership of scarce, firm-specific resources. The dynamic capabilities view of the firm differs from the RBV in that capabilities are there to be developed rather than taken as a given. Ghemawat (1986) concludes that, ultimately, the search for sustainability involves a series of decisions about the degree to which you are willing to commit your business to a particular way of doing things.

Ghemawat (2002) states that the need for a formal approach to corporate strategy was first articulated by top executives of multi-divisional companies. He says that Peter Drucker had argued that in the age of multi-divisional corporations, managing

implied taking responsibility for attempting to shape the economic environment, for planning, initiating and carrying through changes in that economic environment, and for constantly pushing back the limitations of economic circumstances on the enterprise's freedom of action. This insight became the rationale for business strategy – that by consciously using formal planning, a company could exert some positive control over market forces.

Rivkin (2000) notes that some firms have the striking ability to resist imitation despite public scrutiny of their strategies, and suggests that the sheer complexity of a strategy can raise a barrier to imitation. He suggests that two factors make a strategy complex: the number of decisions that comprise the strategy and the degree of interaction among those decisions.

### **2.7.2 Game theory**

*The Scandinavian Journal of Economics* (1995) states that game theory is a mathematical method for analysing strategic interaction and emanated from studies of games such as chess or poker. In these games the players have to think ahead and devise a strategy based on the expected countermoves from the other player(s).

In the 1950s John Nash introduced the distinction between cooperative games, in which binding agreements can be made, and non-cooperative games, where binding agreements are not feasible. Nash (1950) developed an equilibrium concept for non-cooperative games that later came to be called the Nash equilibrium. In a Nash equilibrium, all of the player's expectations are fulfilled and their chosen strategies are optimal. If the game has several Nash equilibria, the equilibrium criterion cannot be used immediately to predict the outcome of the game. Selten then introduced the concept of subgame perfection and the "trembling hand" equilibrium. The analysis assumes that each player presupposes a small probability that a mistake will occur, that someone's hand will tremble. A Nash equilibrium in a game is "trembling-hand perfect" if it is robust with respect to small probabilities of such mistakes.



According to Myerson (1999) Nash's great contribution was his theory of two-person bargaining. Nash taught us to keep our eyes on the process of individual decision-making, even in a negotiation to collude. Van Damme and Weibull (1995) suggest that Nash equilibrium embodies a fundamental idea of economics, that people act in accordance with their incentives.

Nash (1953) built a non-cooperative bargaining game that involves four stages:

1. Each player simultaneously commits to a mixed strategy which he will be forced to use in case they cannot come to an agreement in stage 2.
2. The players inform each other of their threats.
3. Players independently state utility demands and minimal utility levels that they require.
4. If the utility demands can be simultaneously satisfied then each player gets what he demanded; otherwise the threats must be executed.

Van Damme and Weibull (1995) considered Von Neumann and Morgenstern's argument that one must avoid the hypothesis that others are always "rational". Their argument is that a satisfactory and exhaustive theory of rational behaviour can only be developed in a context that allows for irrational behaviour. To know whether an action should be termed irrational or not, one has to evaluate its consequences, i.e. one has to know how a rational player would react to it.

### **2.7.3 Competitive shock**

According to the South Africa foundation (2003), the South African economy and its management have changed dramatically since 1994. As South Africa re-entered the global economy, the level of external and internal competition faced by South Africa's private business intensified. The South African economy is some 30 per cent larger than it was in 1994. Much of this growth took place outside of the historical mainstays of the South African economy. This reflects South Africa's increasing integration into the world economy.

The South Africa Foundation (2003) also states that in the last few years, the business sector has accelerated change in five important areas: success in global markets, empowerment, innovation, investment in Africa and contribution to society. They conclude that business exists to generate value for society. When it succeeds, it generates employment and wages, as well as profit and taxation revenues. At this moment in South Africa, business is also called upon to help construct a new, inclusive South African society.

Ghemawat and Khanna (1998) argue that diversified business groups dominate the private sectors of most of the world's economies. Several of these economies have undergone sudden policy changes that significantly increase domestic competitive intensity. They define an economy-wide "competitive shock" as sweeping changes in a panoply of policies that significantly expand the role of competitive processes in determining business success or failure.

For example, in 1991 India embarked on significant changes in its industrial policies when a newly-elected government switched from a planned model of development to a more market friendly one. This led to changes in policy distortions and in informational imperfections and entrepreneurial scarcity. Ghemawat and Khanna's (1998) studies of Ballarpur Industries (BILT) indicate that, in response to the competitive shock, BILT restructured its multi-sectoral business. The R.P. Goenka (RPG) group was more diversified than BILT and by 1995 had been repositioned around six core sectors to enable it to build up dominant competitive positions. Ghemawat and Khanna (1998) conclude that time lags in restructuring can be expected to be quite long if one recognises that the restructuring process comprises three stages: acceptance by the group of the need to restructure; identification of the groups to be restructured; and implementation of that restructuring strategy. Perhaps the most significant source of lags in the first two stages of restructuring is that groups do not have the necessary skills to identify whether or not they need to restructure.

Ghemawat (1997) lists South Africa's opening to Africa and the rest of the world as one of ten geopolitical developments since the 1970s that indicate that competitive

forces, internal and external, have become more important in determining patterns of wealth creation and distribution. He suggests that we are living through an unprecedented experiment in social engineering – an experiment involving harnessing the power of competition through sudden, significant policy changes that are referred to as competitive shocks.

#### **2.7.4 Relevance to the research problem**

Game theory allows the possibility of irrationality, but does not consider the context of the game. There are several players in the pension funds game, each intending to maximise their own utility. Perhaps pension provision is a non-cooperative game because the “binding agreement” for pension guarantees was not feasible. It was a limited agreement in any event, given that it was only as good as the company that guaranteed it. It appears that the evolution did not result in a Nash equilibrium, given that not all of the players’ expectations have been fulfilled. The question can be raised as to whether players can be rational during periods of environmental shock. The players did not necessarily have all the required information at the time and if the consequences are considered, member behaviour appears to be irrational.

### **2.8 LEADERSHIP IN TURBULENT TIMES**

#### **2.8.1 Turbulence**

Cameron, Kim and Whetton (1987) investigate organisational attributes commonly associated in the literature with organisational decline and turbulence. They identify a common theme that organisations place a premium on predictability and stability in transactions with the environment. They found that most investigations have not separated turbulence or fluctuations from absolute decline and suggest that turbulence exists when changes faced by an organisation are nontrivial, rapid and discontinuous. Turbulence usually creates uncertainty, so that uncertainty is best thought of as an outcome of turbulence rather than a synonym.

Cameron et al's (1987) research results suggest that top managers tend to respond differently under conditions of high turbulence than under conditions of low or medium turbulence. When high turbulence is experienced there are: significantly more centralised decision-making, absence of long term planning, nonselective cuts in resources, top-administrator turnover and loss of leader credibility. Turbulence has no significant association with organisation-member response. During times of turbulence, the brunt of the consequences of uncertainty falls on the top-management cadre. Cameron et al (1987) suggest that practicing managers as well as organisational theorists will benefit from researchers paying attention to issues of causality.

Chakravarthy (1997) suggests that advances in technology and a global political climate favourable to free markets have made parts of many industries, such as financial services, health care, and transportation more turbulent. He suggests that a new approach to competitive strategy is required. When a business environment is highly complex and changing rapidly, the resulting turbulence in a firm's environment makes orderly conduct among its competitors more difficult. Multiple competitors that behave unpredictably cause turbulence. Market leaders must face and cope with turbulence by reconceptualising strategy, sharing the responsibility for strategy more broadly within the firm, and focusing on organisational capabilities as the real source of competitive advantage. He concludes that a firm's true competitive advantage for coping with turbulence is not in its current distinctive competencies, but in those that it can grow tomorrow.

### **2.8.2 Strategic leadership**

Ireland and Hitt (1999) define strategic leadership as a person's ability to anticipate, envision, maintain flexibility, think strategically, and work with others to initiate changes that will create a viable future for organisations. They suggest that the global economy has created a new competitive landscape – one in which events change constantly and unpredictably. For the most part, these changes are revolutionary, not evolutionary, in nature. Revolutionary changes happen swiftly, are constant, even relentless in their frequency and affect virtually all parts of an

organisation simultaneously. The uncertainty, ambiguity, and discontinuity resulting from revolutionary changes challenge firms and their strategic leadership to increase the speed of the decision-making processes through which strategies are formulated and implemented.

Ireland and Hitt (1999) suggest that effective strategic leadership practices can help firms enhance performance while competing in turbulent and unpredictable environments. They describe six components of effective strategic leadership: determining the firm's purpose or vision; exploiting and maintaining core competencies; developing human capital; sustaining an effective organisational culture; emphasising ethical practices; and establishing balancing organisational controls. Strategic leaders must use some of their time and energies to predict future competitive conditions and challenges. Organisations in which strategic leaders adopt a new competitive mindset – one in which mental agility, firm flexibility, speed, innovation, and globalised strategic thinking are valued highly – will be able to identify and competitively exploit opportunities that emerge in the new competitive landscape.

Organisational longevity, however, is more a measure of the ability to “weather the storm” than of strategic competitiveness. Montuori (2000) refers to organisational longevity as the durability or continuance of organisations – he was particularly interested in what efforts leaders must undertake to ensure their organisation's capacity to endure. Montuori suggests that conceptually complex leaders assume the responsibility of organisational self-awareness and empower organisational members with actions consistent with organisational self-responsibility. The crux of systems thinking is the recognition of where and when actions and changes in structures can evoke lasting improvements.

Kotter (2001) suggests that leadership and management are two distinctive and complementary systems of actions. Managers promote stability while leaders press for change, and only organisations that embrace both sides of that contradiction can thrive in turbulent times.

### **2.8.3 Conceptual complexity**

Leadership is about coping with change. Major changes are more and more necessary to survive and compete effectively in this new environment, and more change always demands more leadership. Institutionalising a leadership-centred culture is the ultimate act of leadership. Montuori (2000) suggests that effective leadership requires an ability not only to recognise and navigate around the visible obstacles and threats, but also to anticipate those that are not readily visible. Organisational longevity is more than the avoidance of cession, it is the continuation of active, productive life. Leaders must be conceptually complex.

Conceptually complex people have been proven to possess superior communication skills, greater interpersonal perceptual accuracy, attributions of internal causality and responsibility, and information search and utilisation. Conceptually complex leaders are most likely to notice the often-subtle changes in the external environment requiring not-so-subtle changes in the organisation. The ability of persons high in conceptual complexity to view situations from multiple perspectives and to rely on more integrative schemata for decision-making and problem-solving seems to increase their tolerance for conflict (a common element of environmental complexity) and allows them to adjust more effectively to change and uncertainty.

Leaders of the “fittest” – those organisations for which longevity is a super ordinate goal that propels the organisation through a relentless stream of tumultuous environmental conditions – have in their repertoire an array of cognitive skills. Montouri (2000) suggests that the goal of organisational development is to put into overall organisational processes an approach conducive to increased organisational longevity through a series of steps: put in place a system for understanding the interaction between the organisation and the environment; alter the organisation’s culture so that the engagement in ongoing change becomes second nature to ensure organisational learning, and enmesh in this modified culture a mechanism for the development and support of conceptually complex leaders.

Eisenhardt (1990) suggests that strategy making has changed. The premium now is on moving fast and keeping pace – fast strategic decision-making is essential. She suggests that people can make fast choices by skimping on the analysis, limiting the conflict and being autocratic. She explored how managers actually make fast, yet high-quality, strategic decisions. Overall, fast decision-makers use simple, yet powerful tactics to accelerate choices: track real time information on firm operations and the competitive environment; build multiple, simultaneous alternatives; seek the advice of experienced counsellors; use consensus with qualification to resolve conflicts; integrate decisions with other decisions and tactics.

Cunha, Kamoche and Cunha (2003) define organisational improvisation as the conception of action (as it unfolds) by an organisation's members drawing on available resources. They suggest that the relevance of improvisation for contemporary organisations has been mostly presented as a consequence of the increasing levels of speed and turbulence in organisational environments. The process of improvisation can be described as discovery-driven action aiming to explore unknown and unexpected opportunities or to neutralise unforeseen threats. Organisational improvisation seems to call for a specific type of leadership, one where the leader needs to be able to make a synthesis among apparently conflicting or dissonant styles, such as planning and acting behaviours, directive and permissive styles, providing guidelines, rules and procedures, while allowing individual discretion for goal attainment. This is "improvisational leadership" and serves to characterise leadership in a specific situation.

#### **2.8.4 Relevance to the research problem**

Specific leadership skills are required for organisations to survive in turbulent times. In the pension fund investment evolution, leadership actions were key determinants of the process and eventual outcomes – yet many leaders did not recognise (or ignored) the potentially negative outcomes.

## **2.9 ORGANISATIONAL CHANGE**

Morgan (1986) states that the open-systems approach to organisations focuses on a number of key issues. It emphasises the environment in which organisations exist, since organisations are open systems that need careful management to satisfy and balance internal needs and to adapt to environmental circumstances.

Dugger and Sherman (1997) state that Karl Marx placed emphatically reasoned that all major social change is caused by the contradiction between the productive forces and the class relations of production. Class conflict, they suggest, is a necessary condition for evolution. In class conflict theory, it is this fundamental clash of interests that drives social change under given circumstances. They attempt to demonstrate that any fruitful theory of evolution must have at least two elements. The first element is an analysis of the disruption or tension between institutions and technology. The second element is the analysis of why some groups fight for institutional progress while others resist. Theories analysing this issue have been called the power of the vested interests or the class conflict.

### **2.9.1 Organisational evolution**

Morgan (1986) suggests that the population-ecology view of organisation brings Darwin's theory of evolution right into the centre of organisational analysis. Organisations, like organisms in nature, depend on their ability to acquire an adequate supply of the resources necessary to sustain existence. In this effort, they have to face competition from other organisations, and since there is usually a resource scarcity, only the fittest survive. The nature, numbers, and distribution of organisations at any given time is dependent on resource availability and on competition within and between different species of organisations. The environment is thus the critical factor in determining which organisations succeed and which fail, selecting the most robust competitors through elimination of the weaker ones.



The population-ecology view has been rightfully criticised for downplaying the importance of the choice of strategic direction for an organisation. Organisations are, in principle, able to influence the nature of their environment. Environments then become in some measure always negotiated environments, rather than independent external forces.

Montuori (2000) suggests that we must conceptualise a notion of organisational Darwinism (i.e. evolution) that implies that, for continued existence in ever-changing environments, this generation of alternatives is an evolutionary process that enables organisations to make the requisite changes for survival. A learning organisation is more likely to recognise and respond to any changes brewing in its environment. The phenomenon of environmental change-organisational recognition/response is the driving force behind organisational longevity. Montuori (2000) suggests that in living organisms, when behaviour change occurs in response to feedback, we conclude that learning has occurred. For the living entity to survive in its environment, learning is critical. Thus, organisational learning is a necessary precursor to organisational longevity. Empowering decision-making across all functions, all employees at all levels forms the lifeblood of the learning organisation.

Aldrich (1999) suggests that evolution results from the operation of four generic processes: variation, selection, retention and diffusion, and the struggle over scarce resources. Variation is intentional or blind change from current routines and competencies. Selection is the differential elimination of certain types of variation through forces external or internal to the organisation. Retention is the preservation, duplication or otherwise reproduction of selected variations. Struggle is a contest to obtain scarce resources because their supply is limited.

Whatever their origins, selection processes operate by affecting the information and resources available to people, work groups, organisations and populations. Variations in information are filtered through members' perceptions and incorporated into their interpretations and understandings. Organisational members must act on the information they glean from typically incomplete searches of their

environments. Selection processes change the information that people act upon. Aldrich (1999) suggests that an evolutionary model must be general enough to encompass variation and selective retention of different units at different levels of analysis: individuals, work groups, divisions, organisations, populations and communities.

Eisenhardt and Galunic (2000) suggest that companies that actually achieve synergies have mastered a corporate strategic process called co-evolving. Managers routinely change the web of collaborative links. The result is a shifting web of relationships that exploits fresh opportunities for synergies and drops deteriorating ones. They suggest seven steps to kick-start co-evolution: establish at least monthly must-attend meetings among business heads; keep the conversation focused on real-time information about operating basics; reward self-interested pursuit of individual performance against rivals; brainstorm possible collaborative tools; realistically analyse the costs and benefits of the most promising options; fine tune as time goes by and take the time to cut stale links.

A key aspect of interdependent systems is that the outcome for any party to a transaction is fundamentally entwined with the actions and outcomes of other players. Therefore a change in one component of an interdependent system produces unpredictable changes in others, leading to coordination problems. Taking this into account, Child and McGrath (2001) suggest distinct design challenges that the dialectic of new organisational forms must address.

Salvato (2003) suggests that evolutionary models envisage an organisation as a collection of routines, providing a robust micro-level unit of analysis to address adaptive processes. Over time, variations occur in the routines and in the ways in which they are recombined. Some of the new routines and recombination patterns are selected and incorporated into the ongoing practices, thus shaping new strategic configurations. His research makes contributions to micro-sociological accounts of strategic evolution and to the dynamic capabilities perspective. He found that innovative strategic initiatives stem from a combination of routine

behaviour and new elements and that organisation leaders purposefully guide evolutionary processes.

Sammut-Bonnici and Wensley (2002) take at a broad-ranging view of the dynamics of change and transformation in organisations. Their objective is to move beyond the conventional paradigms of change analysis, to introduce novel perspectives of how organisations change, and to stimulate others to work on these issues. They suggest that the modern theory of the mechanism of evolution differs from Darwinism in two important respects: it recognises several mechanisms of evolution in addition to natural selection; and it recognises that characteristics are inherited as discrete entities called genes. Variation within a population is due to the presence of multiple alleles of a gene; and it postulates that speciation is usually due to the gradual accumulation of small genetic changes. Punctuated equilibrium, they note, describes a view of evolution where there are extended phases of consistency intermittently disrupted by short surges of new life forms.

Complexity theory partly explains the process of how organised systems spontaneously emerge out of chaotic systems – it views organisations as systems that evolve through a process of selection. Thus, a complex adaptive system starts with simple rules and goals for the individual, which then creates an organised complex formation. The end result is a configuration that seems to have its own life, which is capable of moving in harmony without a leader or external control. The theory of complexity shows how two systems starting out in similar, but not necessarily identical environments, will develop entirely different scenarios. Sammut-Bonnici and Wensley (2002) conclude, however, that evolutionary theories cannot explain why organisms and organisations behave in certain ways.

### **2.9.2 Time pacing**

For most managers, according to Eisenhardt and Brown (1998), event pacing constitutes the familiar and natural order of things. Companies change in response to events such as moves by the competition, shifts in technology, poor financial performance or new customer demands. In markets that are stable, event pacing is

an opportunistic and effective way to deal with change. By definition, however, it is also a reactive and often erratic strategy.

Eisenhardt and Brown (1998) state that time pacing emerged from almost a decade of research into the drivers of success in high-velocity, intensely competitive industries. They found that wherever managers were coping with changing business environments, time pacing was critical to their success, helping them resolve the fundamental dilemma of how often to change. In rapidly shifting industries, time pacing can help managers anticipate change and set the pace for change. It is a strategy for competing in fast-changing, unpredictable markets by scheduling change at predictable time intervals. Small and large companies, high and low tech alike, can benefit from time pacing, especially in markets that won't "stand still".

They argue that even in industries in which the rate of change is less than warp speed, time pacing can counteract the natural tendency of managers to wait too long, move too slowly, and lose momentum. By definition, time pacing is regular, rhythmic and proactive. Although the tempo is fast, it is predictable and so gives people a sense of control in otherwise chaotic markets. Time pacing disciplines managers to excel at managing transitions and managing rhythm. They suggest that time pacing can help organisations resist the extreme of changing too often.

### **2.9.3 Organisational transformation**

Aldrich (1999) suggests that, rather than framing transformation as an either-or issue, the conditions under which change occurs should be considered. A transformation is a change, but not all changes are transformations. He defines a transformation as a major change in an organisation involving a break with existing routines and a shift to new kinds of competencies that challenge organisational knowledge. Transformations are dramatic events, introducing discontinuities into an organisation's life. Weick (1995), as quoted by Aldrich (1999), argued that interruptions in organisational routines – shocks produced by unexpected, disconcerting, and inexplicable events – disrupt the communication activities that

are the lifeblood of organisations, triggering intensified efforts at sense-making. The disruptiveness of transformations depends, in part, on their speed and size, so these three dimensions are clearly interdependent.

Aldrich (1999) suggests that transformation is significant for organisational evolution for three reasons. First, an organisation that cannot change in fundamental ways will constantly be at risk, if its environment is evolving and it cannot keep pace. Secondly, if most organisations in a population are constrained from undergoing significant transformation, then that population will persist in evolving environments only through the founding of new organisations that are better suited to the changing context. Thirdly, if a substantial fraction of the organisations in a population are unable to make the transformations necessary to evolve in tandem with their environment and new organisations do not replace them, the population itself may be doomed.

Aldrich (1999) suggests that evolutionarily significant transformations are those that occur across many organisations within a population, that spread within particular cohorts of a population and fragment it, or that spawn new populations.

Kotter (1995) suggests that the change process goes through a series of phases that, in total, usually require a considerable length of time. Skipping steps creates only the illusion of speed and never produces a satisfying result. He suggests eight steps to transforming an organisation: establish a sense of urgency; form a powerful guiding coalition; create a vision; communicate the vision; empower others to act on the vision; plan for and create short term wins; consolidate improvements and produce still more change and institutionalise new approaches.

#### **2.9.4 Relevance to the research problem**

The generation of alternatives is an evolutionary process that enables organisations to make the requisite changes for survival. As the environmental processes impacted on pension funds and organisations, processes should have

occurred to enable the generation of alternatives and the selection of an optimal outcome.

## **2.10 ANSWERS FROM THE LITERATURE**

An analysis of the existing literature suggests the following key points regarding pension fund conversions:

- \* Pension funds evolved to survive in their environment.
- \* Defined benefit pension funds were designed to provide for retirement and death benefits, not withdrawal benefits – change was inevitable.
- \* The regulatory framework for the pension fund investment evolution was inadequate.
- \* Firms off-loaded contingent liabilities – members acquired investment risk.
- \* Firms have evolved and must consider several stakeholders – not just shareholders.
- \* Benefit from the evolution was not equal – power positions were relevant.
- \* Boards of Trustees made the conversion decisions.
- \* The pension fund investment evolution was a non-cooperative game – stakeholders were acting to maximise their own benefit.
- \* Leaders did not recognise or discounted or ignored potentially negative outcomes.
- \* Co-evolution of firms and pension funds occurred.

## **SECTION TWO: RESEARCH DESIGN**

### **CHAPTER THREE**

#### **PROBLEM STATEMENT, PROPOSITIONS AND RESEARCH METHODOLOGY**

##### **3.1 RESEARCH PROBLEM**

Pension funds perform an important role within the economy. They enable their members to make provision for old age and provide large sums of money for investment in various asset classes. Stakeholders in the pension fund industry include: government, the regulator, trade unions, employers, members, trustees, business, service providers, the adjudicator and the ombudsman. The Pension Funds Act of 1956 governs the industry and is in the process of being amended. A pension fund evolution has led to defined benefit fund structures (where a retirement benefit is guaranteed and calculated in terms of a percentage of pensionable salary at retirement depending on years of service) being converted to defined contribution structures (where a retirement benefit is determined by contributions made and investment growth). Employers have off-loaded substantial contingent liabilities and members now carry investment risk.

The phenomenon of the pension fund conversions occurred within a complex environment and has implications within a number of areas critical to societal well-being. At the time of the conversions, South Africa was in transition to democracy and a booming world economy was providing excellent returns on equity. In addition, the South African economy was in the process of fundamental structural change. It was not a time of “business as usual”. The rules of the game were changing. Herein lies the research problem. Even if we accept as given that the nature of pension funds was required to change, why did the outcome of converting defined benefit structures to defined contribution structures arise? Did the environmental circumstances of the political transition; economic re-structuring; globalisation; and world markets influence the outcome? It is a question of organisational behaviour during a period of fundamental environmental change.

## **3.2 RESEARCH PROPOSITIONS**

This research proposed to construct a model as set out in the research framework.

During environmental shock:

- \* factors combine to drive evolution (i.e. adaptation to the environment);
- \* organisational evolution speeds up;
- \* uncertainty and vacuum circumstances arise, leading to unintended consequences that require redress;
- \* relative power of stakeholders changes and determines the strategic outcome; and
- \* an imbalance in stakeholder interests arises and ethical considerations become consequential.

## **3.3 RESEARCH DESIGN**

According to Leedy (1997), research design and architectural planning have much in common. Creswell (1998) refers to research design as the entire process of research, from conceptualising a problem to writing the narrative. Yin (2003) suggests that the research design is the logic that links the data to be collected (and the conclusions to be drawn) to the initial questions of study.

### **3.3.1 Research method**

According to Leedy (1997), the quantitative approach is typically used to answer questions about the relationships among measured variables with the purpose of explaining, predicting and controlling phenomena. The qualitative approach is typically used to answer questions about the nature of phenomena with the purpose of describing and understanding the phenomena from the participants' point of view. A quantitative study usually ends with confirmation or disconfirmation of the hypotheses that are tested. A qualitative study may conclude with tentative answers or hypotheses about what was observed.



Creswell (1998) states that qualitative research is an inquiry process of understanding based on distinct methodological traditions of enquiry that explore a social or human problem. The researcher builds a complex, holistic picture, analyses words, reports detailed views of informants, and conducts the study in a natural setting. Creswell (1998) mentions that quantitative researchers work with a few variables and many cases, whereas qualitative researchers rely on a few cases and many variables.

Miles and Huberman (1994) suggest some recurring features of “naturalist” research:

- \* Qualitative research is conducted through an intense and/or prolonged contact with a “field” or life situation.
- \* The researcher’s role is to gain a “holistic” overview of the context under study.
- \* The researcher attempts to capture data on the perceptions of local actors “from the inside”.
- \* The researcher is essentially the main “measurement device” in the study.
- \* Most analysis is done with words.

The proposed research seeks to answer the question of why the outcome of converting pension fund structures from defined benefit to defined contribution arrangements arose and how environmental factors influenced the process. Therefore, a qualitative research method is required.

### **3.3.1.1 Qualitative research**

Qualitative research focuses on data in the form of words – based on observation, interviews or documents. These data collection activities typically are carried out in close proximity to a local setting. Miles and Huberman (1994) list three approaches to qualitative research:

- **Interpretivism**

Researchers are no more “detached” from their objects of study than are their informants. Researchers, they argue, have their own understandings, their own convictions, their own conceptual orientations; they, too, are members of a particular culture at a specific moment in time. Pre-established instrumentation is required to separate out “external” information from what they themselves have contributed when decoding and encoding the words of their informants.

- **Social anthropology**

Extended contact with a given community with particular care given to the description of local particularities; focus on individuals’ perspectives and interpretations of their world and relatively little pre-structured instrumentation, but often a wider use of audio-and videotapes, film, and structured observation than in other research traditions.

- **Collaborative social research**

Collective action is taken in a social setting where the researchers design the outlines of a “field experiment”.

Miles and Huberman (1994) suggest that some analytic practices may be used across different qualitative research types and list a set of fairly classic analytic moves arranged in sequence:

- \* Affixing codes to a set of field notes drawn from observations or interviews.
- \* Noting reflections and other remarks.
- \* Sorting and sifting through these materials to identify similar phrases, relationships between variables, patterns, themes, distinct differences between subgroups, and common sequences.
- \* Isolating these patterns and processes, commonalities and differences, and taking them out to the field in the next wave of data collection.
- \* Gradually elaborating a small set of generalisations that cover the consistencies discerned in the database.

- \* Confronting those generalisations with a formalised body of knowledge in the form of constructs or theories.

The interpretivist approach was adopted for the proposed research and incorporated the analytical process as proposed by Miles and Huberman (1994) as detailed above.

### **3.3.2 Case study**

Miles and Huberman (1994) suggest that we can define a case as a phenomenon of some sort occurring in a bounded context. Studies may be of just one case or of several. Yin (1993) points out that cases may have sub-cases “embedded” in them. The proposed research aims to study the phenomenon of pension fund conversions within the context of an environmental shock. Thus, the case is the phenomenon observed at an industry (macro) level, with sub-cases detailing particular manifestations of the phenomenon. The outcome of the research is to develop a model that:

- \* describes behaviour in the system;
- \* extends the application of theory to understand the key concepts; and
- \* clarifies the relations between the concepts.

Creswell (1998) suggests that a case study is an exploration of a “bounded system” or a case (or multiple cases) over time through detailed, in-depth data collection involving multiple sources of information rich in context. According to Yin (2003), the case study is preferred in examining contemporary events, but when the relevant behaviours cannot be manipulated. The case study relies on many of the same techniques as a history, but it adds two sources of evidence not usually included in the historian’s repertoire: direct observation of the events being studied and interviews of the persons involved in the events. A case study has a distinct advantage when a “how” or “why” question is being asked about a contemporary set of events, over which the investigator has little or no control.

Yin (2003) details six sources of evidence in doing case studies: documentation; archival records; interviews; direct observation; participant-observation and physical artefacts. He suggests that the benefits from these six sources of evidence can be maximised by following three principles: use multiple sources of evidence, create a case study database, maintain a chain of evidence.

Yin (2003) suggests that, for case studies, five components of research design are especially important:

- \* a study's questions;
- \* its propositions, if any;
- \* its unit(s) of analysis;
- \* the logic linking the data to the propositions; and
- \* the criteria for interpreting the findings.

Eisenhardt (1989) suggests a process of building theory from case study research; the proposed research followed this process:

### **3.3.2.1 Definition of research questions and constructs**

Miles and Huberman (1994) argue that any researcher, no matter how unstructured or inductive, comes to fieldwork with some orienting ideas. In this instance, something is known conceptually about the phenomenon (the conversion from defined benefit to defined contribution structures), but not enough to house a theory. The researcher has an idea of the parts of the phenomenon that are not well understood and knows where to look for these things – in which settings and among which actors. As suggested by Miles and Huberman (1994), the research tends towards the structured end of the extremes of loose, emergent design and a tight, pre-structured design. The research framework forms the basis of the conceptual framework for the study.

The research seeks to answer the question of why this particular outcome of the pension fund conversions arose (i.e. the conversion from defined benefit to defined contribution structures).

A construct, according to Leedy (1997), is any concept that cannot be directly observed or isolated. The constructs within the research are: environmental shock; organisational evolution; evolutionary factors; speed; uncertainty; vacuum circumstances; unintended consequences; redress; relative power and strategic outcome.

An environmental shock is a change to the existing rules of the game or the requirement to create new rules for a new game. Uncertainty is when there is no precedent and vacuum circumstances arise where a framework is inadequate or does not exist.

### **3.3.2.2 Selecting cases and sampling**

The research population includes individuals from various stakeholder groups who participated in the conversion process or who have expert knowledge in a particular section of the research framework. The population also comprises all defined benefit pension funds in South Africa that converted to defined contribution structures or considered conversion.

Miles and Huberman (1994) suggest that qualitative samples are purposive, rather than random. With small numbers of cases, random sampling can deal a decidedly biased hand.

Therefore a collective case study was conducted. Purposeful and theoretical sampling, not random sampling, was used. These shed different perspectives on the problem. Cases required were: pension funds that converted from defined benefit to defined contribution structures; pension funds that considered conversion, but did not proceed with the conversion; and pension funds that are now considering conversion. These cases provided sufficient data to consider the reasons for conversion and the context within which the conversions took place.

The unit of analysis is the individual – either the industry expert or the participant in the sub-case study. The sample was selected on a judgemental basis, through snowball sampling rather than random sampling.

Prior to the formal commencement of the data collection process, industry experts from various stakeholder perspectives were asked to comment on the research framework (Appendix 1 lists the industry experts). The research framework was modified on the basis of feedback received. These experts suggested other industry experts who could be approached for feedback. The other experts mentioned were then included as respondents as part of the formal research process.

- **Within-case sampling**

Miles and Huberman (1994) suggest that the activities, processes, events, times, locations and role-players to be sampled should be considered. They suggest that a sample must be theoretically driven and that choices of informants, episodes and interactions be driven by a conceptual question, not by concern for “representativeness.” To get to the construct we need to see different instances of it, at different moments, in different places, with different people. The prime concern is with conditions under which the construct or theory operates, not with the generalisations of the findings to other settings. Within-case sampling is iterative – we observe, talk to people and pick up artefacts and documents – this leads us to new samples of information and observations, new documents.

- **Multiple-case sampling**

Miles and Huberman (1994) suggest that multiple-case sampling adds confidence to findings. By looking at a range of similar and contrasting cases, we can understand a single-case finding, grounding it by specifying how and where and, if possible, why, it carries on as it does. If a finding holds true in one setting and, given its profile, also holds true in a comparable setting, but does not do so in a contrasting case, the findings are more robust. By way of illustration: the first conversion occurred in 1980. This was the first instance of the phenomenon being researched and was largely a union driven initiative. Now, a major parastatal is considering conversion and the union appears to be resisting its conversion.

Miles and Huberman (1994) suggest that three kinds of instances have great payoff. The first is the apparently “typical” or “representative” instance. Funds that converted from the early-1980s to mid-1990s would fit this profile. The second is the “negative” or “disconfirming” instance. Funds that converted after 2000 would fit this profile – i.e. the “problems” associated with conversions were more clearly understood and the environment was more certain. The third is the “exceptional” or “discrepant” instance. The first fund conversion was in 1980 and it would be of value to study this case.

Eight cases were researched:

- \* One of the first instances and a current instance (cases A and F).
- \* Two funds that converted between 1980–1995 (cases B and D).
- \* Two funds that converted after 1995 (cases C and E).
- \* One fund that considered converting, but remained partially open (case G).
- \* One fund that considered converting, but did not convert (case H).

These specific instances are sub-cases of the case study on the phenomenon of South African pension fund conversions.

### **3.3.2.3 Crafting instruments and protocols**

Miles and Huberman (1994) suggest that if you are doing a confirmatory study, with relatively focused research questions and a well-bounded sample of persons, events and processes, then well-structured prior instrument designs are the logical choice. This also emphasises internal validity (i.e. am I getting a comparably measured response from different people?) and generalisability (i.e. is this case a good instance of many others?).

Triangulation refers to the use of multiple and different sources, methods, investigators and theories to provide corroborating evidence. Multiple data collection methods were used: semi-structured, in-depth interviews were held with participants and documentary evidence (such as minutes of meetings of fund

Boards of Trustees and court judgments) were also considered. Instrumentations include an interview guide (Appendix 2), contact summary form (Appendix 3), document summary form (Appendix 4) and a case analysis form (Appendix 5).

#### **3.3.2.4 Data collection**

Eisenhardt (1989) suggests that overlapping data collection and analysis can be helpful in speeding up the data collection process and can reveal helpful adjustments to data collection. Flexible and opportunistic data collection methods allow investigators to take advantage of emergent themes and unique case features.

Informal interviews were initially conducted with several stakeholders for their opinion on the research framework. Their inputs and insights were incorporated into the research design. A key feature of theory-building case research is the freedom to make adjustments during the data collection process. These adjustments can be the addition of cases to probe particular themes as they emerge.

#### **3.3.2.5 Data analysis**

A detailed description of the case emerged, themes and issues were analysed within the constraints of the research framework and an interpretation made. Analysis was rich in terms of the context of the case. Within-case analysis of each sub-case and themes within the case was conducted, followed by a thematic analysis across the sub-cases, called a cross-case analysis. Within-case analysis typically involved detailed case study write-ups with the overall idea to become intimately familiar with each sub-case as a stand-alone entity. This process allowed the unique patterns of each sub-case to emerge before pushing to generalise patterns across the sub-cases.

Sub-cases were analysed to determine:

- \* Facts and history – the history of the fund and the dates and activities of the conversions.



- \* Employer perspective – why the employer converted the fund and the decision-making process.
- \* Member perspective – actions of the members and outcome for the members.
- \* Problems and issues – any difficulties that arose during or after the conversion process.

Appendix 6 details the case analytical framework used to investigate the sub-cases. Sub-case findings were compared with data collected from interviews to determine whether the actual manifestations confirmed the expert opinions.

Miles and Huberman (1994) strongly recommend early analysis. It helps the field-worker cycle back and forth between thinking about the existing data and generating defined analysis as three concurrent flows of activity: data reduction (the process of selecting, focusing, simplifying, abstracting and transforming the data that appear in written-up field notes or transcriptions); data display (an organised, compressed assembly of information that permits conclusion drawing); and verification (the meanings emerging from the data have to be tested for their plausibility, their sturdiness and their validity). They suggest that data reduction leads to new ideas on what should go into the data display. Entering the data requires further data reduction. As the displays fill up, preliminary conclusions are drawn. In this view, qualitative data analysis is a continuous iterative enterprise.

A contact summary is a single sheet with some focusing or summarising questions about a particular field contact. Miles and Huberman (1994) suggest that it is a rapid, practical way to do first-run data reduction without losing any of the basic information (the write-up) to which it refers. It focuses on the primary concepts, questions and issues.

### **3.3.2.6 Shaping hypotheses**

From the within-case analysis, plus various cross-case tactics and overall impressions, concepts and relationships between variables began to emerge. The central idea is that researchers constantly compare theory and data – iterating

toward a theory which closely fits the data. One step in shaping hypotheses is the sharpening of constructs. This is a two-part process involving the refining of the definition of the construct, and building evidence which measures the construct in each case. Cases which disconfirm the relationships often can provide an opportunity to refine and extend the theory.

### **3.3.2.7 Enfolding literature**

A comparison with similar literature and conflicting literature was considered. Tying the emergent theory to existing literature enhances the internal validity, generalisability and theoretical level of theory building from case research.

### **3.3.2.8 Reaching closure**

Theoretical saturation occurred when marginal improvement became small. According to Miles and Huberman (1994) a number between four and ten cases usually works well.

## **3.4 REASONS FOR USING THE METHOD**

The proposed research aimed to consider a particular phenomenon and various manifestations thereof. It set out to answer why a particular outcome arose. It was necessary to collect information from stakeholders in the process to determine their experience and to consider particular instances of the phenomenon.

The proposed method met the research objectives.

## **3.5 LIMITATIONS OF THE STUDY**

Availability of information was a key consideration. The pension fund conversion phenomenon is a sensitive topic given “surplus legislation” that is attempting to right past “wrongs” against fund members. Unclaimed benefits in funds are also becoming a contentious issue. National Treasury (i.e. the government) is currently in consultation with stakeholders in preparation for a rewrite of the Pension Funds

Act. Concern that stakeholders or case study participants may be reluctant to disclose information proved unfounded.

Miles and Huberman (1994) have identified seven pervasive issues that arise with qualitative research:

- \* the labour intensiveness of data collection;
- \* frequent data overload;
- \* researcher bias;
- \* time demands of processing and coding data;
- \* the (in)adequacy of sampling when only a few cases can be managed;
- \* the generalisability of the findings; and
- \* the credibility and quality of the findings.

Miles and Huberman (1994) also identified the strengths of well-collected qualitative data:

- \* They focus on naturally occurring, ordinary events in natural settings, so we have a strong handle on what “real life” is like.
- \* Local groundedness – data are collected in close proximity to a specific situation and the emphasis is on a specific case; a bounded phenomenon embedded in its context.
- \* Richness and holism is a feature with strong potential for revealing complexity, such data provide “thick description” that are vivid, nested in a real context, and have a ring of truth that has a strong impact on the reader.
- \* There is an emphasis on people’s “lived experience” which is fundamentally well suited to locating the meanings people place on the events, processes and structures of their lives: their perceptions, assumptions, judgments, and presuppositions.

### **3.6 GENERALISABILITY**

Leedy (1997) suggests that the external validity of research is concerned with the generalisability of the conclusions reached and asks the question: Can the

conclusions drawn from a sample be generalised to other cases? According to Yin (2003), case studies, like experiments, are generalisable to theoretical propositions and not to populations or universes. In doing a case study, the goal is to expand and generalise theories (analytic generalisation) and not to enumerate frequencies (statistical generalisation).

Firestone (1993), as quoted by Miles and Huberman (1994), suggests that the most useful generalisations from qualitative studies are analytic, not “sample-to-population”.

### **3.7 RELIABILITY AND VALIDITY**

Leedy (1997) states that, to be reliable, each instrument must consistently measure the factors for which it was designed. Reliability is the consistency with which a measuring instrument performs (i.e. how well the instrument consistently yields similar results). Validity looks at the end result of measurement. Miles and Huberman (1994) suggest that meanings emerging from the data have to be tested for their plausibility, their sturdiness and their “confirmability” – that is, their validity.

The question that reliability asks is: If the study was repeated, would the same result arise? The question that validity asks is: Are we really measuring what we think we are measuring?

Miles and Huberman (1994) suggest that in qualitative research, issues of instrument validity and reliability ride largely on the skills of the researcher. Essentially, a person – more or less fallibly – is observing, interviewing, and recording, while modifying the observations, interviewing and recording devices from one trip to another. They suggest that good markers of a good qualitative researcher-as-instrument are:

- \* some familiarity with the phenomenon and the setting under study;
- \* strong conceptual interests;
- \* a multi-disciplinary approach, as opposed to a narrow grounding in a single discipline; and

- \* good “investigative” skills, including doggedness, the ability to draw people out, and the ability to ward off premature closure.

### **3.8 NATURE OF THE RESULTS**

Theory was built from the research. The theory is parsimonious, testable and logically coherent.

The emerging model can be applied to other scenarios of environmental shock. An example is Black Economic Empowerment, where:

- \* There exists pressure to apply BEE – environmental shock.
- \* Various driving forces are at play.
- \* The process is speeding up.
- \* Uncertainty exists, there is no precedent to follow.
- \* Relative power of stakeholders is changing.
- \* Stakeholder interests need to be balanced.
- \* Ethical factors are a consideration.

## **SECTION THREE: CONTRIBUTION TO KNOWLEDGE**

### **CHAPTER FOUR RESEARCH RESULTS AND ANALYSIS**

#### **4.1 ANALYTICAL PROCESS**

Industry experts representing the various stakeholders were selected by snowball sampling. To obtain a macro view of the phenomenon, 44 respondents were interviewed, of whom 11 were interviewed twice. Thus a total of 55 interviews were held, in Johannesburg and Cape Town, over a period of nine months (Appendix 7 details the experts interviewed).

To investigate particular manifestations of the phenomenon, eight cases were studied. For reasons of confidentiality, Principal Officers and other respondents interviewed for the cases are not listed, neither are the company-specific publications that were referenced (Appendix 8 lists the cases studied). Cases, drawn from various industry sectors, were studied in Johannesburg, Cape Town and Durban (Appendices 9–15 set out the within-case analyses).

The analytical process was qualitative. Data collected from the industry experts was analysed both horizontally and vertically. The horizontal analysis considered the responses of industry experts within their stakeholder categories. The vertical analysis considered the various themes that emerged. Appendix 16 sets out an analysis of data collected from the experts interviewed. Data collected from the case studies served to confirm findings from the industry experts. Appendix 17 sets out a cross-case analysis of data collected from the case studies.

To ensure a robust analytical process, research results collected from the industry experts interviewed were reported as verbatim responses. These responses, as set out in section 4.2 below, therefore, do not necessarily read as smoothly as would have occurred if they had been obtained from a single source. The data is included in the body of the research rather than as addenda, since they form part

of the reader's experience of the research. Data triangulation occurred on an ongoing basis. Interview results from each interview were contrasted with other interviews held, verified against available documentation and confirmed by evidence collected from the various case studies. Emergent themes, across the various stakeholder categories, were drawn from the research results and are set out in section 4.3 below.

During the research process, various articles<sup>3</sup> were published in *Today's Trustee* magazine, making reference to data collected in the research. This magazine is widely circulated within the pension funds industry and reaches all stakeholders. Findings were also presented to various industry experts at a conference of the Pension Lawyers Association<sup>4</sup>.

## **4.2 RESEARCH RESULTS**

Results from the interviews and case studies are set out below.

### **4.2.1 The regulatory framework<sup>5</sup>**

Government is responsible for passing legislation, which the regulator must implement. The office of the pension fund adjudicator was established in 1998 to decide on disputes regarding pension funds. The long term insurance ombudsman, although voluntary, makes determinations on pension matters, usually on annuities purchased by members of pension funds at retirement. Since they all form part of the regulatory framework, responses from the following stakeholders were analysed together: government, regulator (FSB), pension funds adjudicator and long term insurance ombudsman.

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<sup>3</sup> DB vs DC too late for tears, Sept/Oct 2005.  
BEE disempowerment avoided, Nov/Dec 2005.  
DB/DC conversions members beware, Jan/Feb 2006.

<sup>4</sup> Presentation to the Pension Lawyers Association Conference, 7 March 2006 on "Legal issues arising from doctoral research on pension fund conversions in South Africa: 1980–2006."

<sup>5</sup> Eleven industry experts were interviewed on a confidential basis.

### ➤ **Union activity**

The early conversion years were confused years. Defined benefit funds did not work. On withdrawal, members got back their own contributions plus, in some instances, a small portion of the employer's contribution.

In the late 1970s, a government white paper was drafted, proposing compulsory preservation. There was political unrest, with riots and demonstrations and the paper was withdrawn. This was a trigger for trade unions to take control over pension fund assets that could be utilised to their benefit (refer to cases A, B, and D). The Nationalist government at the time was perceived to be using union money against the liberation struggle.

At the time, employers dominated the funds and trustees were appointed by the employer. The unions were looking for an issue and wanted economic power. Unions did not want a cross-subsidy, they wanted contribution equity. If this outcome is requested, consultants would respond with defined contribution structures (refer to cases A, B and D).

Defined benefits had poor withdrawal benefits, retrenchment benefits and low rates of interest. There was also distrust of the payment of an income; it was difficult for pensioners to collect their pensions if they lived in rural areas. A perception also existed that poor blacks were subsidising white pensioners; although there was no evidence of this. However, research has now shown that there actually is a difference in mortality rates – blacks do not live as long as whites.

The means test excluded your house, but included annuity payments. Thus, it made sense for members to take a lump sum, buy a house and then claim the state old age pension (SOAP).

Employers did not push for defined contributions in the early days, some employers resisted because they thought it was bad for members (refer to cases A and D). Blacks went into provident funds because this is what they wanted.



➤ **Consultant activity**

In the late 1970s, actuarial practice was dominated by a few large firms. One group of consultants, in particular, was driving union member conversions (refer to cases A and B). Unions did not specifically ask for defined contributions as a position – the employers wanted it. Some employers were paternalistic, but when they saw the major political change and fears of hyper inflation, they relented. Thus the conversions in the 1990s was politically and economically motivated (refer to cases A, B, C, E and G). Business was not prepared to take the risk.

On defined benefit pension funds, especially in the industries, when members changed jobs, they often had to leave their money in the fund and at retirement could get all their previous benefits. For example, the Hospitality Industry Fund was based on United Kingdom (UK) guild funds. It was expected that a worker in the hospitality industry would remain in the industry and only move between employers. Money was thus locked into funds when members moved from one job to another.

The dynamics of life then was that people were always on the move under threat of repatriation to the homelands or jail. Early death was a reality and family members often did not know about benefits or how to claim them. Members often used different names on different funds, so funds often did not know whose money it was. Member contributions were not protected. Illiteracy of previously disadvantaged members was another problem, and when companies closed down, members often struggled to access their money.

An individual who was to become a key player as a consultant was in North America and witnessed the move to defined contributions. He returned to South Africa with the idea and aggressively set out to market the concept with employers and unions. He started the market plan and recruited another individual who also became a key player in the early 1980s. This brokerage was the big pusher (refer to cases A, B and D). A division was established specifically for the purpose of attracting union business.

It was mostly trade union members who were affected when companies retrenched employees and fund members received poor benefits; defined contribution provident funds sounded like a better deal. Employers first objected and said that members would squander the lump sum and then look to the employer for more money, but then warmed to the idea that defined contribution was a better option. Now, few defined benefit funds are left. No employer would now open a defined benefit fund (refer to cases F, G and H).

➤ **Economic factors**

In 1985–86 the economy faltered as the Rand dropped and sanctions started to impact. Pension fund assets took a knock. Employers saw the dangers of liabilities. Thus, the conversions in the 1980s were union driven, and in the 1990s were employer driven (refer to cases A, B, C, D, E and G).

Conversions to defined contribution structures were linked to control. There was a focus on economic emancipation following political emancipation. This was led by labour and its underlying motivation to increase its power.

Markets were very good in the mid-1990s. Defined benefit funds were seen to be lagging behind with poor returns (refer to case D) whereas defined contribution funds were performing well.

➤ **Revised legislation**

In 1996 the question of representation of members on boards arose. Employers were in control of funds, used the pension fund as their own money and generally did as they pleased. They had their own representatives on the Boards of Trustees. Unions approached the registrar at the time and threatened to occupy the minister's office. The union controlled Metal Industries Fund refused to pay the FSB levy. The unions demanded an apology, which the FSB gave. The minister instructed the FSB to resolve the problem. The FSB took the matter to the National Economic, Development and Labour Council (NEDLAC). Labour and employers were hostile towards each other, and each met with the FSB separately. The

resultant requirement that at least 50 per cent of trustees be member elected was aimed to shift the power to members.

In 1997 a revenue gap existed and Retirement Funds Tax (RFT) was introduced to fill it. These funds were required to pay for government objectives. There was an unsuccessful backlash against this tax.

In 1998 Parliament rejected initial legislation regarding surplus apportionment as unworkable. Two years later, the legislation was passed. The Minister had promised revised pension fund legislation by 2002–03 and National Treasury was working on it. In 2005, the mandate was expanded to include public sector funds – in addition to private member funds. A unified public service is a driver for growth and this cannot occur with diverse pension funds.

The unions are not clear on the issue, they claim not to have asked for defined contributions and do not speak with a united voice.

#### ➤ **Consumer protection**

The FSB and the pension fund adjudicator did not exist in 1980. The Mouton Commission in 1996 referred to the need for an adjudicator because member problems could not be resolved within the existing framework.

The office of the registrar reflects the mind of the regime that is in power. The FSB reflected the government of the time. The mindset was that employers (100 per cent white and male, like the government) were in control of the industry. Members of funds were, however, mainly trade union members. Seven to eight years before the 1980s black trade unions were not permitted to join retirement funds (refer to cases A, B and D). Trade unions did not trust the government with their savings, as members were not in control of the assets of the funds.

Two things were required. An immediate objective to take control of assets – this was not possible while members were active, but when members retired they wanted to leave nothing behind, hence the push for provident funds to get lump

sum benefits. The trade unions wanted provident funds, the issue of defined contributions was not an issue in their mind. The longer term objective was to take control of funds before retirement – hence the drive for member elected trustees. In 1994, the FSB worked on legislation to assist members to become involved on Boards of Management on a 50/50 basis. This requirement would be immediate for all new funds, and for existing funds the target date was 15 December 1998. This also required employers to appoint trustees. The issue was inclusivity and achieving equality.

From 1 April 2005, the long term insurance ombudsman no longer had jurisdiction over retirement annuities issued by life insurers. On retirement matters, the long term insurance ombudsman has no jurisdiction, only in cases where the member has purchased an annuity in their own name. If it was purchased in the name of the fund, the pension fund adjudicator has jurisdiction.

Members were given a sweetener, funded from the surplus, to convert (refer to cases A, B, C, D and E). It made no sense for members to say no, it seemed logical. In defined benefit funds, employers saw the fund as theirs and controlled it as such. In the conversion from defined benefit to defined contributions, the unions should have played a more active role; surplus apportionment legislation now seeks to resolve the past.

In the 1980s, government attempted to introduce compulsory preservation – unions went on strike and government backed down. In the following negotiation process, the conversion from defined benefit funds to defined contribution funds was accepted. Unions did not understand the ramifications. The conversions were done without much thought, analysis, or research.

#### ➤ **Consideration of other organisations**

Part of the policy development process includes looking at the macro view. In developing the discussion paper on pension fund reform, the history was considered and attempts were made not to make decisions in isolation. Policy must consider various sectors and should not be done on a theoretical basis. Information

is obtained from various parties. National Treasury is a relative newcomer regarding the retirement fund industry. Financial sector policy is still evolving in South Africa; pre-1994 it was inward looking. This was a reflection of the country and its government. Experiences of the UK, USA and Australia have now been considered.

National Treasury has always seen private pensions as part of a broader structure. The question they asked was: if the state financed welfare now, can they fund it in the future and how? The key issues are: access; price and adequacy. The idea is to collaborate with the private sector. The various stakeholders have to exist together.

There are various principles involved and nobody understood the relationship and distribution of rights. Employers were convinced that they owned the surplus. Employees argued that they held claim. National Treasury had to show that nobody held claim. When you set up a fund, if things go bad, you use the surplus; if things go well, you keep the surplus for times when things are bad. However, companies had used surplus for contribution holidays so many funds had no surplus in hand.

The office of the long term insurance ombudsman is a voluntary ombudsman scheme – not like the adjudicator. It was established by the industry about 20 years ago by Old Mutual's Jan van der Horst who knew of the Dutch scheme. Ninety-eight per cent of insurance companies belong to the scheme, which relies on reputational and peer pressure. It is funded by insurance companies and large brokerages on a pay per complaint received basis. Policy holders do not pay.

The FAIS ombud will hear complaints on advice given after 1 October 2004. The long term insurance ombudsman resolves disputes between policy holders and insurance companies. The model operates as follows: an independent council sets out the terms of reference; rulings are binding on the insurance company since 1996 – prior to this rulings were only regarded as recommendations. The internal

appeals process is by a panel of judges and decisions are absolutely final. Annuitants are not bound until appeal, thereafter rulings are binding.

The Minister of Finance is in charge, but in name only. There are several issues to consider. First, employers wanted to get out of the uncertain contingent liability (refer to cases A to F). But maybe this was unfounded in South Africa since few people actually reached retirement. Secondly, members had to give consent, only they did not make informed choices – they only saw the enhancement. It seemed like a good idea to members, but their focus was on the sweetener. Where unions represented members the discussion was on the enhancement percentage. There was no focus on the guaranteed right. Thirdly, surplus was available; if the funds were not in surplus there would have been a different issue and no conversion would have taken place (refer to the employer “escape clause” in case E). Maybe that is why the government funds did not convert – they were in deficit.

The pensions department at the regulator was severely under-resourced and the FSB was largely a “toothless bulldog”. After 1996 it was better staffed.

By the late 1980s conversions looked like win-win. Members wanted it for the reward of better investment performance. Where the herd came in was with senior management and executives who copied their peers (refer to case G). There were also changing work habits (refer to cases A, B, C and E) – if you spent your entire career at one company you were not interested in leaving benefits. The problem with defined benefits was inadequate withdrawal benefits and people knew this. Defined contributions offered better benefit for shorter service. In the late 1980s, hybrid funds were not successful; a large insurer did try to sell these products. Hybrid was where the rules read like defined contributions, but for individuals they worked like defined benefits. Hybrids were set up in some instances where conversion terms set these out.

There was a lack of trade union education – they accepted poor conversion terms (refer to cases A, B and D). Unions did not realise that surplus was left behind – hence the need for surplus legislation. Before legislation requiring a split in the

Board of Management between employer appointed trustees and member elected trustees, the MD or CEO alone was in control. Now members must elect and employers must appoint, so there was change on both sides. Conversions happened in two phases – union driven conversions (refer to cases A, B and D) and employer driven conversions (refer to cases C, E and G).

➤ **Employers and trade unions**

In the atmosphere of the 1980s the idea prevailed that markets were king, and the influence was on individualism. Legislation was driving the employer driven conversions – the requirement for 50 per cent of trustees to be member elected. Many employers stated that this was the final straw – there would be no more contribution holidays and they were not confident in the workforce participating in the decision-making process. So employers pushed very hard against the proposal for member elected trustees, while the unions pushed very hard for it.

Unions wanted improved withdrawal benefits. There was the desire of employees to have control. The process is not yet complete, it is still unfolding (refer to cases D and F).

Employers were happy with members moving out of existing defined benefit funds with a small sweetener and much of the surplus being left behind. They thought that surplus left behind would belong to them – they did not expect the surplus legislation (hence the outcry). The legislation was dated back to 1980 to cover the first conversions.

In ordinary defined benefit funds, contributions varied from 2 per cent for a young person to 40 per cent for an older person. When defined benefit funds only had a few older members left, this looked very expensive. The SOAP means test encouraged members to want lump sums – they were often better off spending the pension benefit and then relying on SOAP.

➤ **Decision-makers**

At the time of the first conversions, only the trade unions were making the decisions. Trade unions pushed for provident funds (refer to cases A, B and D). Employers understood that under defined contribution provident funds the risk would shift to members<sup>6</sup>, therefore they did not resist.

At the time of the employer driven conversions, employers offered sweeteners to encourage members to convert (refer to cases A, B, C, D and E).

Yet conversions were not purely union or employer driven – consultants also saw it as an opportunity (refer to cases A, B, D, F and G).

➤ **Evaluating the outcome**

No-one truly and specifically evaluated the probable outcome of the conversions. In one sense the process was successful in that we now have an all inclusive situation – funds are not under the control of white people only. In another sense it failed because few trustees are skilled in managing the funds and there is a great need for trustee training. Phase one was for inclusion, phase two is skill.

From a members' point of view, the outcome has been evaluated. There have been hundreds of complaints – dating from mid-1980 to early 1990. Markets were booming until 1998. Thereafter, there were three crashes – information technology, emerging markets and the Argentine economic crisis. If members left a defined contribution fund at that time – between August and October 1998 – they left with half their previous values. Members complained of poor performance, but the root cause was that they now carried risk that they did not understand. It is about how products were developed and how they were sold. It was not easy to understand. What information was given out? Prior to 1998, it was better to be in a defined contribution fund.

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<sup>6</sup> Other evidence does not support this view. Evidence suggests that employers initially resisted and then relented because they wanted the strikes and work stoppages to end.



Even now, proper evaluation has not happened. The surplus issue was a by-product. Only when members start retiring will the matter become an issue. Yet, employers will never go back (refer to case F). Employees may seek recourse from the consultants who persuaded them to move. In some instances, consultants strongly recommended the transfer, and the fiduciary duty of consultants has not yet been challenged. But litigation is expensive and long. There are limits on contingency fees and thus there is little incentive for lawyers. Class actions are also possible.

➤ **Reform process**

After 1994 South Africa was suddenly part of the world. South Africa is vice-president of the International Organisation of Pension Supervisors – a worldwide organisation. While the labour movement in South Africa was banned, it operated underground and pension funds formed part of the general freedom movement. The philosophical principle was important – it was a desire of “I want to be equal”.

Retirement reform was slow – the Pension Funds Act was written and then left to itself. On Boards of Trustees, half were informed and half were not. (It was usually the employer appointed trustees who were informed. That is the reality.) Yet the conversion process went remarkably quickly. The residue of rights was not considered. In the environment of low interest rates and market vagaries many lost a fortune. The crucial question is how the message regarding risk is conveyed to members.

But the speed is not as important as the ultimate result. The thought process is key. The ideal would be a process that starts, for example, in 1996 and then others learn before they follow suit later. A catastrophic event was needed to show the point. If the market went up there would not have been an issue. The regulator could have intervened – they now deem it necessary to do so, but a different regulator was in place at the time of the conversions.

The tax regime is also relevant. For example, employers were allowed a special tax deduction in benefit funds. This was withdrawn in 1998–99 and now employers

no longer provide the benefit. Pension benefits will not be provided if the employer is not given a reason to provide them. The tax regime needs to be revised to incentivise because tax regulations are out of date. The second draft paper is due in October 2005<sup>7</sup> and recommendations for tax will be included.

➤ **Suitability of the speed**

The conversion from defined benefit to defined contribution in South Africa was the fastest in the world. The FSB held a good pace, but members wanted to move faster, they wanted to drive recklessly.

It was slower in other countries possibly because of the process framework and members that are more difficult. South Africa is ahead of the pack. Legislatively, not much changed, but in practice fundamental change was actually taking place. Actual change went faster than regulatory change and the conversion from defined benefit to defined contribution saw a mushrooming of service providers.

The situation was perceived as being win-win. A new government was imminent and was perceived as a big threat. Funds were very fortunate that they were not in deficit<sup>8</sup>, otherwise they could not have converted. Internationally, funds were looking at deficits. When an emerging brokerage started the drive, other consultants objected and said it was not in the members' interests.

➤ **Infrastructure**

The registrar at the time would not have advised unions of the unintended consequences (i.e. shift of risk). It would if it happened now. The old FSB did not look at the issue and was not communicating with organised labour.

The basic problem with the adjudicator is split jurisdiction (multiplicity of jurisdiction). Members of government funds go to the public protector; bargaining council funds to the bargaining council; and members of funds set up under the

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<sup>7</sup> This paper remained outstanding as at March 2006.

<sup>8</sup> A fund is in deficit if an actuarial valuation determines that the fund's assets are insufficient to fund its liabilities. If a fund in deficit converts, there would be a shortfall in the required transfer values and the employer would be required to pay the difference.

Labour Relations Act go to the Commission for Conciliation Mediation and Arbitration (CCMA) and the Labour Courts. Funds registered in terms of the Pension Funds Act go to the adjudicator. In the 1980s and 1990s disputes over transfer values were referred to the FSB appeal board.

It was a learning curve that members never understood. There was insufficient supervision – in prior years, the registrar of pension funds was close to employers. Only after the FSB was established did this change.

Unions shook the fabric of the legislation. In the conversion from defined benefits to defined contributions, people saw an opportunity in defined contributions to access the money. The result was leakage. While there is a political urge driven by anger and hatred, people do not properly apply their minds. Today the process would be better managed. Then, it was not managed, it was an emotional issue.

➤ **Factors influencing the speed**

The power base was changing, for both political and economic power. Unions are possibly less powerful now than they were in the late 1990s. Unions are succeeding in building economic power and much energy is going into fighting for capacity building of members. They are making the noise.

The conversions happened fast because members wanted it, and funds were in surplus so they could offer a sweetener. Now members are becoming better informed.

➤ **Uncertainty**

The issue of surplus reared its head in the 1980s when contribution holidays started. At that time, employers wanted to generate a surplus, which was probably a result of conservatism. For conversions, transfer values were below par. This could have been intended, as there was a tendency to deliberately transfer black employees and retain white employees. If black employees received values below par, whites could then benefit from the surplus generated by those who had left the fund.

Employers were very worried about legislation requiring 50 per cent of trustees to be member elected. From 1994–96, the government was still finding its feet. There was a vacuum around proper analysis and this was certainly in the interests of service providers. Although defined contribution is more sustainable and the economy is better off, the process could have been different. Very few people argued against the risk and realised that it might come back to bite them.

As a result of union agitation, legislation was changed and the FSB restructured. In 1996, the pension fund was the battleground – employers felt that they were losing control of the funds. The adjudicator was established in 1998, but does not have equity jurisdiction.

➤ **Analysis of the process**

Members of defined contribution funds needed to purchase annuities on retirement and were sold living annuities. Information disparity existed and disclosure was required. (The FSB is now focusing on member and consumer education.) Unclaimed benefits in the defined benefit fund went to surplus, but in defined contribution the question arises as to what happens with the surplus. Regarding the surplus, members did not understand what they were getting.

On the whole, most people are worse off – the second amendment act did not remedy the problem. The insurance companies have increased in power, whereas individuals are on their own. Employers got out of the risk (refer to cases A, B, C, D, E and G). Risk shifted and soiled the SOAP – members could squander provident fund lump sums and then revert to SOAP. Redress may be to disallow lump sums and not allow members who have claimed from retirement funds to then access SOAP. The surplus that was left over could not be used and unions argued afterwards that their members did not get their fair share. Pensioners were left over in unviable defined benefit funds.

The Pensions Institute (forerunner of the IRF) wrote a paper on surplus. It recommended that in a defined benefit fund employers should have access to the surplus. This favoured the employer and in 1997 the FSB drafted a Bill for

submission to parliament. Suddenly the unions realised what was going on and objected. They were becoming aware of the fair value issue and threatened to strike. The Bill was withdrawn by the finance minister in February 1999. The Sentrachem<sup>9</sup> matter reached a high profile that alerted the unions.

Defined contribution members must play a more active role and should control the fund through shareholder activism. Under defined benefits, the employer controlled the fund, under defined contributions, the service providers control the fund. Under defined contribution arrangements, members purchase annuities from an insurer and the link with the fund is cut – the contractual arrangement is between the insurance company and the annuitant (including advice given).

The unintended consequences were not taken into account. The government was too new in the environment and tried to do the best for workers. The unions' previous motive was to take control – but in doing so they lost financial security. For members, low interest rates now have a significant impact. Some unions want to go back to defined benefits (refer to case F). Members did not understand the risk issue, and there was not enough information available for them to make an informed choice. They only had an option between better withdrawal benefits or a better retirement. Hybrid was only offered if there was not enough surplus – most funds had surplus.

The number of complaints to the office of the long-term insurance ombudsman is rising. Approximately 5000 cases per annum require investigation – of these 33 per cent get resolved in favour of the complainant (similar statistics occur internationally).

### ➤ **Redress**

The process starts with policy (in theory, policy initiatives come from the president to the various cabinet portfolios and then down to those in government structures). Actually there is a multi-faceted approach, but it must align with the minister and

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<sup>9</sup> Case No: PFA/GA/3/98/JM in the Tribunal of the Pension Funds Adjudicator.

the president. The Pension Funds Act of 1956 was outdated and was amended on an ad-hoc basis – aiming at consolidating and providing a holistic view. The new legislation aims to address current issues and bring South Africa in line with international trends. South Africa is a leader in some respects.

There has been a major shift in the environment because of conversions from defined benefit to defined contributions. Consultation is very important in South Africa today. The National Economic, Development and Labour Council (NEDLAC) provides the forum for business, government, community and labour to pull together. Government wants to consult and will put together a panel to oversee the legislation process. It will be discussed at NEDLAC and then presented to parliament for cabinet approval – if cabinet approves, proposed legislation will go into the parliamentary programme. The Parliamentary Portfolio Committee on Finance (comprised of African National Congress (ANC) and Democratic Alliance (DA) politicians, and others) will look at proposed pension fund legislation.

Legislation must match the policy set by the National Treasury. The regulator (the FSB) implements legislation. The regulator has drafters, and, once policy is set, the regulator drafts legislation via inputs from various constituencies.

It is possible to revert back to defined benefit funds. Maybe conversions would not be reversed, but all new funds from a particular date would be required to be defined benefit funds. An alternative to defined contributions did not arise because the process was too fast – it was grab and run.

There is more volatility in the pension fund industry now, but over a period of time people are still getting good real returns. The question arises: is there really something to fix? Some people are bitter because of wrong choices.

But actually, the real issue that must be faced is what happens in a low inflation environment. Members' longevity is improving – in the past, R10 capital was required for R1 pension, then R12, now R13.80. Lower investment returns and improving longevity is a big change – more capital is now required to produce the

same income. There is a fundamental and demographic change. Defined contribution is not wrong per se.

Employees have lost something, but employers cannot accept this responsibility. The discussion paper makes proposals that attempt to reverse the damage. There may be compulsory pension, and compulsory preservation, but the guarantee cannot be brought back. Employers are not in any position to underwrite risk. The Pension Funds Act is very old and in need of change. Reform of the retirement fund industry is linked to Black Economic Empowerment (BEE). This forms part of the broader discussion on black economic empowerment transformation. BEE has oiled the cog of change. The industry would be more resistant to change if it was not sensitised to the need for BEE.

The FSB is not reforming the industry – it is sharpening. The final aim is to have an industry that is totally transparent; totally compliant; and totally protective of assets of members. Pension saving for most people in South Africa is the only saving they have and there is a duty to look after this. The government's role in managing conversions from defined benefit to defined contributions was very limited, but they are now playing the required role. Once new legislation is in place, there will be no change for 25 years. Government has carefully considered what needs to be done.

➤ **Stakeholder power**

The issue is whether there was awareness, rather than whether the parties were strong or not. In 1998 the unions had no idea and it was worse before. Today unions are more aware and can interact effectively (refer to case F).

Most employers have an arrogant stance. They have always understood the real issues involved and will make sure they continue to do so. Before 2004 employers did not want to hear about reform. They were only concerned about taxation. (This is among employers who are not service providers.) Employers have not learned – it is disappointing that they are not taking the environment into consideration. Amongst employers who are service providers this is even worse because they do not want to change. The market is now more powerful, and more people are

interested in the market. The information disequilibrium could transfer costs to members.

Power was not a material issue. The unions wanted it, even if the ANC government was sitting, and the markets were good. Government was not a deciding factor. It was the 1980s thinking. Now there is parity. There is a sense of victory, but also of loss and alienation. With time, groups are realising that there is only one industry, and protecting members has become a common objective. Matters are discussed at the Institute of Retirement Funds (IRF) and NEDLAC. The IRF should not admit service providers – only trustees – the Institute of Retirement Industry (IRI) is for service providers. A new IRF is to be created by trustees to take control of the funds.

The regulator is going through a transition of its own. The FSB always had power, it just did not exercise it. The FSB wants more power from the revised act, because power is needed to deal with delinquent trustees and to make decisions without having to go to court. Previous cases brought by the FSB needed to be resolved at the Appeal Court.

Service providers generally do as they please. Employers should take more responsibility for costs – perhaps this is the give-back. In the new scenario, service providers have a profit motive. There is a natural conflict of interest between the sponsor and independent trustees.

In the government fund, fees are low relative to the industry. The shift assisted the development of the unions. Service provider influence has grown. If you go to a service provider, you must be prepared to pay for it. Funds cannot afford to pay what is required – small funds have all the complexity of larger funds, but proper governance is not cost effective.

If the consultant acts in good faith, they look at the company and talk to the Financial Director or the Managing Director who could take the necessary action in the early days. In the 1980s, the employer could appoint all the trustees. After the



requirement that 50 per cent of trustees should be member elected, most trustees are badly uninformed, which results in one or two people on the board making all the decisions. Some funds work well on this basis. The size of the fund is the determining factor – the cost of training trustees and managing a small fund in terms of legislation is very expensive (80 per cent of funds have 2 per cent of the members). That is why umbrella funds is not such a bad idea – provided they are properly run.

Now, the regulator is stronger, and unions are better educated. There is much more transparency and this has empowered members. There is trustee training, but there are problems with service providers training trustees. To resolve this, the key is not to indoctrinate the trustees. By virtue of greater awareness of implications, unions also now have more power. Because unions are playing a more active role, employers' power has diminished in that more informed discussion is taking place. The pension funds adjudicator offers a free service to unions – previously there was no a mechanism for the person on the street to use.

With the mass of defined contribution funds, employers are less interested (refer to cases A, B, C and E). It is what employers wanted – certainty. The rest of the world is also moving in this direction. In South Africa, defined benefit funds are mostly fully funded. (The UK and USA are having big problems with deficits.)

If you compare with five years ago, annuitants now have more power than before. The financial press has made a difference and has done a great deal to educate consumers about their rights. They have also done much to advertise available dispute mechanisms. When the FSB issued a circular in 2002–03 that allowed pensioners to transfer annuities, it gave annuitants more power. Before this, annuitants were stuck with the insurer for life. Once purchased, the contractual rights are income stream and investment income. There have been complaints regarding transfers, however, particularly about the fees charged.

## ➤ **Ethics**

Funds were paternal when they started. The world has since changed, and the focus has shifted to individuals to take responsibility for themselves. Boards of Trustees have elements of paternalism and social responsibility. The question is whether we will end up at complete individualism where we just give employees money and “off they go”.

Cost is a big issue. Service providers have a right to offer products and charge for them, but not to overcharge. Leakage from withdrawals is also a big problem. More service providers should create more competition and this should drive down the prices.

On the matter of surplus, the key issue is how it was generated. If we are to distribute the surplus in an equitable fashion we need to go back and look at the source of the surplus.

In information disequilibrium, an increase in the knowledge base of the beneficiary is required. Beneficiaries will always be there. It does not take sense when fund conversions result in lower contributions.

If you consider SOAP, it does not make sense for lower paid workers. It would save them not to save – i.e. they pay money towards pensions and then get a pension below SOAP – they would be better off not contributing at all and just collecting SOAP. There is a disincentive to save. Workers had no choice but to contribute to pension funds, but it was to their detriment. National Treasury comes from a particular perspective. They could just increase tax and assume that all will get SOAP and then eliminate the means test. It costs 30 cents of a Rand to administer the basic income grant. If it was addressed creatively, this could be resolved. South Africa is not a poor country – we do not request loans from the International Monetary Fund and have revenue over-runs.

Employers recognised the ethical gaps. Various cases (such as the Pepkor case) were absolutely unethical. It will take a long time for a balance to arise. Members

and trustees need to be financially skilled because knowledgeable trustees can question administrators. If members are less educated there is an imbalance. Then disclosure becomes important.

Service providers and actuaries recognised the ethical gaps. They were employed to provide a service – they should have raised the issue. In the Pepkor case the actuary under-declared the funding level to the FSB. Professionals were paid for providing unethical advice. Service providers are now behaving differently because they know the FSB will take action. In the CAF case trustees wanted to do something unethical – they acted before an amendment was approved and said it was “practice”. They lost the case.

Conversions happened because of a perception of win-win. A win-lose would have been more difficult. Conversions were inevitable because we are in a significantly changed environment. There was a huge proliferation of service providers, and this pushed costs up for members. Before, a huge number of funds were defined benefits and administered in the company’s office, they were much more self-driven.

What people see “going wrong” with defined contributions is a reflection of a lower inflation, investment environment. The move from defined benefit to defined contribution is a fundamental change and retirement funds will struggle to accommodate the new environment. There will always be environmental change. Members did not understand what they were accepting. When things change, not everyone benefits. If members left after conversion, they were better off. If they stayed, they were not. Even if members had better information they still would not have known what the future would bring.

One service provider in particular pushed the conversion to defined contribution. Other providers tried sticking with defined benefits and then jumped on the bandwagon. Through networking, CEOs spoke to other CEOs and the process mushroomed (refer to case G).

When a former parastatal fund converted, the fund was split. The top 2 per cent, executives, got 46 per cent of the assets. The other 98 per cent got 54 per cent. Fingers were pointed at the FSB who had approved the Section 14 transfer. Company executives had transferred company profits into the pension fund. The company had panicked in the face of the new South Africa. In Namibia, when freedom came, many Namibian funds registered in South Africa. There was a sudden increase in foreign registrations because companies were panicking. Some employers did not have an interest in pension funds, others were genuinely tired of work stoppages and funds being used for political reasons.

A union fund was administered by a large insurer. Members began complaining to the FSB, whose auditors found R200 million unallocated. The response was that schedules had not been received so money could not be allocated. This had been going on for about three years, but the unallocated amount remained the same. It was clear that it should have been increasing – indicting that someone was skimming the funds. The insurers' administration system could not cope with 75 000 members after the fund had grown very rapidly. There was tension between the members/union and the insurer. The FSB did not recommend removing the administration from the insurer since it first needed to correct the problem.

Insurers are not showing more interest in resolving the problems. There has been a general increase of 20 per cent in the number of complaints but no increase in the desire to resolve them.

From October 2004, the FAIS ombud will deal with advice related problems – actual mis-selling of the product. If the policy was purchased before that date, the problem can still be referred to the long term insurance ombud.

The main problem with annuitants is mis-selling and dissatisfaction with policy values. There is equity jurisdiction at the ombudsman. The test is whether the person made an informed choice at the time – if they did not understand, the policy was void at inception. For example, if the member purchased a linked annuity, but this was not appropriate and the member should have purchased a fixed annuity,

the life office would be compelled to pay a fixed annuity going forward. The problem lies with linked annuities – these work well in a strong market, but could have been inappropriate advice. Mis-selling is an area of complaint often arising with linked annuities. The long term insurance ombud only looks at the annuity, not at other aspects of the Pension Funds Act. Thus, when a member retires, they purchase an annuity and no longer fall under the fund jurisdiction – they fall under the life office.

The more service providers the better. There is no problem with the number of service providers, but when the consultant/asset manager starts to run the fund with the trustees, it becomes an ethical issue. The stage of professional trustees may have been reached – for the establishment of a skilled office. For member elected trustees, popularity is not a good measure of competence. There should be a lawyer on each board of management, or the principal officer should play an informed role.

In the late 1990s the argument arose that converted members did not get fair share of value. Now defined contribution is considered bad – in response to fundamental change. Defined contribution is good for the mobile, young and sophisticated members, but bad for older, less mobile, and less sophisticated members. It is not good for them to have a lower risk cover and lower contributions to the retirement fund after conversion.

#### ➤ **The future**

More of the small defined contribution funds will move to umbrella arrangements. There will not be a reversion to defined benefits – employers do not want risk. South Africa has woken up late to the reality of improved longevity. There are three employer approaches to conversions:

- \* Forced – we will move from defined benefit to defined contributions.
- \* Voluntary – choice of transfer plus an extra sweetener.
- \* In-between – as from tomorrow, the fund is defined contribution structure, but we guarantee that members will not be worse off. This approach is disliked because its exposure for the employer is too great.

There may be a withdrawal from choice because it is expensive to administer and very few people exercise the option. Most members select the default.

Service providers are looking for someone to influence maximally. Trustees are still the seat of power. Power is with the chairman and the principal officer – they are the opinion makers. Principal officers are becoming increasingly important, especially as the role of the chairman often rotates between member elected and employer elected trustees.

Prior to the IRF changes, the FSB asked for a legal opinion on who the IRF was supposed to represent, and the response was that it should be the fund. Yet IRF members are mostly service providers and employers. The FSB went via NEDLAC to change the IRF. Trustees are moving in under the cloak of the unions. Maybe there remains a battlefield.

The process has commenced for legislation to create balance – the trick is to find that balance and not to over regulate. Over regulation will lead to players ignoring the rules because they are not practical and cannot be implemented. A one-stop shop resolution forum is required. There are trust issues with life offices and high costs of pension provision. In the Maart case, the employer wanted to set up a pension scheme, but could not because costs were too high. This was referred to the Minister of Finance for consideration of the implications.

#### **4.2.2 Trade Unions<sup>10</sup>**

##### **➤ Union history**

In the early 1980s, there was a rapid proliferation of trade unions. Grievance unions were organised on the back of specific grievance issues rather than at company level and opportunistic unions would ride on the back of the issue. There are times of strike contagion when there is more strike activity – especially when unions are growing. The strike weapon is very strong. In periods of strike action,

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<sup>10</sup> Six macro-level and four case study respondents were interviewed on a confidential basis.

specific geographic areas were hit. There was the Black Allied Workers Union (BAWU), the SA Allied Workers Union (SAWU), the Federation of SA Trade Unions (FOSATU) which later became the Congress of South African Trade Unions (COSATU). SAWU and BAWU had charismatic leaders and would not target specific companies, they would ride on the back of an issue.

All strike action was wild-cat at the time and strike jurisdiction was underdeveloped. In the late 1970s, BAWU and SAWU were active in Natal and the Eastern Cape. Workers were demanding a return of their retirement funds because rumours were circulating that they would not receive their money back again. Employers gave in and decided that “if they want it, let them have it”.

There was no concerted effort of unions to use pensions as an organising strategy – it was the other way around. It is wrong to say that unions took on a deliberate strategy. There was no strategy from the unions – especially BAWU and SAWU – strikes are always multi-factoral and the chute often loaded.

At a later stage, unions did become interested – especially COSATU/FOSATU – and did demand recognition and better wages. In the mid- to late 1980s there were inputs from Europe on how unions could strategise – especially from the German labour confederation. In Europe, unions could use institutional investments to their advantage. In the 1970s, ICI in the UK gave in to union demands under threat of the union dumping company stock. In South Africa, work was done on how unions can leverage companies through institutional investments. Unions aimed at taking control of workers’ funds. COSATU got interested in issues of organising and controlling their own destiny. At that time, unions began to float their own funds in the metal and other industries (refer to cases A, B and D). This was not high on the union agenda. The move to defined contributions was for the employer who wanted to off-load liability.

➤ **Strike activity**

Unions have been around since the 1920s. The Federation of Unions of South Africa’s (FEDUSA) stance is social democratic, COSATU is socialist.

The militant black unions drove the conversion process in the 1980s. In the 1980s, unions went on strike for defined contributions (refer to cases A and D). They supported defined contributions at the time, but are now resisting employer attempts to convert (refer to case F). This situation is not a direct contradiction – the environment was different in the 1980s. Section 7 of the Pension Funds Act (requiring at least 50 per cent of Boards of Management to be member elected) did not exist. There were paternalistic employers and workers wanted control over their assets. There was no portability and the apartheid government applied investment guidelines and used worker money to attack liberators.

Black mineworkers could not join funds until the late 1980s. Mineworkers are now in defined contribution funds and want defined benefit funds. The National Unions of Mineworkers (NUM) now defends defined benefits – many unions now protect current defined benefit funds (refer to case F) and in the South African Local Government Organisation, unions reject conversion to defined contributions.

➤ **Social security**

Privatising social security is not a good idea. Unions will guard against any move to erode assets of the members and will protect existing defined benefit funds (refer to case F).

There is a need to get shareholder activism right. The view is that “we cannot allow people to use our money to destroy us”. A piecemeal approach to reform will not work. There is a need for retirement funds and reasonable benefits for members and a need for social security reform, and pension should be part of this process. Unions are concerned about the lack of a comprehensive social security system. An unemployment insurance fund is important since members use their withdrawal benefits because of insufficient unemployment insurance.

Unions wanted lump sums on retirement and improved withdrawal benefits – the structure was not the issue. Pensions were used as a tool to organise. Provident funds were used to organise and to provide outputs for members. The consequences were not a factor. There were unequal benefit structures between



black and white employees. It was a moral struggle – equal work, unequal pay – which became an arena for struggle.

With member elected trustees influencing funds, the market was democratising. Unions were asking for provident funds and it was a political issue. Workers were not considered to be South African workers – they were considered homeland workers. There were problems getting their benefits. Monthly annuities were very low and workers were outside of the bargaining structure after retirement. The commercial market was actively engaging with the unions and if the fund was managed “in-house” there was less control. There was benefit to the trade union to move out of the company structure and have the fund managed by an outside entity.

Pension funds were one of the easier battles to win. Trade unions enabled worker benefits to be self-managed (refer to cases A, B and D). The provident funds were a major issue in the 1980s. The commercial market saw opportunity in this and they developed bonds with the trade unions. Unions were driven by a desire for democratisation. Commercial players were driven by a desire to earn commission.

### ➤ **Political issues**

Many different areas of law impact on pensions. Two critical issues were driving conversions from defined benefits to defined contributions: members wanted lump sum payments as there was insecurity and people were not alive until retirement; and there was a drive for control over assets. Defined benefits were unknown and not understood – workers did not know how it impacted them.

Service providers advised employers how to convert funds to their own advantage. Workers did not understand that risk would move as their knowledge of defined benefits was limited. Employers also needed to reflect pension fund liability in financial accounts. The union campaign was driven by issues other than pension fund benefits. Now workers will not give up rights that easily. In the mid-1990s when legislation was pending there were many concerned parties – business only

entered the debate at a very late stage. Government is reluctant to be perceived to be “anti-business”.

Before the 1980s, blacks did not have pensions. In the 1980s they began pushing for provident funds (refer to cases A, B and D). There was a drive in the industry that looked at Europe and concluded that people were living too long. The defined benefit formula was limiting and contributions to funds were becoming a financial burden for companies. Employees wanted defined contributions or provident funds and employers started supporting the position. But, it was a change to the conditions of employment and this was ideal for the employer to change from defined benefits to defined contributions.

➤ **Political, economic and social factors**

Political, economic and social change was occurring.

Generally, most funds moved from defined benefits to defined contributions. With the benefit of hindsight, it is evident that the risk shifted. When the unions saw risk had moved, they looked at ways how to reduce the risk. They also opposed the imposition of retirement funds tax.

Union federations played a key role in the establishment of union funds. The funds were “our money, and we wanted to control it”. The national executive of the trade union considered whether they wanted their own pension fund or wanted to be part of a central fund and partner with insurance companies. In the context of the broader collective, they were in favour of partnerships with insurance companies if it increased democratisation. There was bargaining with service providers.

From 1989–90 much time was used at Central Committee meetings to discuss investments offers from various large insurers. Presenters would say that the others were “verkramp”. South Africa was democratising, and trade unions were operated with international solidarity funds. There was a need for a new source of funding and to tap into investments. Many problems arose with the union funds

which were abused by the trustees who were wearing two hats – as trade unionist and trustee.

At first, there was no union position on pensions. Unions did, as an organisation, look at the risk shift. They thought that maybe they could alleviate the risk, but supported the drive to defined contribution. It has been discussed that defined benefits is best, but the difficulties are understood. There was a drive for complete withdrawal from pension funds, but no broad discussion.

Unions looked at each sector. For example, if ISCOR wanted to convert, the union would look at that sector. Some sectors moved faster than others. Conversions started in the industrial sector. For big employers it was ideal to move. Conversions were mostly employer initiated (refer to cases A, B, C, E, F and G). Trustees should have consulted with the members. It was part of a package deal and employers gave them sweeteners to move. There was no specific process, it just went along.

The outcome was evaluated afterwards and unions do not want to see member benefits further eroded. The aim was to protect what members have – the current situation is not as good as it could be.

Between 1990–93 it was realised that defined contributions had many flaws, but defined benefits was also not perfect. Some funds were not telling the truth to members, for example the payment of interest on housing loans was not explained. Retirement funds were for retirement, but many members wanted to take their money and start afresh. The issue was transferability. Members wanted monies. Service providers used much jargon and never mentioned risk.

Some companies were resistant while others did not care. Black workers were short-sighted when they transferred. Evaluations were not fair. When the unions pushed, black workers went to provident funds and others stayed on existing defined benefit funds; when the employer pushed, the defined benefit fund was kept open only for executives.

Evaluation is only happening now. The move started in 1989–90 and by 2001–02 trade union members were starting to ask questions. Members queried why some of their colleagues, who were trustees on the funds, were now driving luxury cars and could afford a lifestyle that they themselves could not although they were supposedly earning the same.

Once there was control of the provident fund, trade unions could get a stake in companies and trustees were appointed to boards of directors – this became and drove Black Economic Empowerment (BEE). People became rich when trade union investments facilitated the formation of black investment companies.

➤ **Black union initiative**

Conversions started with a black union initiative – but conditions needed to be standardised. If we still had defined benefits, the question is whether they would be sustainable. The process gathered momentum and moved very quickly.

All major financial services providers were involved in the process. Many businesses grew out of it, such as micro-lenders and fully guaranteed lending services. They all wanted to tap into the market. There was a proliferation of asset managers.

Unions have proved to be volatile clients. From a democratisation point of view, the process should not have been slower. Workers needed to democratise. But, electing to move to defined contributions should have been slower, and after a studied process. Implications should have been more carefully considered.

Provident funds are a government liability. Members can take a lump sum, spend it all and then rely on the government – which is there to protect people. There is a social cost.

After 1994, consultants persuaded funds to convert. They contacted the employer and suggested that the defined benefits were unsustainable. Pensioners were outsourced. Unions argued that you cannot change the benefit without negotiation.

Consultants also tried to advise government on the Government Employees Pension Fund. Within a particular consultancy there appeared to be two groups – one against defined contributions who wanted to maintain the status quo; and the other that wanted to grow the defined contributions business. It was both a business and an ideological issue.

Now there is NEDLAC, the FSB, and the pension fund adjudicator – there are enough forums. The insurance companies have a dilemma because they have the most to lose. With consumer rights emerging, insurers are now trying to save face. There are no regrets, union action was relevant then. But if they knew then what it would look like today, unions would have said “let us wait”. Actuarial assumptions were not perfect. The root cause was the employer’s lack of equal treatment to members – if this problem did not exist, conversion would not have been necessary.

Previously the unions were powerless, but after the Wiehahn Commission, trade unions became more powerful. Once trade unions had power, they held employers accountable to the collective. Employers started listening to the unions. As an example, a large gold mining company had 80 per cent black workers and so could not have functioned without concessions.

There was a shift in the power base as political transformation occurred. Trade unions used demands for economic change and the influence of BEE continues to shift the economic power base.

➤ **Process complexity**

In most instances of conversion after the 1980s, a proposal was made by the employer and unions took it to the members. Members saw the benefit and trade unions then agreed.

Times are now more uncertain than they were before. There was definite uncertainty at the time of the conversions, a lack of knowledge and distrust. At the time of the conversions, there was no platform for discussion or consensus in the

industry. Most unions were supportive of the move and often acted out of resentment. Anything that undermines the authority was welcomed – even if it did not work. Unions did not understand the whole environment.

The financial sector recognised that workers were an important market. If the three union federations pooled resources for investment they could disrupt the financial sector.

Investment markets may have become more volatile as unions frequently move money between asset managers. With the conversions, social risks arose because defined contributions require more sophistication. With the surplus, the problem was that there was no tangible benefit that they could see. Money did not grow as expected. Nothing empirical indicates that members are now better off.

There was, however, personal gain for trustees. No proper management of funds led to conflict of interests. Union members were concerned about their interests. It was difficult to have a neutral view as a trustee if elected by a constituency – you will first look at the needs of your constituency. For example, member elected pensioner representatives look at pensioner interests.

The Pension Funds Second Amendment Act was not purely a product of converting defined benefits to defined contributions – surplus in defined benefit funds was building up (refer to cases A, B, C, D, E and G) at the expense of members. Unclaimed benefits arose because there was duplication of membership of funds. Black people often did not have a reliable residential address, there was violence in the PWV area and people died with their families not knowing that they had benefits.

Currently there is open scepticism about the retirement fund industry. There is much anger and frustration – an entire generation of people has been misled. Pensioners lost out because service providers focus on the active members. They get a percentage of the payroll as an administration fee and are not interested in the former members. With trustee training, service providers wanted to create

dependency. They aimed to provide everything (training; administration; consulting; invest advice). Service providers want control.

The conversions were part of an evolutionary process. Unions became wiser about how members had been shortchanged. The process was a learning curve and trade unions developed specialists in the field. Members are in a vulnerable position and should have been more cautious about economic benefits – trade unions would do it differently if conversions would arise today. Members are now carrying investment risk and benefits are reducing due to the markets. It is not only the issue of HIV/AIDS, member risk is a problem. Funds were democratised – a restructure was inevitable. But if it happened now, the outcome would be very different. There is a possible middle road to achieve the best of defined benefits and the best of defined contributions. If it is not provided by legislation, then we should create it.

We cannot go back to defined benefits. The market is different now. Employers know their liability and the industry do not want to go back. Non-governmental organisations can fill that space. For example, trade unions can start worrying about it and can be party to Boards of Trustees and industry funds. Unions do have an industry fund, but Boards of Trustees have problems with transferring members to these funds.

The national central unclaimed benefit fund is acceptable for dormant funds. For other funds, direct trustees must do their job and find the members (and they need to explain what they have done to find the members).

Pension fund reform is one step forward and four steps back. In 1996, the Portfolio Committee on Finance had hearings regarding proposed member elected trustees; employers wanted a majority of three out of five trustees to be employer appointed. A new world is now being created. The politics is different. In the current reality there are big problems on the horizon. New legislation has been on the table for a long time – about six years.

### ➤ **Power dynamics**

Attitudes have hardened. Members of unions were elected to Boards of Trustees, prior to this, elected members were often part of management. Trustee education and training has become an important issue. Labour is frustrated. Power did change. The power of the trade unions and regulator has increased and there is now more transparency.

There are two scenarios, the employer contributes because of the participatory system and wants to do the best that they can. Some employers have different agendas and will contribute, but are not interested in what is done subsequently. One of the large insurers is now pushing this view.

Matters can be re-balanced, it is possible. The Minister of Finance said at a conference of trustees that people should take control of their own money. There is a drive to take hold of money, but there is reluctance to let the union in. Trustees are somewhere at the bottom of the pile. The regulator is working on checks and balances to be addressed through training programmes. Service providers have positioned themselves as “saviours” of the trustees.

In the tripartite power balance and in social dialogue, employers are no longer prescribing, nor are unions. Everyone will do their own thing if we are not vigilant. The employer’s power diminished and worker’s power did not really increase – they did not really control retirement funds. Funds are still controlled by service providers. The advent of umbrella funds and independent trustees is a manifestation of this.

### ➤ **Labour developments**

Prior to the development of effective labour legislation, when a strike arose the first thing employers did was dismiss the workers. Unions were acting as a proxy for the government in exile and, as a result, South African trade unions took on a political role. This is not strange. Labour parties across the world were spawned by workers. There is political expression from labour. There was growing understanding of the collective in places of work and the need for workers to get



involved at legislative level. Legislative expression was denied. The role of unions was not clear; it was submerged in the fight against apartheid and move to socialism.

The struggle had not yet clarified into party politics where capitalism is seen as the enemy and apartheid was just another form of capitalism. In the mid-1980s, government found it more difficult to govern. There were states of emergency and strategic thinking started changing to look at political power.

Unions can be used to show the resistance of workers. There was a huge strike on the mines in 1987 – in response to the states of emergency. Thinkers began to believe that a parliamentary solution would come up, but unions were disinterested in politicians – they needed to consider their power base. Large insurance companies rushed out to woo the unions. In particular, one of the large listed insurers was very much out of favour after strikes at the company in 1982 – the company founder dismissed all strikers and refused to re-instate them. At issue was recognition of the union. Years later the company established a foundation in an attempt to buy back the friendship. Other insurers made efforts not to be perceived to be the same as this company. Another insurer moved from being a bastion of Afrikanerdom to supporter of the struggle. Business tried to buy the unions. Unions became very important in the early 1990s.

No unions ever said “we want defined contributions” and employers knew that risk would be transferred. 1998 was the high-water mark for unions – they have lost influence and power since then. One of the labour federations, in particular, is currently punching above its weight.

As the labour market changes, the traditional power base of unions changes and the financial power base becomes more important. Unions have passed their peak. Union funds – “good idea, let’s do it” – arise because unions want to hold onto the member. Unions have problems retaining members especially when members change employment. If you find ways to control members, you retain them.

Unions that have survived internationally are those that recognise that their role has changed. Old models of industrial conflict are gone. White collar unions in the UK provide services to members such as education, health and welfare. Unions are no longer about dignity and protection. In South Africa, the union movement needs to look at survival post the old smoke stack industries. Life expectancy has changed. The key is providing benefits to members which union funds have failed to do.

➤ **Employer needs**

It is incorrect that defined benefit structures are not compatible with cost-to-company structures. Employers are set on limiting unforeseen consequences (refer to case F). Companies can accommodate uncertainty, but they flick the risk to employees and put caps on salary. Benefits are the “result of working” and if employees were more alert, cost-to-company is not inconsistent with defined benefits.

Employers do not like to give out control. They all panicked at the thought that they were going to get caught with the risks. They wanted to get rid of it (refer to cases A–F).

With social benefits, people do not see the analogy. An analogy is leave pay and paid sick leave. A hundred years ago there was no leave pay. People never went on leave because they could not afford to not get paid when on leave. Society decided that leave was required and that everyone should not work every day. For a working person, the risk of illness was like a death sentence, if they were ill they would not get paid and would be replaced while they were away to recover. Government shifted the cost of paid leave benefits to employers, given that they were the beneficiaries of the labour. If society deems something to be a requirement, it is required.

Employers provide a social net, but finesse their way out of it at society’s cost. The notion of what can be expected at retirement needs to change. Members must be more competent and there will be a huge proliferation of investment vehicles.

It is not likely that successful legal action will arise. Members had a choice in the conversions and made decisions. Employers were always aware and beginning to insulate themselves because of small print. This is not a serious issue.

➤ **Ethics**

Employers are still interested, especially business and the insurance world. But, employers have taken something away from society. They are sending workers to retire in poverty and to join the unemployed.

The historical baggage of the conversions was the notion that you can keep defined benefits for white workers and give defined contributions to black workers. Now the FSB and pension fund adjudicator is looking at equality. People who took decisions were also employees – managers are also employees and can “stab themselves with their own knives”. This is not new from management, they do not consider what is the best solution for us all. This is a social protection matter. Our children will suffer if we do not make the right decisions. The industry needs to come up with a product that works.

The conundrum is what you do if you get millions. Government is there to protect the weak. Some in the trade unions believe that defined contribution is best. A new structure is possible. It is morally wrong for government and employers to leave people in the lurch. It is ethically wrong for trade unions to mislead members.

Consultants, advisors and actuaries, must have known that the investment risk would shift. Employers knew that it was to their advantage. Members were the last to understand.

Between the employer, labour and government, a balance can arise. If there are many of the other players – other third parties can also play a role. The savings rate in South Africa is very low. Black people revert to their own community products. Cultural sensitivity is an important issue. If insurance companies understood this, they could provide products.

## ➤ **The future**

Members are now coming back to the unions regarding poor benefits. They go on pension and realise that the medical benefit has fallen away and this becomes a big issue.

There is a union strategy to establish an administration company. Fund management would be different and any investment company would need to compete with other players. There is a clear distinction between administration and investment. There are no favours for investment managers. The job of the union is to protect the members.

In future, the view is that members should access pension funds via an annuity. Now the challenge is to determine how much is required at retirement as a percentage contribution and then work backwards. Then it is not important if a fund is structured as defined benefit or defined contribution. Risk can be managed via investment, such as less exposure to equities and a revision of Regulation 28.

All workers should be able to join a pension fund but this cannot compel workers who earn below R2000 per month to do so. Pension reform needs a unique formula for South Africa. Pension reform is also an ideological battle. We need one retirement fund regime that ties the Pension Funds Act and Labour Relations Act.

Trade unions want separation of powers between union run funds and national executive structures of unions. Also, more professional engagement to manage investments is required.

The momentum is that the industry would move to defined contributions. The whole industry is moving and there is not much we can do. People are much worse off and the world of work is changing.

### 4.2.3 Members and trustees<sup>11</sup>

#### ➤ **Changing environment**

In the 1980s it was unions versus employers. A political struggle was being fought on the shop floor with unions asserting their power to get members into their funds, so that they could get control. There was a union argument about the morality of business and access to bank accounts. Then, in the 1990s, employers started to push for conversions. From 1989, companies saw value in limiting costs. The 1996 legislative requirement for members to elect 50 per cent of the trustees was not a big issue<sup>12</sup>, since the big companies had already converted by then. Funds already had member representivity and senior members remained on defined benefits because of the benefit to themselves (refer to cases A, B and C).

In 1978, Owen Horwood, then Minister of Finance, introduced legislation to force preservation on transfer of retirement funds. Unions opposed this because of a need for withdrawal benefits. Unions became aware of the political power they could wield via investment of pension funds. Unions wanted political power; now their focus is different, they want economic power.

#### ➤ **Member benefits**

When funds were opened to black members, many joined. In the 1980s union members complained that funds were controlled by the company and provided poor withdrawal benefits (refer to cases A, B and D). Members also wanted lump sum payments on retirement because they often experienced difficulties in receiving their monthly pensions.

Events were always fuelled by the environment. Consultants were actively encouraging unions and employers to convert (refer to cases A, B, D, F and G).

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<sup>11</sup> Six macro-level and thirteen case study respondents were interviewed, on a confidential basis.

<sup>12</sup> This statement was contradicted by another respondent who accounted how business delegations had engaged with government at senior level and were strongly opposed to the new legislation.

There was much money to be made. Consultants often strongly recommended that members should convert to the revised structures.

Things were going awry and the function of the industry bodies was to bring things back into line – this is now also their focus. They had limited success, however.

➤ **Trade unions**

The unions pushed, but did not fully understand and never considered the risk. Unions are now under pressure from members over benefits. Members who did not convert are better off despite the “sweetener” that was given to those who did convert.

Unions pushed for 50 per cent member representation, but did not consider that the member elected trustees were ill-equipped. Members are now resisting any conversions since they do not want defined contributions (refer to cases D and F). There are two aspects to consider. With defined contributions, members get out 100 per cent while in defined benefits withdrawal benefits were very poor. Unions were driving this. Defined contribution is best when you have a better understanding.

There was a short-term view. If we had retained a pure defined benefit model, members would be getting reasonable withdrawal benefits because of the minimum benefits legislation now in place. Since unions pushed so hard for defined contributions, they should take responsibility for educating members. They did not want the big brother approach, they wanted benefits for members.

There is a view that members are better off on defined contribution provident funds. There was a lack of understanding – they did not understand that defined benefits could also give reasonable withdrawal benefits.

➤ **Employer liabilities**

Employers made the conversion decisions (refer to cases A, B, C, D, E and G). Boards of Trustees should have considered member interests.

Financial institutions are based on trust – “trust us with your money”. If this is belied, the industry will fold. The process was driven by service providers – in particular one brokerage that grew on the back of the conversions to dominate the industry. Conflict of interest was a big concern because service providers were collaborating with the employer.

The outcome was not evaluated afterwards. The consequences only became known when the markets crashed in 1998 and members were due for retirement. Insurers developed products so that funds could off-load pensioners. There were big commissions paid. When the realisation hits that something is done against your welfare there will be a reaction. Individuals take a position, but morals are often used to camouflage self-interest.

The conversions turned the industry on its head, but then we did not think about it. South Africa is adopting many international principles, some of which do not work here. South Africa is not geared for them, because South Africa is unique. The thought is that it may be a “great concept”, but the question needs to be asked whether it is doable. We must consider South Africa’s environment. If things were thought through, education would have been the key issue. The member election of 50 per cent of trustees was asked for, but the education requirements were not thought through. Trustees are sometimes just not capable.

➤ **Rapid pace**

The process was very quick. In fifteen years, thousands of funds converted. Yet, retirement funding is a very long term issue. Before high inflation in the 1970s, the general practice was to make use of “career average salaries” – this was converted in the 1960s and 1970s to “final average salaries” in the face of high inflation.

There should have been a pronged approach. First the basis should have been laid. Then an awareness and test time should have been applied. Thereafter, there would be a move in the new direction. A decade per aspect was possibly required. Considering the education backlog in South Africa, maybe a decade is too optimistic.

In terms of Section 4 (3) of the Pension Funds Act, the registrar can apply certain powers. These include: "...and he is satisfied that the registration of the fund is desirable in the public interest..." and "...if...the registrar is not satisfied...he shall...indicate...the requirements to be complied with in order that he may be so satisfied."

The Pension Funds Act gives the regulator much power. If the fund is not in the interests of society it can be rejected. If rules do meet specific criteria, the FSB is obliged to register the fund. If the rules are in conflict with overall wellbeing, the FSB cannot register the fund.

The process was too quick. There was too much manipulation by the actuaries. People were not told the truth. (The aim was to get rid of the risk and to plunder the surplus.) Employers could foresee much more than they claim. Pre-meetings were held between employers and actuaries before trustee meetings. Actuaries knew what was going on. There was no education and no financial journalists who understood. At retirement, people were suddenly rich – "for a moment, one second, in their lives" – and did not know what to do with the money. People got poor advice regarding living annuities.

The National Party allowed the conversion of defined benefits to defined contributions. There were no rules. The new ANC government came in with no rules. The National Party's power base was business who kept them in power, so they wanted to keep business and employers happy. The National Party was not interested in consumer rights, they had a vested interest in keeping business happy. Unions are now at a disadvantage with members carrying the risk. The rules remain inadequate and government is now trying to change this. The new government is now intervening because they are worried about an erosion of the tax base through SOAP. Pension fund review started with a tax review.

The law was not able to cope with the conversions; transfers in terms of Section 14 of the Pension Funds Act were not required for underwritten funds transfers.



If the process was slower, fewer funds would have converted. This would have seen consequences as people would have been more knowledgeable. The process was driven by “scare tactics” such as hyper inflation and the new government. The process would have been much slower if service providers did not drive it as they did.

Employers are now walking further and further away. There is no benefit other than the tax benefit. Actuaries and consultants command large fees. All of this puts pressure on SOAP and National Treasury is aware of this.

When members trustees were elected, actuaries worked with employers outside of trustee meetings; they took round robin “majority” votes without consulting all of the trustees. This was the old behaviour pattern in terms of the old rules and not necessarily driven out of malice. The law was not clear on who owned the surplus. Some funds apportioned the surplus pre-legislation. Surplus was sometimes used to finance buildings and employers used the surplus as if it was their own money. At NEDLAC, Business Unity South Africa (BUSA) claimed that the surplus belonged to the employer; labour claimed it belonged to the members. The employers view was that they promise to underwrite the pensions, so they could own it.

➤ **Process complexity**

Members were uninformed and service providers knew exactly what was going on. There is always uncertainty. The retirement fund industry is the most buoyant industry and much is happening, constantly. It is a cash cow for the government.

The level of training required for trustees was underestimated. Members were oblivious to the investment risk that goes with defined contribution type funds. Now there is pressure on the unions with members asking them for a response. There were numerous papers about who owns the surplus. Conversions were good in that it made people more aware of their retirement. Benefit statements are more explicit and members are aware of pensioner liability.

Members were not part of the process, they were bystanders looking the other way. A few top members took large parts of the surplus. Under defined benefits, member did not need to purchase a pension at retirement, it was bought and paid for by the fund. Under defined contributions, members need to purchase a pension and the cost involved results in leakage. Defined contributions also spawned the Linked Investment Service Providers (LISPs) – there was a strong focus on this. Service providers knew, but others did not catch on until much later, that lump sums in member hands at retirements was a whole new source of revenue. Under defined contributions and with member choice, members need a consultant. When they purchase a pension, they need a consultant. This results in capital erosion. Service providers saw retirement funds as a honey-pot. Pensioners were off-loaded to insurance companies.

Education is the key for trustees to properly understand their roles. Four levels of training is required: aspirant; basic; intermediate and advanced.

There was no collective thought and the process was driven by profit at the expense of the members. The life industry does not know how to handle it now. There has been the Rusconi Report (exposing excessive fees and surrender penalties applied to Retirement Annuity Funds), adjudicator rulings and Trevor Manual (current Minister of Finance) has spoken on a number of issues. The environment has changed since before 1994. Previously, government and the life offices had a close relationship and the regulation of commission was not to protect consumers, it was to protect the life offices from excessive demands from the brokers. Financial service providers need to change because the relationship of trust has broken down.

South Africa could possibly have considered something in-between: the best of defined benefits and the best of defined contributions could have created a new entity. The situation can be remedied by legislation and consumer resistance. The government is trying to do this via trustees. It is also happening at the National Treasury with retirement fund legislation. The NEDLAC and BUSA views are tainted by vested interests.

The conversions from defined benefits to defined contribution were short-sighted and decisions were taken in a vacuum. Stakeholders did not think of the long term consequences. Brazil is considering a new Pension Funds Act and South Africa is looking at a re-write. There is concern that the new Pension Funds Act will be reflective of international trends and not uniquely South African. There are R10 billion in unclaimed benefits<sup>13</sup>.

The Pension Funds Act dates from the 1950s and is dated legislation. International trends dictate a re-write. Only time will tell if it is good. It will probably feature: trustee training; national savings fund and many of the positives. It is hoped that the proposal will be suitable for South Africa in future. The existing act is outdated and does not fit the current state of the industry. With the new government, it is needed to change the legislation, together with other legislation. The consequences should have been more aggressively highlighted.

#### ➤ **Stakeholder power**

The FSB and COSATU are driving industry reform. An emerging brokerage became leaders in the industry and then other players also became involved. Insurers only entered the fray in 1991–92.

Consumer power has increased with the perceived power of the adjudicator. Consumer complaints are now more widely reported. Previously these were only reported by one newspaper. More and more media has diminished the power of life offices and product providers.

Service providers have taken over from the employer by offering umbrella funds, but will also inherit the problems. Costs are higher if large funds join umbrella schemes. High costs and high commissions cause leakage and are created by the product supplier.

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<sup>13</sup> Dube Tshidi, deputy executive for retirement funds at the FSB, recently stated that the FSB has been collecting information on unclaimed pension benefits from funds over the past three years. So far, 967 funds, from a total of approximately 15 000, have submitted information to the board and the unclaimed benefit total stands at R970 million for 135 479 members.

A solution would be industrial funds with compulsory membership – a mini-nationalisation of the industry. Trustees would be able to decide.

The unions and the regulator are stronger. The regulator is far more prominent than in the past. The Minister of Finance and Governor of the Reserve Bank are now at loggerheads over the establishment of a super-regulator. The fight is that the FSB may be ill-equipped to regulate as a super-regulator (including banks).

The understanding of the unions has improved and there is greater awareness. It is possible to have defined benefits with member control.

### ➤ **Ethics**

Members were not aware of the investment reserve that employers built up to protect themselves from adverse market conditions. The employer would use this reserve if it became necessary to fund any shortfall in providing the benefits promised to members in terms of the rules. Thus, this reserve was held to ensure that the member's benefit as set out in the rules could be met. This reserve was used for various purposes at the employer's discretion.

In some instances in the 1980s, members transferred with only their own contributions plus some interest (refer to case A transfers in the 1980s). In other instances, members received an amount equal to the fund's "actuarial liability" towards them (refer to case B transfers in the 1980s; and case D). This excluded any portion of the surplus or investment reserve. In later conversions, investment reserves were included with any surplus and a portion offered as a "sweetener" to encourage members to convert (refer to case A and B conversions in 1996; case C and D conversions in 1998; and cases E and G). After the conversions and payment of the "sweetener", surplus remained (refer to cases C, D, E and G). Members received different benefits depending on when they converted and were not beneficiaries of a full distribution of the surplus.

The root cause of the problem with defined benefits funds was that nobody trusted their management. Nobody believed or used the principles. Defined contribution

was sold on the basis that members could be in control. Actuaries violated their ethical code by redefining the investment reserve as surplus and not acting in the best interests of the members. The year before conversion, funds would have no surplus; the next year the fund would be converted with surplus of hundreds of millions. It was a failure of governance. Members should be given equity in the company in compensation for the reserve that was misappropriated.

There is now more governance at companies. In the past, a meeting with the financial director or managing director was sufficient. Service provision to retirement funds became a huge industry, especially pensioner outsourcing and living annuities.

Employers are now less interested in the well being of staff in general. There is a reversal of the socially responsible employer. Top executives obtained millions during the conversion process. The increase in strikes is reflective of the excessive pay at the top and insufficient pay at the bottom.

The ombudsman for long term insurance is now dealing with pensioner problems. Ethics is a big focus of government, which is following a people centric approach. Trevor Manuel is concerned about equality.

Actuaries and advisors were completely aware of what was going on. They also had exposure to international trends. Some recognised what was going wrong and some actuaries actually said it was wrong. They blamed the emerging brokerage that was driving the process, but it was not enough to stop the “feeding frenzy”. Commissions drove the frenzy. The push was for annual premium income and increasing the size of assets under management.

Commissions, profits and incentive trips speeded up the process. A large insurer took trustees to the world soccer cup.

Very few recognised the ethical issues. A section broke off from one of the large insurers in 1996–97. This new entity’s model was to provide full disclosure,

especially on rebates. They were independent of any service providers and provided actuarial services only.

There was a huge lack of ethics. Players did it cynically – they knew what they were doing and members were uninformed. The lack of ethics was pervasive; it was greed. Trustees are being trained by service providers and become dependent. Service providers proliferated and created their own jobs. Service regulation is required. The question to be asked is whether we are seeing value for money. Consultants just present contracts to trustees who do not read or understand them. There is a need for value-added service. There is vast conflict of interest and consultants should not be product providers.

The government wants to “milk” the industry and unions are pestering – there cannot be a balance. The matter is about negotiation and power.

➤ **The future**

Industry bodies should be the conscience of the industry and highlight the consequences of a move to defined contributions. There is a need for training and other things to be in place before you can move from defined benefits to defined contributions. Industry bodies have never taken a view for defined benefits and disfavoured defined contributions. New proposals need to look at positive factors in defined benefits and positive factors in defined contributions and find a unique model. The best of both worlds can be developed.

People are in defined contributions and there will not be a shift back to defined benefits. People will retire with insufficient capital and will be more reliant on SOAP. Companies can just give members an amount and leave the member to purchase their own pension. Members do not want to be on company funds, they want to receive cost-to-company and make their own provision. But, they will not do it and create a burden on the state.

The international trend is to consider alternatives to defined benefits. Maybe there will be no funds, just investments into various vehicles such as unit trusts. We are

going to see is an uprising of the trustees. Some try to educate themselves and try to stand up for themselves. Trustees are taking control and power for the trustees.

The future depends on legislation and actions of the adjudicator. Whether matters are upheld or not is crucial. There is an enormous need for reform in the industry and public awareness of the penalties.

#### **4.2.4 Business and employers<sup>14</sup>**

##### **➤ Changing environment**

After changes to labour legislation, the black labour movement began to emerge in the 1970s and 1980s. From 1976, there was a confrontational relationship (refer to cases A and D). Unions wanted no part in the process. They wanted to do their “own thing” with pension funds. The push on pensions developed through FOSATU (Federation of South African Trade Unions, later renamed COSATU). There was the preservation issue and the vesting rights issue. It was a difficult time in the industry. It was political and adversarial, with much historical baggage.

Defined benefit and defined contribution was not an issue. Initially it was the white management and the white trade unions. Black members were excluded. When the black unions emerged, there was a push for provident funds. This issue was discussed at business forums. MAWU (later became NUMSA) was pushing for a provident fund. Employers were strongly opposed. A consultant was advising the union and pushing for a provident fund. Captains of industry were not in favour of provident funds and said that the members would use the money and then become destitute.

One of the key captains of industry asked to see the numbers. Pensions being paid were very low, in some cases R60 per month. When he saw these numbers he changed his view and this led to a change in the business view. It was agreed that

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<sup>14</sup> Six macro-level and twelve case study respondents were interviewed on a confidential basis.

members would be permitted to join provident funds. The issue of defined benefit to defined contribution was not on the table or understood.

Concerns from employers were genuine concerns. They were worried about the members. In industrial relations, times were very exciting. There was the Wiehahn Commission and in the early 1980s employers were grappling with the new labour legislation. It was a massive shock to the system. It was a revolution of kinds. The average rank and file employer was in shock. Many of them tried to hold back the tide, but then they gave in to the nationwide movement.

At this time, pension funds were controlled by management. Employers could do as they liked. They did not mind having the obligations if they could control it. When employee rights started and 50 per cent of trustees were required to be member elected, business pushed for defined contributions. They did not want to pay the cost (refer to cases A, B, C, D, E and G). Also there was cost-to-company and fringe benefits tax to consider.

Conversions to defined contributions were the worst possible things. The political environment at the time suggested that if workers and trade unions could control retirement fund assets, they would have the power. There was also a people's government facilitating the process. The quid pro quo was the power. There were strikes at major corporations. At one of the large banks, there was a major disagreement at board level because some of the directors were of the view that a proposed conversion was not beneficial to members. Changes in the employment contract are important and there was a revolution in the relationship between employers and employees.

In the early years, the defined benefit environment was driven by the employer's paternal approach. It was a particular employment environment. The aim was to secure long term employment and the fund was used for this purpose. There was an expectation of a fairly high inflation rate, but this was not borne out. Lowering of inflation has become a significant issue.



### ➤ **Driving forces**

Labour pressed on the pensions issue because there was no forum for discussion. There was no structure in place like there is today. It was a hostile environment with business and labour as adversaries. There were no pleasantries and the atmosphere was openly hostile. Pensions were the least of employers' concerns; sanctions were starting to bite and employers were under siege. There was union pressure for members to come out of the industry funds and this was resisted.

There was no post-mortem on the conversions. The surplus issue arose and led to the Pension Funds Second Amendment Act. A national savings fund has been proposed for unclaimed benefits. In the 1980s, conversions were about reducing political risk, employer cost was not an issue.

BUSA, an employer organisation, takes matters to NEDLAC for discussion. Pensions are discussed now, but were not in the past. Employers who appointed trustees ran the conversion process and power came from the company. Reform now says that trustees need to take the lead and require education.

Unions were happy with the change from defined benefits to defined contributions. The BUSA view and Life Office Association (LOA) view is the same, with the exception of: the need for consultants (intermediation incentives) and support of umbrella funds (especially for small employers). Unions are against the formation of umbrella funds because of lack of representation.

Conversions became an employer competitiveness issue (refer to case G). Defined benefits did not attract good young staff, but employers could have structured defined benefit funds differently to get sufficient withdrawal benefits. South Africa was a closed environment and when it opened up it was less easy and there were big pension fund liabilities. Analysts pointed out the liability. Post-retirement medical aid was also a substantial liability.

Company boards made the conversion decisions. They came from the top. Some large defined benefit funds were closed to new members (refer to cases A, B, C

and E). Members who converted with “sweeteners” of 25 per cent are now in the same position despite the “sweetener” and good investing, yet they now carry the risk.

The financial press says that the employer absolved themselves. Certain journalists are writing for the government audience. There has been an awareness of “oh no, what have we done”. There was a lack of thought. Defined benefits can be bad, but it could have been considered how to amend defined benefits. There could have been more creative thought. Management was not trying to be helpful.

With the opening up of the South African economy, analysts were looking at pension liabilities and macro economic factors. The South African political environment and the world of work were changing. There was mobility, less loyalty, cost-to-company structures and fringe benefits tax. Social policy was also changing.

The ultimate question on pension funds is whether more South Africans will retire better off because of what we did. The answer on defined contribution funds is no. There is a move away from collectivism to individualism and this is a reflection of a more social move to independent responsibility. The ANC is trying to swing the risk back to the employer.

The large insurers were late comers in the conversion process. A large insurer took a position that defined benefit was preferable and wholesale conversion was not a good thing. Everybody was, however, on the conversion boat – big clients, trade unions and employers. The consulting view was that defined benefits should not always be replaced by defined contributions and that each case needed to be considered on merit. The large insurer changed its stance when it found itself on a limb. Some old funds remained, but all ultimately did close and convert. In some cases there was wholesale change, in others defined benefits remained for some members.

The outcome was evaluated on an ad-hoc basis as part of a particular response and not as a strategy. The focus has now shifted to the proportion of income required for retirement and the cost of risk benefits. Costs have become very important. There is erosion of contributions to retirement funds and a need to consider the replacement rate.

Levels of awareness were very low, but have increased in recent years. Actuaries understood the process. Products are now available to hedge risk and there are also guaranteed funds. There were three drivers. There was a trend in the industry in general; greater transparency and people were more mobile with the concept of life time employment changed. People were getting retrenched and there was a need for better withdrawal benefits.

There was a reluctance to change mining industry funds given that they were collectively bargained. They were very complicated benefit arrangements and were never defined benefit funds.

➤ **Speed of the process**

Capitalism and free enterprise was providing the momentum. In the USA, there are 401K plans. Social trends cannot be speeded up or slowed down. In South Africa's unique political environment, the process speeded up. Now if we consider a retrospective look there were many factors at play. Political factors were at play and speeded up the process.

Fifteen to twenty years was not necessarily too quick. The thought process is the key. In the 1980s the thought process was not sufficient. Political circumstances in the 1980s drove conversions without consideration of the longer term. In the 1990s, employers were concerned about their own position. The longer term was secondary. There was no concern about the longer term. Various commissions held over the years such as the Mouton Commission have had a beneficial effect and were taken on board to inform the discussion. The commission did not re-configure the process until legislation was enacted. The Mouton Commission

referred to representative management boards and created a different perspective in management of funds.

The National Treasury retirement fund reform paper acknowledges that pension provision for the formal sector is good in terms of coverage. The profit drive provided a viable structure for some of the economy. But, it has not provided for people outside of the formal sector. The question is whether the private sector can really meet that need. The expectation was that service providers should have done this, but cost would have been an issue. The private sector may not provide for the informal sector, but who will provide benefits when low cost is essential?

Some service providers do look at societal tax. The Mzansi bank accounts, for example, will be difficult to sustain, but banks need to take a long term view.

The speed of member sensitisation has been very slow. The level of expertise of trustees is low. In general, people do not manage their money effectively. By nature, trustees slow things.

The speed of the conversion process in the 1980s was driven by the pressing need of business to get on with business. Employers gave in to union demands to end strikes and work stoppages (refer to cases A, B and D). From an employer perspective conversion speeds varied (refer to cases A, B, D, E, G, that took one year; and case C, that took four years).

#### ➤ **Consequences and redress**

The surplus and unclaimed benefits were consequences. The retirement fund reform discussion paper suggests a national savings fund (NSF). Employers object to this and want to be the custodian of unclaimed benefits because of concern over “leakages”. Unions do not want a NSF, they want a sincere attempt to find members and they want to get it away from employers.

At NEDLAC, clear thinking is required. BUSA puts the business view and COSATU and FEDUSA put the labour view. Consensus is important. Once consensus is

reached, legislation will go to the Parliamentary Committee on Finance. Tax issues will be raised later and are being looked at. When government issued the retirement fund reform discussion paper; BUSA had a position, and labour had a position. They then discussed the matter at NEDLAC. There will be a second draft of the white paper, followed by a second round of discussions.

Retirement fund reform needs to conform to and align with BEE. On top-hat schemes, unions want no exclusions and non-compulsion is an issue. Member friendliness is a key as are dispute regulations Dispute resolution is to be consolidated. The power of the regulator is an issue and unions want them to have more power.

The consequences were clear to employers. There was social pressure. Members' knowledge was overestimated and they were confronted with decisions they cannot make. There was a particular attitude and the cost of that attitude was a whole new industry where costs became very expensive.

National Treasury is very concerned about the substantial increase in social grants. Lump sums have caused dilution of SOAP and costs a great deal. Trevor Manuel has indicated as such. Life expectancy is increasing. In South Africa's dual system, a black man born today has a life expectancy of 44 years while a white man can expect to live to age 71. AIDS is rampant and there is a need to unlock pension monies when required.

The pension reform white paper, other than the NSF, enjoys broad consensus. The aim is to fix up problems. Defined contribution funds have developed into more costly structures, especially with member choice.

The build-up of surplus in defined benefit schemes after transfers out was not intended by the employer. Initially the surplus was not intended by the employer, but then consultants "cottoned on" and they became intended by some. Soul-searching trustees are much more focused on the impact on members. Members have become more aware of their savings and the need to invest. Awareness of

the cost of risk benefits became necessary, members did not need to care before. The better intended consequences were that pre-retirement withdrawal benefits were improved. Regulatory costs are rising and the regulators job has been very difficult.

In part, some redress has already happened. The white paper on pension reform attempts to preserve the “good”, but needs to find a solution for those who do not have access to retirement funding. There is a need to plug the governance gaps. The paper is of limited ambition and sets “stabilisation” as an objectives for the formal sector. It is staged rather than radical and is a cautious approach to reform. It is the first clear acknowledgement for the informal sector. It is a step in the right direction.

The risks are less now, but in the 1980s the risks were not appreciated. The system was based on retirement, not retrenchment or withdrawal. Unions were happy to show that they had collected extra money for their members. It was not a simple negotiated arrangement. Retirement funding is now very prominent.

Pensioners should not be left on their own when they retire. There needs to be action to achieve a higher plane of efficiency, service and experience. There is so much that needs to be done, but Trustees do not have enough time and politics is an issue.

Ideally, trustees should take a hard look at themselves. They offered better things to funds. There are governance issues – add value or get out. The risks and rewards to trustees do not match. Many equipped people could become trustees but the benefits are not great. Using a board of directors as a model may be a solution.

#### ➤ **Changing power base**

Government power has increased enormously. They can change things by changing the tax regime. South Africa has a social interventionist government.

Business power is diminished and union power is diminished. The mandate of the Pension Funds Act is to protect member benefits, it has more political power.

The close relationship between business and government no longer exists. Previously, business leaders could pick up the telephone, talk with the Minister of Finance and make changes. Now the relationship is not close. We now have a stakeholder democracy and government now needs more engagement.

Employers are weaker in the retirement fund sphere. The product of the conversions is the need for power and change to management structure. Service providers have benefited in some cases with product development opportunities. This is paralleled by increasing scrutiny of what service providers are providing. FAIS and the introduction of sectoral ombuds is a good thing, and have had the effect of questioning practices. This may be related to conversions via a parallel process. Service providers are more transparent but also more subject to scrutiny.

The regulator has a more difficult task and their powers were found to be inadequate. Entities have persuasive power over the trustees, for example, unions and service providers. Trustees must act with their own discretion. There is no reason why principal officers could not act for trustee development. There are difficulties, however, for smaller funds.

Trustees are now more conscious of the division between boards and collective bargaining structures. In Australia, trustees are more empowered. There was no shift in the balance of power. Trustees are not very empowered, but there are exceptions. In general, too much is left to the service provider. Trustees are elected on the basis of popularity, whilst employers have a wider pool to choose from when they appoint trustees.

### ➤ **Ethics**

Now there is cost-to-company and members must take control of their own medical aid and pension. Many employers recognised that conversions could result in problems, and did not want to make conversions. They did question, but the tide

was turning and the unions pressed. There was a strong ethical element, but employers gave up. They also gave up on the surplus.

If you look at the risks to the employer, risks in defined contribution are generally lower than defined benefit. Employers would like to see people retire better off. The employer is no longer viewed as the last port for destitute beneficiaries. There is a tendency for employers to be more distant. This creates a burden for trustees, especially considering the time required. For smaller employers, the cost of time can be substantial. Employers will look at solutions to distance themselves from running the fund. Mostly in the smaller to medium companies there is some searching for solutions to distance the company from the day-to-day operation of the fund.

➤ **The future**

Management pushed conversions through to make it happen and limit the fall-out (i.e. to limit choices and make it workable). To a company shareholder, defined contribution is better. If you look at conversions with a social bent, defined benefit is better. Defined benefit was criticised for being complicated, but with current levels of education and responsibility, defined contribution is much more difficult. People have much to learn. The pendulum will swing back to guarantees.

There is the issue of governance and the cost of governance. Layers of governance are good from an ethical point of view, but someone must pay. The cost of choice is substantial. People want all the bells and whistles on retirement funds, but then they must pay.

There is a great need for sophistication and to run a fund like a business. Performance appraisals for trustees are a step in the right direction.



#### 4.2.5 Service providers<sup>15</sup>

##### ➤ Trade unions

There were political issues with members wanting influence over the retirement fund. The union movement was exerting its authority in the 1980s and was striving for political power. Defined contribution structures existed but it was not a popular option.

Conversions from defined benefit to defined contribution structures have largely run their course; most of them are done. There was increasing labour turmoil and a belief that provident funds were better than pension funds. What labour wanted could have been replicated in what existed. There was pressure from unions to properly spread retirement funding. The lack of empathy from employers had resulted in low withdrawal values. In the 1990s there was a clamour for choice. People moved gradually out of defined benefits to defined contributions and there was more transparency. Gradual thinking from employers was that they could not afford defined benefits. It was a cost factor in company's competitiveness (refer to cases A, B, C, E, and G).

There was a government move in the 1980s to enforce preservation. This caused strikes in the country and the government paper was withdrawn. There was a move in the 1980s to migrate from pension to provident funds. Unions said that it was better to get the cash. Members were saying that they did not live long after their retirement given the strenuous nature of their work and that they lost their money when they died (i.e. no further pension or lump sum was paid to their beneficiaries). Pensioners needed to travel far to get their pension. Employers were concerned that members would not be able to manage a lump sum. However, it appears that the ability of black people to manage their small amounts of money is better than whites who earn more and still get into financial trouble. It was argued that the employer's contribution to a provident fund was not tax

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<sup>15</sup> Fifteen macro-level and four case study respondents were interviewed on a confidential basis.

deductible. There was a general move for executives to be in a provident fund – with the belief that executives can better manage their money.

In the 1980s trade unions were making a case for their own aspirations. Defined benefit was complex, contributions secretive and not transparent. Trade union members were predominantly black and post retirement their longevity was short. Defined benefits favours longevity – blacks had shorter life-spans and invested lump sums in their communities to buy cattle, for example. When government proposed compulsory preservation, many members withdrew. There was a negotiation process and in the early to mid-1980s defined contribution provident funds for the unions were established (refer to cases A, B and D). They had poor withdrawal benefits under defined benefits and the process was slow initially. From the early 1980s one brokerage in particular was pushing for conversions.

#### ➤ **Employers**

In the early 1990s the unions were still driving the conversions. Only in the second part of the 1990s was it employer driven. Employers saw the benefits. There was a push from employers when many employers saw the liability of a defined benefit fund as being a bad thing. One brokerage in particular drove very hard.

Markets in the late 1990s and early 2000s were not good for defined contributions. Investment managers were accused of poor performance and then there was a push for member choice. The problem is not the defined contribution structure, rather it is the poor savings ratio.

There were two different agendas – control of assets and conversions to provident funds. Conversion terms were not favourable; at best they were neutral but not good terms. Workers wanted control over their assets, it was a political drive. During the employer drive in the mid-1990s, consultants in the business were confused about who the principal was. Consultants were advising employers on how to cap risks and open ended liabilities. There were political risks and the cost of AIDS and pension fund advisors gave advice to favour the employer. There is not a good understanding of this open-ended liability. From a fund perspective, the

extent of open-ended liability is not substantial. There were changes in the employment relationship and risks moved with the shift to cost-to-company.

The employer always made the decisions (refer to cases A, B, C, D, E and G). It was part of a negotiation with the unions. Conversions were of two kinds: a union driven process and the employer selling the benefits of defined contributions to members, such as salary sacrifice, tax benefits and sweeteners being offered.

There were many comments, articles and discussions. The Mouton Commission appeared to be the right thing to do. No analysis was done, yet members should have been part of the process.

Employers were having a difficult time with unions with strike actions. Sanctions were also starting to impact. The employer wanted to manage their expenses. There was an open-ended liability and they wanted a guaranteed, known contribution. This suited consultants who could get more work with conversions.

Insurance companies did not adapt and were not able to ride the wave. Corporate structures got in the way. Remuneration did not encourage a longer term view, it was salary and commission based, rather than entrepreneurial.

For the employer, open-ended liability was not attractive (refer to cases A, B, C and E). Legally, an employer can convert from defined benefit to defined contribution for operational reasons. This is possible in terms of the Labour Relations Act. In other, countries employers can walk away, but not as easily as in South Africa. If you close a fund in the UK, you must consider the impact on members.

Accounting standard AC116 required companies to disclose their pension fund contingent liabilities. There was new legislation requiring members to elect at least 50 per cent of the trustees. Employers were advised to unlock the pension fund surplus and were told that they could transfer risk to members. The union's aim was to get members in control.

The process gathered momentum through the herd instinct. Defined contributions became the thing to do. The employers' role evolved. It was conventional wisdom, the spirit of the day. There was a lack of research to test conventional wisdom.

Trustees needed to act in terms of the rules. It was employers and unions that drove the process. Employer and trustees are often not distinguished. Trustees were presented with the question of: "the fund is changing, how do we manage". Trustees were not the driving force to convert funds. Some Section 14 documentation talks about "transfer as a result of agreement of parties". The employer, union and service providers were the strong players.

It seems that the emerging brokerage had a strategy to convert funds from defined benefits to defined contributions<sup>16</sup>.

Conversions were done on a client by client basis and not as a general strategy<sup>17</sup>. The same kinds of issues were coming up over and over again. The emerging brokerage did not have the baggage of the life offices and it presented a nice consulting opportunity for them.

Trade unions wanted it, with a division of the emerging brokerage providing the service. Service providers were drivers, not just facilitators. Employers wanted certainty with the move to cost-to-company packages and tax efficiency. At the time there was no good reason not to: trade unions wanted it, employers wanted it; and their employees wanted it because it was easier to understand.

One of the key reasons for conversion was that unions did not trust advisors who were giving advice. There were instances in the 1960s and 1970s where blacks were not members of the fund. Funds built up surpluses in the 1960s and 1970s and large insurers encouraged employers to include black members on funds. Because of the surplus, when blacks joined employers were able to purchase back

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<sup>16</sup> This remark was made by several respondents.

<sup>17</sup> The emerging brokerage's comment on their involvement.

past service to inception of their employment. This was lost when the members converted (refer to cases A, B and D).

Few people at the employer had a say. There was no difference between employers and trustees. Change to pensions was a labour issue and may have been negotiated with representatives.

➤ **Valuation bases**

Valuation bases were conservative and this led to the build up of surplus in the funds. For some consultants this was very attractive. Actuaries who played a role as advisors to both employers and trustees faced a governance problem.

There was a receptive market. To understand, it is necessary to look at the history of pension funds; they were initially a reward provided by employers for long service. This paternal view prevailed until the 1970s, 1980s and even the 1990s. It was paternalistic and driven from the employers' needs. The history of defined benefits moved along quite well with employers mainly interested in running the business. It was a cost factor for employers who did not like surprises. The conservative view resulted in pension fund surpluses.

Initially, employers were not interested in employees who left the company's service and it was difficult to persuade them to improve pensions. This led to the Mouton Commission. There was a drive to withdraw when compulsory preservation was proposed. There was initial resistance from employers – but it was a political happening. One of the brokerages in particular was pushing and pointed out problems experienced by black members. They pointed out that cross-subsidies were unfair. They were clever and saw the gap. A division was formed specifically to capture the union market. Employers were promised that their costs would be capped and black members were promised better withdrawal benefits. Then there was a clamour from other employees and it started to happen all over the world. It went very fast.

There was a pull from members, via the unions, for lump sums and withdrawal benefits. There was also a push from employers to get away from open ended liabilities. Accounting standards and behavioural drivers were also factors. Defined contribution is harder to administer than defined benefits. Developing technology allowed for defined contribution administration. Cost-to-company was a factor, with service providers driving for business.

➤ **Consultants and an emerging brokerage**

The industry was much smaller and much more naive. Employers controlled the funds and there was much more paternalism. Employers were stronger and member involvement was the exception. Employers controlled defined benefit funds because of the risk they carried. Actuaries advised employers how to use funds to the employers' benefit.

The concept of employment was changing since there were no more jobs for life and cost-to-company was a fundamental difference. The opportunities were aggressively pursued by an emerging brokerage. Insurance companies were not pushing that hard. The emerging brokerage took to the employer what was a union –need and presented it as a win-win. But the employer won more. It was a substantial opportunity for the emerging brokerage, whose next step was to develop an investment manager. The actuarial society contributed to the “death of defined benefits” by providing low withdrawal benefits. Information was low, then it increased and employers did not pass the benefit to the members.

Awareness started with research on the differences of mortality between whites and blacks. Blacks performed heavy work, with no proper safety. Exposure to gases, for example, led to lung cancer and tuberculosis, with the result that black people did not live until age 60. They lost out in terms of the rules of the funds which provided benefits from age 65. There were substantial surpluses in the funds and this did not make sense. Declarations to workers were also below the inflation rate. Senior management were the fund trustees, if there were trustees. In 1981, government tried to impose compulsory preservation. Massive strikes followed. There was an approach by an emerging brokerage that had a big corporate

customer base. A presentation was made to parliament that stated that the retirement age of 65 was not workable. The values of the white sector were being applied to the black sector with unfair consequences. Black members did not know about certificates of existence and often never received their money after the first year on pension. Defined benefits were not working.

The emerging brokerage mandated an employee to develop an alternative to show what was wrong with defined benefits. This individual went to Detroit where the manufacturing unions were strong. People of colour had lower life expectancy. He came back and the South African unions were interested in the work he was doing. He was perceived as political. The sugar industry had commissioned a study, but had difficulty getting in touch with the black community and this individual was asked to approach the unions. There were political connotations when the individual pointed out the problems with benefit provisions and the brokerage started looking into the matter.

The emerging brokerage led and everyone else followed thereafter. This brokerage held the top clients and were market leaders with others following suit. Life offices could not move fast enough although some good people came out of these companies.

Large insurers took advantage of an unfolding trend. They were relative late-comers to the market and were in the defined contributions environment because of necessity. When the conversions arose, insurers were perfectly positioned. They focused on executives and “cherry picked” clients.

Employers made the conversion decisions on the advice of consultants (refer to cases A, B, D and G). Large insurers did recognise the risks because mini-surplus apportionments were done on each conversion. The advice of the brokerage was to give the surplus to the employer.

For clients whose business was successful, defined contributions was not a problem. Where job security is fragile, there is greater interest in pensions because

this is all that the members have. Once parties received defined contributions, nobody wanted to look back. From the union view there is now a longing for defined benefits. Unions now feel they never should have converted. They did not evaluate, neither did the white collar workers.

There was much discussion with the company. Issues were: costs; ability to handle investments and that the rules of union funds were unfair. Employers consulted with consultants and actuaries. History shows that union funds were badly managed. Life office service is so bad that brokerages have moved up the service chain. In an environment of good returns, companies benefited from defined benefits. In the 1980s and 1990s, people thought that they could receive high returns for their own benefit, but ability to make investments was an issue and groups of sales people grew.

It is very difficult to swim against the tide (refer to case G). Most players could not swim against it. It was a gradual process. If you consider actuaries at the time, they were advising employers how best to manage their money. Contributions were based on very low interest rates from 1940s, 1950s and 1960s. Employers refused to give more.

It was a concept by an emerging brokerage to save employers from an open-ended liability. If the company was in trouble, it would need to negotiate salaries down. In the 1990s, some employers were in trouble. It gathered momentum when there was a broader understanding. The emerging brokerage was consultant to the largest funds and created momentum for defined contributions.

Actuaries and service providers are important. Key issues are:

- \* matters of law and good governance;
- \* fiduciary responsibilities of boards;
- \* how assumptions are made;
- \* insurers – the problem of policy-holder versus shareholder; and



- \* adjudicator cases – the legal basis of rulings can be questioned in the courts.

There were clearly problems with defined benefit funds and service providers aimed to provide a solution.

### ➤ **Employees**

White middle management was also interested in the individual's work. Withdrawal benefits on defined benefits were bad and many junior white managers had no intention of staying employed at one company for their entire career (refer to cases D and G).

Defined benefit funds offered poor withdrawal benefits and they were not transparent. If you were a member of a civil or large organisation, you never obtained answers and could wait up to a year for answers to a query. It was old and arcane. Even educated people did not understand.

There were two key issues: trade unions fighting for membership used pension funds as a major issue and the high nominal rates of return made money purchase funds look attractive. The whole thing started with black members, who suffered incredible loss due to the swing in the markets. It was in the employers' best interests. Blacks had very small pensions and could not get their money in the rural areas. There was also a lack of trust in payment of the benefits. But, the problem could have been remedied differently.

Trade unions wanted better withdrawal benefits; employers wanted certainty. Other members wanted to secure their benefit. Under defined contribution structures, there was an immediate secure benefit but investment returns were not considered. Under defined benefits members can lose out, an example is that pension funds are underfunded in the UK where pensioners get the first bite then benefits get negotiated (e.g. increasing retirement ages).

There is no longer lifetime employment, and it was an obvious choice to go to defined contributions (refer to case G). Other structures were not necessarily

considered and cost-to-company did not fit defined benefits. The process changed: in 1991–92 there was not much consultation; in 1996–97 there was more transparency and consultation.

➤ **Market conditions**

Conversion decisions were made predominantly by the employer (refer to cases A, B, C, D, E and G). It was an easy sell for employers before surplus legislation – they manipulated the funds by employers accessing the surplus. There was a convergence of incidents. Because there were benefits for the employer, there was an incentive to convert.

It was a high inflationary environment, which was of concern for defined benefits. The introduction of accounting practice, AC116, was not a driving factor. Very few evaluated the outcome, there were leaders and followers. An emerging brokerage did evaluate because they had the resources and intellectual capital to do so. They could spend money on travel to see what was happening overseas. A few individuals drove the process. For example, individual member choice is good for only a few, yet it is introduced.

There was a sharp distinction between blue collar workers and white collar workers (refer to cases A, B, D, G and H). There was a building of pressure and the beginning of transparency. Blue collar workers got token benefits. Markets were running. It was always the employer that made the decisions, sometimes under pressure from the union. Employers were considering their costs and they could peg costs by converting funds to defined contributions. They also did not want labour unrest (refer to cases A, B and D).

During the bull market phase, defined contributions looked good. The unions had challenged the employers' base and won with power shifting to the employee. There was a fear of inflation and the numbers started to get substantial for defined benefit funds. The funding rate could easily increase from 5 to 10 per cent and hyper-inflation was a fear.

➤ **Evaluating the outcome**

The outcome was evaluated, but not quantitatively. The unions view has changed. From a quantitative view, major surplus arose. From a qualitative view, unions had second thoughts and opened their own defined contribution funds. Members are now approaching unions, not employers, when their lump sum runs out and they have no pension.

The initial impact was on labour intensive industries (refer to cases A, B and D). These first conversions were union driven. This was enough of a wave for others to follow. In other industries, it was a financial decision and part of a ripple effect. It was the result of financial factors and companies wanted certainty. Defined benefits were too expensive.

There were two major drivers – both of them brokerages that aggressively targeted insurance company clients. The view of the large insurers was to also get onto the band wagon. They joined the trend rather than created a new reality. Large insurers facilitating conversions to defined contributions were a reaction to a competitive threat.

Discussion on the outcome was verbal. Everyone knew that the environment was changing. There was awareness of risks, but members were not aware. They may have been told but maybe did not understand. The issue was talked about more and more. People got less than their reserve on transfer, this was at least what people should have received. In the conversions of the mid-1990s, this was not an issue. The era of consumerism was a global phenomenon and there was pressure on companies to be good corporate citizens. It was difficult for people to understand the risk in the run up to a strong market. Markets were over-valued and decline was inevitable.

There was no evaluation in the industry, which was dominated by an emerging brokerage. This brokerage was not going to evaluate. If you look at funds today, many members will not have enough money when they retire. There are some

cases where members were exploited. Members did not get sufficient share of the surplus because the unions did not have the knowledge.

New rules are in the process of development and in progress. Defined contribution funds need a defensible basis and assumptions are not necessary. The fastest growing area of law is: constitutional law; environmental law; and pension law.

Umbrella funds want to limit investment houses to their sponsor because most money to be made in investment management, not administration. In defined benefit funds, employers had an interest; in defined contribution funds, the member now only has an interest.

Industry bodies are interested in formulating the rules and promoting the interests of funds with an emphasis on the regulatory environment. The key is providing competition to ensure costs are contained; maybe benchmarks for costs can be established.

Many players had to go through a learning curve as the industry evolved. The outcome was not evaluated afterwards. It seemed like a no-brainer choice. There was a sweetener, withdrawal benefits were low and many people did not intend to remain employed with the company until retirement. It was beneficial for younger employees and was a short-term view.

Very little research was done and is done in the industry. A process was initiated by government, but it was discontinued. The parties did not want to talk to one another. There was not enough intellectual capital. Also, it was a financial issue with wide potential ramifications.

Nobody made an ethical stand – actuaries did understand the implications. The aggression with which members were demanding their money was concerning. A big debate at the time was conversion from career average salary to final average salary. A task team of the actuarial society did look into the matter, but recommendations were not taken further.

If you consider the UK experience, defined contributions did not work, then they moved to defined benefits and that did not work – then they moved back to defined contributions.

➤ **Speed of the change**

The process was out of control. It was a “frenzy” with no understanding. It should not have happened at all. Defined benefit funds provide a better deal for members. The move was too fast. Defined contribution is fine in principle but more costly. If members join a fund late in life, however, defined contributions may provide for better benefits.

Some advisors did not understand what they were doing. They gave what the client (employers) wanted. There was a strong drive to provide employers with access to the surplus. “Sweeteners” that were offered were averagely right, but were applied with a skew. Younger people received too little and older people received too much.

People have a short term focus and want instant gratification. Members who chose not to transfer did so because of the risk. They wanted certainty. However, in many instances up to 96 per cent of members transferred.

There were two drum beats: the unions in the early 1980s – this process was completed by the 1990s and took about 10–12 years (refer to cases A, B and D). The employer one was very quick. It was quick because of the consultant-competitive space (refer to cases A, B, C, E and G). There was a new hook for actuaries. Pre-1994, there were fears; consultants approached employers and highlighted various factors. People did not understand the implications. Many presentations were merely a “sales pitch”. Material things were not covered and it was called “a new wave”. One or two meetings were held and then there was a timetable for implementation. It was political timing and a strong consultant drive.

Consultants were driving the process without a doubt. The “trusted advisor” was the buzz-word. The model was for the client to rely on the “trusted advisor” for

everything. An emerging brokerage gained the most. The environment was ripe for a change agent and it was a disruptive intervention. The first phase is to displace the existing order and the second phase is to stay in the space. An emerging brokerage started pushing out the insurance companies. That brokerage went wrong by itself becoming an insurance company.

Some companies did not become involved with conversions because of the company philosophy. Multi-nationals took positions in favour of defined benefits, but converted in South Africa because of the unique circumstance.

Funds were in surplus and companies wanted to access the money. Surplus was a driver. It was too quick and a bad move, particularly for older members. Members with long service who are in their early fifties should not move. A result of the conversions was that members who expected 80 per cent of their final salary only received a fraction after the market downturn. There was not enough "what if" scenario planning.

The move went very quickly. It was happening in the USA and in the UK, but at a slower pace. Issues and member responses were slower. It is more difficult to continue the pace since everyone who went to defined contributions had the same problem. South Africa moved very quickly because of factors that were driving the process. Political factors turned it on its head. Unions wanted political ground. It was a unique socio-economic structure. It was also necessary to look at how strong the guarantee was since the company could close the fund and not necessarily keep it.

The changing power base was driving the process. Once political change happened, there was a slower response from union and government on pension issues. It was used to obtain political freedom, and once it was obtained, the issue of retirement funding went lower on the agenda.

To some small extent, the conversion process has been a constant over 20 years. It was a small time period in the big scheme, but it went quickly. Twenty years today is very quick and maybe equal to 500 years centuries ago.

The causes should be looked at and the process must be considered. Defined contribution has many advantages, but there were hidden motives and a lack of transparency and fairness. The legal process was not sufficient. There were no guidance notes from the actuarial society. The actuarial society is a professional body and can say something.

Today there is much more power in the hands of members. This knowledge, the financial press and the outside industry led to a shift in governance. Some employers made conscious decisions to keep defined benefits. There were personal interests and those who fully appreciated the defined benefit model would benefit more than others. Defined contribution is beneficial depending on the circumstances. Defined benefit is better for older members.

The process started in the 1980s and sped in the 1990s. With all factors considered there would have been some benefit to going slower if only to highlight the key issues.

Union power grew during the period. It was quite a rapid conversion speed. Things were changing with people wanting to know their values. There was high inflation and poor market performance. Companies looked at where they could budget their costs. The infrastructure did not cater properly because surplus was left behind (refer to cases A, B, C, D, E and G). It was not legislated and, although actuaries did work to do the valuations, there was no industry uniformity. Legislation may not have existed. The FSB was only founded in the late 1980s.

#### ➤ **Learning curves**

Transparency and communication is important and many people did not understand the implications of the movement from defined benefits to defined contributions. Nobody thought it through, the actuaries just decided. This has been

softened through the surplus legislation. In many instances, employers did not understand the wider ramifications.

Fund structures would not have evolved in the absence of the environmental factors. Government did allow provident funds, but they were “specialist” funds or top hats and then the first conversions came. In the 1980s, compulsory preservation was suggested and the unions resisted. The various parties could have been more creative, but it was power politics.

The large insurers did not move quickly. There were discussions on the dangers of defined contributions, but the attitude was “if they want it – they can have it”. The unions wanted the full-house: lump sums at retirement and better withdrawal benefits. It was a win-lose environment. You can have a defined benefit provident fund, but cross-subsidisation is an issue. Something could have been worked out if the climate was conducive.

Actuaries speaking at conferences were saying that the defined benefit model was good for members in a whole range of instances and questioned the ability of defined contributions to do it. They could see the academic benefit, but no real benefit. As funds converted from defined benefits to defined contributions, actuaries would maybe no longer be employed and, thus, they were seen as self-serving.

Business, not the unions, set the pace. They created a new customer base for the consultant. It was clear to everybody that it was based on superficial analysis. Government should have put on the brakes, but did not. Business created a double whammy: they received tax benefits on contributions, but when members retired they soon spent the lump sum and then relied on the SOAP.

There was insufficient time given to discuss the matter. People did not apply their minds to the issue. The changes shot through because the unions wanted to show their members a benefit and attract more members. It also had financial implications for companies and they wanted to manage it.



When government passed draft legislation for compulsory preservation there was no time for people to think properly. Later on, an emerging brokerage thought up many selling points as part of their strategy process. The actuarial society was lacking in giving guidance.

Transfer values were a whole separate debate. The transfer value issue was not thought through properly. The unions never thought about it. It was a political issue. Even with hindsight, the issue is very complex.

Conversions were done on a client by client basis. The process may have been too quick. Some processes moved slower especially to get members on board. There was discussion and some cases were quicker than others depending on the detail. The regulatory framework was not sufficient with checks and balances; now new checks and balances are being implemented to resolve unintended consequences, but they create more. There needs to be a new balance. Government is concerned about dependency ratios increasing.

Employers rather than the trustees set the pace and in those days the employer and trustees were not different. Defined benefit is more appropriate over the long run. People did not think about it. It was a few very unique things coming together. Pension fund adjudicator rulings indicate that people will have less in the long run. The reality is that more than 70 per cent of people will retire with insufficient benefits.

People are now more mobile and defined benefit was not designed for people who move jobs. Employers were not going to push the issue because it costs money to improve early leaver benefits. Defined benefits could fit, but you cannot favour the long term over the short term if 90 per cent are short term. Long employment benefited especially white men because white women broke service to have children.

The regulator was in “catch-up” mode all the way through. Surplus legislation is part of the “catch-up”.

➤ **Process complexity**

Consulting is now more difficult; previously you just needed to take the matter to the sponsoring employer's managing director or financial director, now there are many more players involved (refer to case F). Employers knew with certainty what was going on, they understood after being advised by consultants and advisors who sold the idea; managers evaluate and pick the best option (refer to case G). Members were sold a concept (refer to cases A, B, C, E and G). Employers were in control but are now much more open to discussion (refer to case F).

There are insufficient benefits for people at retirement and they are now worse off. Members sometimes retire with 70 per cent of performance. Members are at the mercy of markets at the time of withdrawal, retirement or death. Members often must take their funds at times where market conditions are less favourable. Now cost-benefit analyses must be done. Retirement annuities, for example, do not provide benefits to justify costs.

The existing Pension Funds Act is old legislation. There are fears of moving into an over-regulated environment. There has been widespread consultation with industry regarding the new act. Labour has greater output. If the UK example is considered, it is clear that the UK labour movement gained control over pension fund assets. If unions control pension fund assets they can have greater bargaining power with employers.

There was greed and people did not think of the consequences. There was a withdrawal of union members from underwritten funds and unions scooped them up to achieve power. People took on risk without knowing it and found out too late. If a member joins a series of defined contributions funds as opposed to a series of defined benefit funds, the benefit from defined contributions is lower. There is now a clamour for choice and today it is much easier to access pension money with 90 per cent of withdrawal benefits being paid out in cash. Actual benefits are inferior in many cases and people who preserve can afford to do so. People are now looking at options with a short-term view. People do not understand risk.

Trustees are now sitting on a time-bomb by not controlling choice in any way. The wheel is turning full circle. Redesign is cutting out individual member choice. Some hybrid products can possibly fix the problem. But these are complex to administer and understand. This can ameliorate the risk. The rate of contribution can vary, for members aged over 55 there should be some gradation.

The UK had thirteen different tax regimes and things became very complex. Reform looked at the high earners and asked why millions of people can be inconvenienced to manage thousands. The UK then introduced a simplified life-time allowance. It was calculated that GBP1.5 million was enough for retirement. People can accumulate this amount in any way and it is possible to take a maximum of your whole salary as a tax deduction in later years if you want to. Things should be flexible.

Employers were absolutely certain about what the outcome would be. There was a rush to change. Defined contributions can show high returns. For members, it now depends what happens in the market during your generation.

#### ➤ **Intergenerational cross-subsidisation**

The biggest consequence of conversions from defined benefits to defined contributions is loss of the intergenerational cross-subsidy – the long term view. In reality from an employer perspective there is no difference. With defined benefits an employer negotiates salary increases and contribution increases (or benefit decreases) and with defined contributions, an employer can also go back and negotiate. If things go wrong in defined benefits, the fund itself is the controlling mechanism. In defined contributions, it depends on how markets perform in your life-time. There now exists an unusual situation where, as members get closer to retirement, they withdraw from equities, only to go back in after they invest post-retirement. When you are younger, lower markets are better because you can buy more. Showing daily values just encourages a short-term view. Some have the view that members should get statements only every five years. Volatility is the whole issue that dictates. The western approach is to try to teach people to understand, but most people are not interested in investments or not able in some

cases. The information can be provided, but depends on a few heuristics. The long term view was replaced by a short term view. There is less commercial benefit in a longer term view.

There has not yet been a big catastrophic event such as a depression or a recession to show the consequences of the loss of the intergenerational cross-subsidy. There are the naïve versus the thinkers: unions may not have considered this aspect and were thus naïve.

Conversions created a discomfort of substantial proportions at retirement. The quality of financial advice is poor. There is a trend to start offering pensions from the fund, but this is only viable in larger funds. Employers are proving difficult in this regard.

The broker community was looking to increase annuity income. Relationships were between broker and client and broker and life office, not client and life office. The consequence is poorer retirement values – nobody thought about it and lost out on long service. It was never thought about, especially by the emerging brokerage.

The revised Pension Funds Act has been on the table for a long time. It was an extension of the process and costs have come to the fore. In the 1960s, 1970s and 1980s we experienced higher tax rates. The tax rate has since reduced and there were many good things in the reform paper. But the loopholes to the means test now need to be closed. Retirement Funds Tax was supposed to have been a temporary measure. Employers have asked the question of why lowly paid members should join provident funds, rather let them have SOAP. A move back to defined benefits will never happen since future increases cannot be funded out of surplus. In the majority of funds, employers did not fully understand the implications. Employees want retirement money, not risk benefits, but financial planners left out employer risk benefits when considering risk requirements for members so that they could sell more insurance products.

The consequences depend on where you are looking from. Members did not realise they would be worse off. Employers knew what they wanted. The curve-ball was the cost of AIDS and the cost of death benefit payments. Capping costs was important, but benefits had to reduce to achieve this. Some saw the cost of AIDS coming. Individual member choice also flowed out of the shift to defined contributions. The surplus was a by-product of the process.

The surplus issue may have been intended or unintended. It was clearly intended for risk to pass to members. HIV/AIDS costs impacting on amounts available for investing was not intended. Most others could have been foreseen, but were not intended. Retiring without enough money is the biggest consequence. Individual member choice was also probably not thought of as a logical progression. Service providers needed to offer something new to justify themselves and get new markets.

➤ **Pension fund reform**

After 50 years, it is appropriate to amend the Pension Funds Act. The current act is out of date and surplus legislation aimed to redress problems from the conversions. The new government is tackling policy.

People were not 100 per cent sure how it would pan out. It should have been more transparent. By changing, members felt part of the process. The employment relationship was changing. The advice now is to always get consent from employees before converting (refer to cases F and H). There was encouragement from brokers, especially the emerging brokerage that assisted the union in the process. They persuaded employers as well as members and their representatives. The brokerage was split into two business units to achieve this. The unions did not understand the defined contributions concept.

There has also been a lessening of ancillary benefits. Some employers did consider the contributions needed to buy cover such as for death benefits which were climbing because of AIDS. The employer would have to pay the cost.

Employers were led to believe that they no longer needed to consider investment returns.

There was a need to have control and to create certainty. Members did not understand the risk or what they should have received on conversion. Members did not know that they would have less financial security on retirement.

The revised act is aimed at taking the industry forward. It would have changed because the power base has shifted. There are now many new fiduciary responsibilities. The spotlight is now falling more sharply on contracts, rebates and the conflicts among consultants. In defined benefit funds, it was enough to know the formula, now there are stricter views of governance in funds and trustees also have a role to play in socially responsible investments.

Trustees are responsible for educating members and the employer previously protected the members. There is now a spotlight on contracts and costs with the aim to have little regulation. Good governance does not require regulation.

The Pension Funds Act is inadequate from poor drafting. It is a real patchwork of recent amendments. It needs some new thinking, for example on the distribution of death benefits. The national savings fund is looking at a different section of the workforce to bring them into the arena. It needs to be cohesive from the tax aspect – tax now is complicated and fragmented.

It was the end of an era. There was no more lifetime employment, with economic ups and downs. It was a view of: “here comes a new plan”. Short-term needs dominated.

Member choice and flexibility seemed logical as a next step. The emergence of linked investment service providers (LISPs) was not so clear. A pension fund is worker capital and unions wanted to control the capital, but it never got that far. The industry could end up with a few large union funds. The concept of the income replacement ratio was lost and risk moved to members. This was unintended by

the members. Leverages in the form of charges grew. Two important factors are now at play at retirement: asset value and annuity rates.

When the new act is written there may be compulsory preservation; compulsory provision; and the requirement to take lump sums as an annuity. If we implement the proposed measures, we will end up with pension funds. The National Treasury paper is very positive, they are working towards a common-denominator.

There were warnings from individuals that risk would shift under defined contributions, but few were listening (refer to case D). The issue of transfer values was also raised, in particular the problem with surplus and calculating the transfer value. Members were severely punished on transfer from defined benefit to defined contribution structures during the union driven conversions – they only got their own contribution and nothing from the surplus. Employers saw the benefit of off-loading liability and pushing costs onto the members.

The second conversion drive was a problem: black members who had moved previously got minimal transfer benefits, when the white workers moved they got “sweeteners”. This was not fair to the members who had moved in the first drive. Members also moved to industry funds where the contributions were even lower than the employer sponsored defined contribution fund.

All the items mentioned in the marketing drives were the intended consequences. There was a move to consumerism, but there is a downside risk because 80 per cent of members choose a more conservative portfolio. In the defined contributions environment, investing has become more conservative (refer to case E). There is also the cost of governance to consider. The move from paternal defined benefits to defined contributions requires vast control. Most employers saw the contained costs as making sense. It made sense for the employer and made sense to members. Conversions provided certainty during prevailing uncertainty at the time. Now trustee training is vital and the cost of regulation must be considered.

There is now a new reality and we cannot go back. We need to look at how to manage the new reality. Members with higher salary increases, and who thus stayed with their employers, would have been better off in defined benefit funds.

Unions knew what they wanted – improved withdrawal benefits and lump sums. Members then spent the lump sums and could rely on the SOAP. They did not understand the long term implications. Unions wanted union funds so that they could take control of the assets. This was in their own self-interest. Many people in the industry understood the long term consequences, but the majority view prevailed. The California Public Service Fund (CALPERS) has shown that pension funds as shareholders are toothless bulldogs. A paper on socialisation of the USA showed that pension funds owned more than 50 per cent of the economy, but members were unable to exercise their power.

The outcome has been a reduction in retirement provision. Provident funds are short term savings funds. Pension funds were framed as long term instruments given the applicable tax incentives.

➤ **Relative power of stakeholders**

There was a shift in that employers now ask members on fund issues. Previously, they were totally in control. Power remains with the employer, because the employer is paying.

Labour became stronger, but the employer is still the controller. Government is trying to make rules, but they tend to over-regulate. Trustees can only do what the rules allow and it is difficult for them to change. Trustees have no power to change, just power to stop detrimental decisions. The regulator is trying to increase its powers.

Trustees are providers of capital. If you are an allocator of capital, it is essential that you understand how and the consequences of capital allocation. There is a sense that mostly fund managers are accountable. Trustees can be held accountable by keeping record of how they vote. Long term sustainable investment



is key. Investments must be made with a view to achieve an objective. Making capital allocation is a danger if someone tries to drive an agenda. Badly directed capital allocation can be detrimental. Black Economic Empowerment deals are not necessarily beneficial, but are critical for the long term future for South Africa. It must be clear where responsibility lies for poverty alleviation. Government should be accountable for the bonds that they issue if there is to be shareholder activism.

Conversions were a disruptive intervention strategy – anyone who was smart could see it. The adjudicator is now a watchdog. Employers now have no risk and employees are just as ignorant as before. Employees are totally in the dark. Defined benefits stated exactly what members would get, now providers are selling capital protection products.

There has been a shift away from service providers to members through the office of the adjudicator and ombudsman. Consumerism has driven trustees to look hard at what they are doing. Employers may come under pressure from the social aspect – to fund a defined benefit cost or a different cost. The regulator now has more power.

The employer no longer has all the power, previously they held it all. The employer must now consult with members and their representatives (refer to case F). Employers acknowledge that they no longer have sole discretion. Some employers are shocked that they need to consult.

Service providers always have more information. Trustees need to work to get the information. The business of service providers is to be aware of available information. Previously, actuaries wielded a great deal of power. Lawyers need to understand what actuaries are doing and lawyers are now questioning what actuaries are doing and the assumptions used. Lawyers are helping to make the world better informed.

Members have a weaker power base and are now much more vulnerable. Administrators and lawyers have become more powerful. Lawyers have claimed

some ground. Deference for the actuaries has now been probed. Most abuse has appeared in union funds and these are aspects of governance. There are problems. Employers previously held all of the power, but do not need to hold it anymore.

Now the power is at investment level. The key now is control over the investments. The gatekeeper is the broker or consultant. The unions wanted power. Choice was never intended for the masses. Unions are now more assertive, but service providers are becoming too powerful.

Unions have far more power now. They are wiser and more organised and have an ear at government level. The African mindset is different to that of continental Europe. The European model is that all are born equal and that fairness does not override contract. The Asian view is that we are born into castes and if a contract does not work for the community, it must bow before the greater need. The African view is similar. Surplus has become a community issue. It was never stated in the rules of funds that the surplus belonged to the employer. If we consider the issue of retirement annuity costs, that is how the contract worked. The financial press is highlighting the matter in a climate that has changed. People are no longer prepared to adhere to the contract – if they do not like it they will challenge it.

The employer has regained power under the influence of service providers who have all the knowledge. Member benefits are being reduced and unions are not fighting hard enough against this. Employers are getting stronger because member elected trustees without the support of strong unions are powerless. The economy is not growing and membership is not growing. Trustees have to be more confident of themselves. An independent trustee means nothing – trustees in general have not taken the power and it is unlikely that they will.

Service providers are very powerful because they have time, money and attitude. It is difficult for independent thought to come out of service providers because their members must tow the party line. The emerging brokerage grabbed power. In the

world of defined contributions, members need advice, especially with individual member choice.

Power moved to the Trustees. Unions are not as strong as they once were. Employers are less powerful. Service providers now have more power because trustees are less educated. Trustees can be abused by service providers. Marketing presentations can be very good – especially for guaranteed products. The question is how can you educate trustees?

Employers no longer have all the power, they must now consult with members and their representatives. Employers acknowledge that they no longer have sole discretion. Some employers are shocked that they need to consult.

It was a top-down driven process and consultants did not have sufficient insight. Business was generated with the conversions. All new trustees required education. There were many vested interests and many people made much money out of the process.

Conversion had a beneficial impact on business. Defined contributions was business waiting to happen. The large insurers were in the right place at the right time. The business just came. The need at the time was met, it was not a long term solution. There must be a mixture to meet the need.

#### ➤ **Ethics**

In the conversion process, each person thought what they were doing was reasonable. Deliberate unethical behaviour occurred in a small percentage of cases. It is unfortunate that so many people converted. There should have been a total distribution of all assets in the fund. The employer's attitude was that they would not give up the reserves they held for their own security even though they were off-loading their risk and transferring it to the members.

Ethics is in the eye of the beholder. Paternalism was adopted by employers in the past. The view was that "my employer will look after me". Now the work ethic has

changed, there is cost-to-company; mobility; and less loyalty (refer to cases A, B, C and E). Black economic empowerment will have consequences; if we look back ten years from now there will be a further shift in the work ethic with a skills vacuum and lower standards. Things will settle down. Forced processes are now taking place and the consequence is litigation with money going into government hands. The surplus issue has not been adequately resolved (refer to cases A, B, C, D, E and G).

Nobody was thinking of morals when companies were faced with strikes or members demanding their money. It became apparent that it was detrimental, but it was too late. It is not politically expedient for unions to say so. Some opportunists play on ignorance. The life industry has been playing opportunist for many years. Disclosure and transparency will resolve this. Understanding and education is required. There is understanding, but education still has far to go. Good salesmen will always exploit ignorance and a gap still exists. More is coming to the fore and becoming apparent, and action is being taken. Some individuals did raise issues regarding conversions but were “shouted down”.

In the world of defined contributions, employers should be less interested in retirement benefits. This has been the experience (refer to cases A, B, C and E). It is not a bad thing since employers did not necessarily know more than employees. There are some very good employee trustees. Funds need to consider rules on how long trustees serve since there is a need for continuity.

Advisors played a key role in the ethics. The manner in which people react to ethics depends on the advisor. Advisors answer the question of what everyone else is doing, such as not transferring surplus to the members. The question is why should I do something different? Companies considered what others were doing (refer to case G).

Drivers for change were justified, but if they were debated the case could have been finely balanced. There are some cases where the employer got the benefit. If employers do not know, they will rely on the advisor. Conventional wisdom

becomes unquestioned. Consultants and advisors can abuse the situation or see it as a privilege; they need to consider where this fits into the business model.

There are no more service providers than before, but they are offering different services. The market share of the emerging brokerage has weakened the insurance companies. The emerging brokerage shifted the landscape over five to seven years. There was a change in the balance of power. Consultants became more powerful. In the 1980s, there were no investment consultants; the member money investment consulting business began around 1993. This changed the balance of power and the emerging brokerage became a very aggressive gatekeeper.

Existing members never contributed to the surplus, it developed because of actuarial assumptions. Members who left the funds were exploited. Members who remained, especially the longer serving older workers, are worse off. Now there is no room for pensioner increases – this was caused by actuaries.

There has been a fragmentation of fees because there are no longer just a few large service providers. Costs should come down with more competitors. There is a balance. Now that we have moved from defined benefits to defined contributions, the current state of the industry is working well. Time is being spent to protect member interests. The onus on trustees is substantial; employers do not understand and the business comes first. Employers often see trustee duties as unimportant.

With the benefit of hindsight, things should have been done better. If the union negotiated the transfer, members of the union had no choice. The Second Amendment to the Pension Funds Act is trying to address the surplus issue. Everyone got dragged to the table and could not agree. Employers were interested in the money side, but the profit motive can be short-sighted. There needs to be a happy middle ground.

Different people have different levels of ethics. Papers were presented at the actuarial society, but there was no major outcome. It was interesting to note that delegates who worked at an emerging brokerage said nothing. Hopefully this has raised some awareness. Now the paradigm is that people will not do things because they might get caught and punished.

Employers are less interested because they do not carry the defined contribution risk. It was initially a fight that employers lost and now fatigue has set in. The surplus issue has branded the employer as “baddies” although what they did was legal. Compulsion may be necessary because employers just want to give members a cost-to-company package and then let members provide for their own retirement. Labour and business largely support the reform paper.

The union accused the emerging brokerage of “robbery” because members in the early days converted with no surplus. There was some abuse, but it cannot be said that it was across the board. Most tried to do conversions on a fair basis. The majority did not abuse the situation.

➤ **Members’ responsibility**

There are now more providers and more competition; this is not bad for consumers. Consumers may not get as much benefit as they would expect. Funds can get different advice. But more providers do not always reduce the cost.

Employers are now more disinterested because the surplus is gone. Now there is less incentive. Multi-nationals are setting up bodies to look at every aspect of funds, not only at the balance of costs issue. If employers are washing their hands, it is because with defined contributions there is less of an opportunity to take funds from the surplus. In the 1980s there was in actual fact very little risk to the employer. Employers who now claim to be contributing more to funds do not show that, for example, 2 per cent pays for administration fees and 2 per cent for broker fees and the net investment for members is actually lower than members’ own contributions.

Gaps will always be exploited – these need to be filled or changed. Most are not interested in ethics, although there are a few exceptions. Some are very honest and distributed the full actuarial reserve. It was mostly not ethical. There were two scenarios. In the first scenario, companies got raided for the assets in their pension funds. A company would be acquired and liquidated to get to the surplus in the pension fund. In the second scenario, current management saw the surplus and liquidated the company. They retrenched the workers and paid them the minimum in terms of the rules – then they took the balance. There were many vested interests.

The need for change drove an evolutionary process. People saw opportunities for business in areas such as communication and training. Opportunists seized the moment. The outcome would be different if the change happened now. A balance has not arisen yet. It will arise – people have come of age and there is much more clarity. People are battling to understand the process of HIV/AIDS. It is not a time of business as usual. Now we need to manage what has happened. Retirement benefits are sold, not bought.

There were cases where there was a view to take the surplus, not right at the beginning, but the opportunity just arose. In the defined benefit structure, this would have been easier to do. For some it was an issue of outsourcing. Defined contributions made living annuities and preservation funds viable. Defined contributions presented an opportunity and led to outsourcing.

Employers are now much less interested in pension funds and remuneration is more equitable, with less cross-subsidisation. The employer's moral and financial obligation ended when they placed money on the table.

There were instances where substantial efforts went to prevent the worst for members and to persuade them not to make wrong decisions. But to persuade members against the union view or that of their colleagues was very difficult. In a defined contribution world, there is more space for service providers, especially in asset management. Anyone can buy a system and set up administration. People

can get rich. There are now many little individual choices, but the pot size did not change.

Defined contribution was the way forward, but it needed to be done fairly. With the benefit of hindsight, the political implications were not straightforward or clear. Defined contribution fits better. We need to look at today's world. Employment can never go back to what it was in the 1960s. Defined contribution is more beneficial in this environment. All must contribute and preservation should be compulsory.

Members should have received more of their share of fund in the earlier conversions. Human behaviour is such that when you are aware of something you feel compelled to do something.

Conversions needed to happen and much is now for the better. There is member control, transparency and education. Use of the surplus was not always appropriate. Not forcing members to transfer was very important.

It needs to be considered that much unfairness occurred in the defined benefits environment. Different factors were used for different members and actuaries played a very strong role. The assumptions on defined contribution transfers were too low. If withdrawal benefits were resolved, there would have been no need to convert. The conversion created new levels of complexity and levels of uncertainty which created work.

If an employer asks whether defined benefit is a good idea, the response would be no and said with more confidence. If asked if defined contribution is a good thing, there is more confidence in saying that internationally, defined contribution is the structure that is employed for retirement provision. In the conversion from defined benefits to defined contributions, the investment side industry has caused more retirement problems than they should have.

Internationally, systems have evolved along a similar path. The UK went from insurance companies to disintermediation. Australia and the USA experienced



systemic drivers for change. The international trend is from simple to complex. Underlying drivers might be the same. Jurisdiction makes sense up to a point. If one player is more powerful the process moves in a certain direction. In other countries where trustees manage the fund and consultants provide the advice there is fragmentation – no one body regulates or makes sure that it works. Nature of the product is regulated by one body and advice provided regulated by another body.

In the Danish and Swedish systems, unions negotiate for the industry on a national basis. It is simpler and cheaper. This is foreign to us. A national basis needs a rule for all. Umbrella funds would not survive in this environment. The role of the consultant was to find a programme that people could relate to. The aim was to make the situation better, to open up the surplus and get justice for the people. Business success was a combination of factors – the emerging brokerage used a different business approach.

There could have been something in between defined benefits and defined contributions and regulated by some act. If the environment was conducive, this would have been considered. People did not understand what they were losing, but if they withdrew after they converted they did benefit.

➤ **The future**

There will be a swing back to defining pension benefits on a defined contributions basis. In the USA, they have the best of both worlds. That is what we should have done here.

Much more can be done to help people retire and to understand risk. Individual member choice is being criticised, but working people can be helped with it and get used to it prior to retirement when there is no control. Defined benefits would never have survived, we need to learn to cope with defined contributions.

There will be continuing evolution as long as the concept is around. It is driven by service providers who need excuses to sell services. There will be new ideas for

sale. Individual member choice will not work. Members are not equipped and it is not even happening in the UK. The tragedy of today is that much may be accepted as the norm and then cannot change. For example, we promote people to management levels because of technical skills when management requires a completely different set of skills. The same is true for trustees.

A new Pension Funds Act will be written and then tested for constitutionality and tested in court. Governance will improve with closer scrutiny in the role of management of the fund. Better skilled trustees will request explanations of the costs and be aware of proliferation of costs.

If one cannot settle the concerns of the union, there will not be peace. The financial press will also not be silenced. Member choice will continue and will become more internet based. It will be like a unit trust account except with the tax benefits of a retirement fund. Broad-based black economic empowerment (B-B BEE) and the Financial Sector Charter (FSC) will become an issue. Transformation needs to be funded with R40 billion from pension funds. The question is how this will be done.

Individual member choice is like a glacier, it is moving slowly then becomes unstoppable. There is a move to umbrella schemes and a move back to a more controlled investment environment. There are new entrants to the market and this is significant. A new provider must provide something new and could have a big impact. There is also a shake up of financial advisors with the establishment of the FAIS adjudicator. There may be a consolidation of providers and controlled choice.

With individual member choice, members tend to select the safe option, such as the trustees default portfolio. A small percentage of members do their own thing. A large percentage of consultants do not know and advise members who do not know. For example, with offshore investments, members were advised to invest offshore when markets were known to be high and the rand low. Long term diversification is the key. Risk/reward analysis should be done.

South Africa will move like the rest of the world where you can fund retirement in a variety of ways.

The wheel is turning and individual member choice is moving towards fewer choices. For example, a large insurer previously offered 300 choices, currently it is down to 80 and soon it will go down to seven. Defined benefit is history. In the future, we have to get something better than the past. It needs to be flexible and attractive.

There will be a move back to targeting – securing returns required to provide a secure retirement.

### **4.3 ANALYSIS OF RESULTS**

A macro-case analysis was conducted to identify key themes evident from the interviews (Appendix 16). A cross-case analysis compared specific instances of the conversion phenomenon (Appendix 17). These analyses reveal the operation of the key elements in the model and the dynamics within the “black box” as set out in the research framework.

#### **4.3.1 Key themes**

##### **4.3.1.1 Environmental factors**

###### **➤ Political factors**

In the 1980s, emerging trade unions representing black members were pursuing a political agenda as part of the broader liberation struggle. At that time, several political movements were banned and trade unions served as a voice for the disenfranchised. The result was a political struggle fought on the shop floor. Agitating for control over pension fund assets was a means of political expression. In this way, a microcosm of the broader political struggle being waged in South Africa manifested itself in companies and the pension funds that they sponsored. It was a difficult time in the industry. It was political and adversarial, with much baggage.

➤ **Economic factors**

After 1994, the South African economy opened up to global competition and this placed pressure on business competitiveness. Employers were increasingly aware of the contingent liabilities presented by defined benefit pension funds.

➤ **Legislation**

Significant changes to labour legislation in South Africa saw the emergence of trade unions for black members in the early 1980s.

After 1994, the FSB, having been approached by the unions, proposed legislation to make the establishment of Boards of Management compulsory. At least 50 per cent of these boards would be member elected. This heralded a significant departure from past practice, where the employer controlled the fund and managed it unilaterally, often without a Board of Management.

➤ **Social factors**

The world of work was also changing with higher mobility and there was a sense that jobs for life were no longer viable propositions.

#### **4.3.1.2 Forces for change**

➤ **Trade unions**

As part of the political struggle, trade unions wanted to take control of pension fund assets. They would then be able to apply the assets to the benefit of the struggle and ensure that members' funds were not used against their own interests. By investing in provident funds, members would be able to remove a lump sum from the system. This was considered preferable to obtaining a pension given the difficulties members experienced in receiving their pensions in rural areas. Pension funds offered poor withdrawal benefits and their operation by employers was not transparent.

Strike activity began in the metal industries in the 1980s and black union members employed in these industries transferred from existing defined benefit pension funds to defined contribution provident funds (refer to cases A, B and D). Trade

union members employed at Company H (refer to case H) did not transfer because they were not members of the fund. Company F (refer to case F) was a parastatal with mostly white employees and did not operate in the metal industries, neither did Company G (refer to case G).

The union view is that the root cause was the employers' lack of equal treatment of members – if this problem did not exist, conversion would not have been necessary. In defined benefit funds, sponsoring company executives controlled the funds – not even white management was involved. This management style needed to change.

### ➤ **Employers**

In the 1980s, employers in the metal industries in particular experienced strikes, work stoppages and hostility in the workplace. There was a political battle being waged on the shop floor which manifested in union agitation for members to access their pension assets. Although some employers initially resisted union pressure, they eventually relented because of pressure on their company's profitability. Also at this time, international sanctions were starting to impact on profitability. The employer body of the metal industries considered the matter and eventually agreed to member demands to transfer to provident funds. Through the 1980s and into the early 1990s, member transfers to defined contribution provident funds were union initiated.

After 1994, union pressure continued and unions engaged with the FSB to initiate legislation to enforce member representation in the management of pension funds. Legislation was proposed to require the establishment of Boards of Management for funds and included a provision that at least 50 per cent of trustees would be member elected. There was concern from employers that they would lose control over the funds and that this presented a significant risk to the business. Under defined benefit arrangements, the employer was required to underwrite any deficit in the fund. Employers were concerned that member elected trustees would make inappropriate decisions that would result in financial implications.

The pending legislation and indications that the cost of risk benefits (due to the increasing prevalence of HIV/AIDS) was rising, resulted in employers initiating a process to convert benefit structures from defined benefits to defined contributions where members would carry the investment risk and bear the impact of rising costs. There was a drive across all economic sectors to convert (refer to cases A, B, C, D and G) at this time. Fund E did not convert at this time because the sponsoring company's founder was opposed to conversion. It did subsequently convert as an employer initiative a few years later. Fund F served members of a parastatal (refer to case F). Trustees of Fund H (refer to case H) were not convinced that conversion to defined benefits was in the best interests of the fund members – non-unionised senior employees.

To a lesser extent, the issue of providing the most effective member benefits was a driving force for conversions. Younger members in particular did not intend remaining employed at the same company until retirement and were dissatisfied with poor withdrawal benefits offered by defined benefit funds. Office staff at Company D (refer to case D) requested defined contributions in 1993, but the company only converted in 1998.

### ➤ **Consultants**

Consultants were active in advising unions and employers on pension fund matters. In the early 1980s, one brokerage in particular was active in encouraging unions to question the benefits and value that members obtained from pension funds. In particular, they highlighted the shortcoming of existing benefit arrangement in providing adequate withdrawal benefits and black members possibly subsidising white members who lived longer after retirement. In proposing alternatives, defined contribution provident funds were suggested as the solution.

This emerging brokerage already had existing relationships with senior executives of major companies through its other business activities and in the early-1990s was advising companies to convert their defined benefit funds to defined contributions. Employers were advised that the surplus could be accessed by the company. Consultants also gave presentations to companies detailing the rising incidence of

AIDS and its potential impact on defined benefit funds. In particular, many young AIDS orphans would require pensions until they reached maturity and this would be a very expensive exercise for the fund, and failing it, the employer, to subsidise.

Consultants employed at life offices were finding increasing difficulty in retaining clients who were being advised of the benefits of conversion. To preserve their share of the market, they also presented conversions as potential options for companies to pursue. Funds that converted presented a new source of revenue for various service providers.

Consultants were heavily involved in the conversion process and also influenced the process. During the 1980s, consultants advised unions on transfers (refer to cases A and B) and in the 1990s advised employers (refer to cases A–H). They remain active to present date and provide a full range of services to pension funds that are required in the emerging environment.

#### ➤ **Markets**

Prior to its correction in 1998, there was an international boom in equities. During this period, returns on defined benefit funds appeared poor in comparison with defined contributions (refer to case D). In this period of good market returns, it was easier to convince members of the benefits of converting to defined contribution structures. Under such structures, members would benefit from high returns. Many funds at the time held substantial investment reserves, given the favourable market position, some of which could be offered to members as an incentive to convert, i.e. the so-called sweeteners (refer to cases A, B, C, D, E and G).

#### ➤ **Valuation bases**

In performing fund valuations, actuaries made various assumptions. These assumptions included: how long the member was expected to live; the post-retirement interest rate (i.e. the real rate of return expected by the fund after the member has retired); the real rate of return expected by the fund between now and investment date; and the realistic present value of fund assets. These assumptions would inform the decision of whether the fund was in surplus or in deficit (i.e.

whether the fund had sufficient assets to meet the fund's actuarially calculated liability to its members). Funds often also held an investment reserve which served to cushion the financial impact on funds should market conditions deteriorate. These did not form part of the surplus. The actuarial reserve was the total amount "reserved" to fund pensions and future pensions and consisted of the actuarially calculated liability, plus the investment reserve.

As detailed above, actuaries began to refer to the investment reserve as a market value surplus and included it as surplus to the actuarial liability. Consultants advised employers that, if the fund converted and met its actuarial liability to the members, the company could access the surplus which in many instances included large investment reserves.

Valuation bases that increased the value of the surplus made it appear attractive to employers to convert the fund. All employer driven cases that converted offered members an amount equal to the funds' actuarial liability, plus a "sweetener" funded from the surplus (refer to cases A, B, C, D, E and G). Cases A, B, C, D, E and G remain in surplus.

#### **4.3.1.3 Pace of change**

##### **➤ Excessive speed**

The industry was fundamentally changed within a relatively short period of time. If funds were to be converted in an orderly, well thought out manner, several decades would have been required. The process was too fast considering all of the factors that should have been taken into consideration and the consequences of such a fundamental change.

##### **➤ Thought processes**

In the 1980s the thought process was not sufficient. There was an adversarial relationship between employers and unions and no platform for carefully considered deliberation regarding pension funds. In the 1990s, employers were concerned about their own position. The longer term was secondary.



By nature, trustees should slow things as they carefully consider the various courses of action (refer to case G). But the process moved ahead of the learning curve and people made uninformed decisions. Consultants were driving the strategy and everyone else followed suit. It was a disruptive change being driven by a particular brokerage. Change is not opposed, but the process must be “good”.

In current conversions (refer to case F) there is no inclination to rush the process, given all of the potential consequences.

#### **4.3.1.4 Uncertainty**

##### **➤ Complexity**

Respondents from all stakeholder categories mentioned the complexity of the process. There were many factors to take into consideration, some of them not easily understood by the members. Where conversions took place, there were education drives (refer to cases A, B, C, D, E and G). The education process was, however, in the hands of the employer and often contained a positive “spin” in favour of conversion. Calculation of the member’s transfer value was not transparent and members did not fully understand the obligations that they would be taking over from the employer in terms of exposure to market risk. This is evidenced in members now taking an overly conservative view when exercising individual choice (refer to case E).

Although service providers and employers were aware of the potential outcome, members were not. Members were unsure and it was a time of great uncertainty. Members were presented with obvious rewards, but the downside was underplayed. In the absence of any precedent, members chose what, on the face of things, appeared to be to their best interests.

##### **➤ Evaluation**

Before the process began, there was no prior evaluation of the potential consequences for the various stakeholders. After the conversion process had run its course, there was no formal evaluation of the outcome. It was only after the

process had been completed that various consequences became apparent and their impact started being considered.

Various respondents stated that employers knew exactly what was happening, but there was nothing to stop them. Now that the consequences are being evaluated, it has become clear that member education needs to be addressed and that the new industry and service providers that have emerged from the process need to be better managed.

➤ **Legislative framework**

The legislative framework was inadequate to cope with the conversion process. There were various ways for a fund to convert from defined benefit to defined contribution structures. In some instances (refer to cases A, B and C), the fund rules were amended. In this process, an amendment to the rules is drafted, signed by the trustees and principal officer, and submitted to the FSB for registration and to the South African Revenue Services (SARS) for approval. In other instances, members transferred to another existing fund or to a new fund (refer to cases D and E). This entailed a transfer in terms of Section 14 of the Pension Funds Act.

The legal framework within which the FSB was operating proved inadequate to identify the potentially harmful consequences for members. It was only later that the authorities were alert to the manipulation of access to the “surplus”. The Pepkor case is an example of the FSB doing the job it was required to do in protecting member interests. In this instance, substantial “surplus” was retained in the fund after members transferred. Thereafter, an attempt was made to liquidate the fund and for a few select remaining members to benefit from the remaining “surplus”. In this instance, this activity was not permitted by the FSB.

In the Sentrachem case, the matter of calculating the “surplus” was raised. The respondent argued that valuation assumptions had been manipulated to inflate the “surplus” available for distribution to the employer. In this instance, the investment reserve had also been included in the calculation of the “surplus”. The pension fund adjudicator ruled that the practice of including the investment reserve in the

surplus was acceptable practice – despite this not being the practice in the UK, where South African actuaries are required to be registered before they can practice their profession in South Africa.

The Pension Funds Second Amendment Act is evidence that the legislative framework at the time failed the members it was required to protect.

Various respondents stated that the government should have intervened, but did not.

➤ **Strategy**

The unions did not have a particular strategy regarding member transfers to defined contribution funds. The objective was to work towards political liberation and pension funds were effective tools in this process.

Employers did not have a strategy to contain the pressure they experienced during the first wave of conversions. Employers panicked and there was great uncertainty – there were many crises with strikes and work stoppages threatening profitability. Employers simply wanted the situation to return to “normal” so that production could continue.

In the second conversion wave, when employers started driving member conversions, however, they did have a particular strategy. This entailed reducing the risk that was perceived in members electing at least 50 per cent of Boards of Management. It was also aimed to contain the potentially rising costs of defined benefit funds. With the increasing instance of HIV/AIDS, risk benefit costs were potentially out of control and the requirement to pay pension to young AIDS orphans for long periods of time appeared unattractive. From the cross-case analysis it is evident that, in all instances of conversion (refer to cases A, B, C, D, E and G) members received an amount equal to their actuarial liability, plus a “sweetener” ranging from 10–30 per cent. Employers were considering what other companies were doing (refer to case G) and thus a trend appeared.

Although the emerging brokerage stated that there was no particular strategy to encourage funds to convert, several sources indicate that there was indeed such a strategy. Former consultants and several case study respondents indicated that there was a strong drive to convince employers of the risks involved with not converting the fund. These included the political (i.e. member election of 50 per cent of the trustees and potentially harmful future legislation) and financial (i.e. potentially rising costs of risk benefits and poor market conditions in future). Although the emerging brokerage stated that they were warning unions of the risk to members in the 1980s, the solution they offered was to transfer to defined contribution provident funds. There is no evidence of other alternatives being considered – such as structures that could minimise risk to members.

➤ **Collective thought**

There was no forum for effective discussion and deliberation. The Pension Funds Institute, and its successor, the IRF, was under the control of service providers to the industry. This body and the Actuarial Society of South Africa (ASSA) did debate the conversion issue from time to time, but did not formulate a coherent policy or position on the matter. The matter was not thought effectively though. It was recognised that there was a problem, but there was no surety regarding what to do.

Members were uninformed. Trustees were uninformed and were influenced by service providers.

➤ **Adversarial relationships**

The conversion process took place against the backdrop of broader events in South Africa. During the 1980s the struggle for political liberation was being fought on the shop floor. There was no constructive forum for debate on the merits and de-merits of the conversion process. Unions aggressively demanded access to their assets, employers initially resisted and then relented in the face of increasing hostility.

During the 1990s, the close relationship that business had enjoyed with government was drawing to a close. There was mistrust regarding the intentions of

the government-in-waiting whose economic policies appeared to be social interventionist. Against this backdrop, employers wanted to create as much certainty as possible and to reduce any perceived risk.

Member friendliness and consumer protection was lacking. Dispute resolution was stacked in favour of the employer. The power of the regulator was an issue as evidenced in their limited ability to protect members against their benefits being manipulated.

Conversions were actioned without sufficient thought and member interests were secondary. Unions and employers were involved in a power struggle, with service providers pushing at the side-lines. COSATU and the FSB are now driving industry reform and it has become a political issue, which is still continuing. Given the current levels of trustee education, service providers are exerting an excessive influence over the industry.

#### **4.3.1.5 Consequences**

##### **➤ Leakage**

When a member retires from a defined contribution provident fund, the benefit is paid as a lump sum. If the benefit is taken in cash, tax is payable. If the benefit is immediately applied to purchasing an annuity, tax is paid on the annuity income. Unlike defined benefit funds where the fund provides the annuity, under defined contribution arrangements members are required to purchase their own annuity.

The lump sum payment is a product of life-time of saving and is often fairly substantial. If members spend the lump sum rather than invest it in a pension, they will need to rely on the state thereafter. If members do purchase an annuity, they usually require the assistance of a financial consultant to advise them where to invest the money. Consultants require payment and often advise the member to invest in living annuities where on-going investment advice is required and where an on-going commission is payable. This represents substantial leakage from the retirement capital available to fund the member's retirement.

Leakage also occurs with the additional fees that fund members are required to pay under defined contribution arrangements. Under defined benefit arrangements, the member will receive a specified benefit and does not need to consider the costs involved. Previously employers would be required to fund the costs if the fund was unable to meet them (refer to cases A, B, C, D, E and G). Under defined contribution arrangements, costs directly impact on member benefits. The retirement benefit consists of contributions made by members and employers, plus investment growth, less costs. Given the various services that members must now fund, the cost leakage can exert a substantial influence on the capital available for investment at retirement.

At retirement, members may be tempted to spend a portion of the lump sum on consumer items and invest the balance. One of the respondents stated that at retirement, for a moment in their lives, members are rich, and they may not be able to apply fiscal constraint. This can also result in substantially lower retirement income.

➤ **Service provider dominance**

Consultants were active in the process of converting funds from defined benefit structures to defined contribution structures and in the process of considering conversion (refer to cases A–H). They collected fees for facilitating the process. They then acted to fill the space for service created under the new arrangements, as a wide variety of new services were required. The division of the IRF into two structures shows the intensity to which service providers dominate the industry.

Under defined contribution arrangements, administration is more complex. Each member owns assets held in an individual investment account. Administration systems designed for defined benefit arrangements were inadequate. Many companies had administered defined benefit funds within their human resources departments, but found it necessary to outsource defined contribution arrangement administration to benefit administrators. During the 1980s, newly established defined contribution funds for union members were administered by the service

providers and not by the employers (refer to cases A, B and D), given the members' distrust of their employers.

Under defined contribution arrangements, investment administration is more complex. Because the member is exposed to market risk, the speed with which monthly contributions are invested become an issue for consideration. Previously if delays occurred in investment, it would impact on the large defined benefit investment pool. Many in-house benefit administration departments were not adequately resourced or equipped to provide the required service.

When members were required to elect at least 50 per cent of the trustees, a need arose for trustee education, which service providers started to deliver. Boards of Trustees also required expert advice on various technical matters and appointed "trusted advisers" to consult on all matters relating to the funds.

Under defined benefit arrangements, fund investments were usually managed within the employers' finance department. Because employers often considered the fund to belong to the company, they managed the fund assets as if they were their own. This has changed substantially. Asset managers are now heavily involved in consulting to funds on where to invest their assets.

#### ➤ **Surplus**

Fund surplus was derived from various sources, including monies reserved for members, but not paid on withdrawal where vesting scales were applied. The cross-case analysis (refer to Appendix 17) shows the trend in transfer benefits paid to members. In the union driven wave, members did not share in the surplus. In the employer driven wave, members were given a "sweetener", funded from the surplus. In many instances, the investment reserve that served to cushion market risk was included as surplus and not considered as actuarial liability to the member, although it existed to ensure the member's benefit could be provided irrespective of market conditions prevailing at retirement.

After the employer driven conversions, surplus existed in the funds and employers were often advised that they were entitled to access the surplus in various forms.

After members transferred, funds still held surplus (refer to cases A, B, C, D, E and G). In some instances, the last few remaining members deliberately liquidated the closed defined benefit fund and received disproportionately high proceeds from the fund. In determining transfer values, members were not treated equally and the benefits changed over time. Trustees did not play the active role that was required of them in ensuring that fund actions were in the best interests of the members.

➤ **Social benefit eroded**

Under defined benefit arrangements, employers were responsible to underwrite the risk of poor investment returns. As is evident from the concerns raised about the investment reserve, employers took steps to mitigate the risk. One of the respondents pointed out that the question to be asked about a social benefit is: who is best able to provide the benefit?

Now that employers do not underwrite the risk, members carry the risk. If members are unable to manage the risk, they will be required to rely on the state for assistance. National Treasury is very concerned about the massive increase in social grants. Lump sums have caused dilution of SOAP and costs a great deal.

Under defined benefit arrangements, pensioners received pensions from the fund and were able to appeal to the company in the event of problems arising with payments. Under defined contribution provident funds, members were required to purchase an annuity from a life office. Once the member had retired from the fund, or agreed to an outsourcing arrangement, they were outside of the Pension Funds Act and subject to the Long Term Insurance Act. This meant that disputes could not be referred to the pension fund adjudicator and required consideration by the long term insurance ombudsman. Pensioners were left in the cold.



➤ **Education requirements**

Under defined benefit arrangements, members were not required to make any decisions or consider the impact of market conditions on their retirement benefits. The benefit was guaranteed and set out in terms of a particular formula. Member elected trustees were not required to make decisions that would have a substantial impact on members.

With “information disequilibrium”, members were worse off and did not understand the risk. Member education is vital to ensure that defined contribution structures work to their benefit. The introduction of member choice has made this need even more critical. Trustees require on-going training to ensure that they can make informed decisions to the benefit of the members.

➤ **Risk**

The only change for employers in the conversion from defined benefits to defined contributions is investment risk, other employer obligations remain the same.

Members have acquired several types of risk, including investment risk and interest rate risk. The defined contribution benefit paid to members on retirement includes return on investments. When markets perform well, member benefits will increase, when markets perform poorly, member benefits will decrease. The difficulty faced by members is that markets will inevitably rise and fall and that the timing of these events will always be unknown. All that members can do is mitigate the risk themselves, if they have member choice, by selecting a guaranteed portion for investment or rely on their trustees.

In a defined contributions fund, members may want to invest differently if they consider themselves to be sophisticated individuals and may prefer a more aggressive investment approach. Concern has been raised that where members have investment choice, their appetite for investment risk is too conservative and may well produce insufficient growth for adequate retirement benefits (refer to case E).

Members also face interest rate risk. When members retire, the annuity benefit they receive will be determined by prevailing interest rates if they select to purchase a conventional annuity. If interest rates are relatively low at the time of retirement, members will receive a lower annuity payment than if they had retired at another time. In most instances, members do not have a choice regarding their retirement date.

Members who purchase a living annuity face market risk. On an annual basis they are required to select an amount that they will withdraw from the investment. To ensure that the investment provides an adequate income for life, members need to select an appropriate level of withdrawal that does not deplete the capital (i.e. the drawings over time should not exceed investment return). This requires a reasonable understanding of market mechanisms.

➤ **Unclaimed benefits**

When members withdrew from defined benefit funds and did not receive their full reserve, monies retained in the fund became part of the surplus. The same is true for members whose benefits remained unclaimed for some reason. Under defined contribution structures, each member holds an individual investment account. Unclaimed benefits were retained in unclaimed benefit accounts and accrued interest. This amount of money has grown to significant proportions across the industry and lies dormant.

➤ **Intergenerational cross-subsidisation**

Under defined benefit arrangements, the fund rules set out a particular benefit formula that determined the pension to be paid to the member. Through management of the surplus and investment reserves it was possible to ensure that benefits were paid irrespective of the market conditions that prevailed in a particular period. For example, if a member was employed at a company during a generation of recession and poor market conditions, the member would still receive the benefit as set out in the rules, funded from reserves accumulated during periods of market prosperity. Thus, members from one generation would subsidise members from another, depending on the market circumstances.

Defined contribution arrangements preclude this possibility. Thus, for example, members whose entire working careers occur under poor market conditions will be worse off than members whose entire working careers occur under good market conditions.

#### ➤ **Intentions**

There were good and bad intended consequences and good and bad unintended consequences. The good intended consequences were that members could experience greater transparency in their retirement funding and could have more control. The bad intended consequences were that members carry a risk for which they are not equipped and that members were prejudiced by unfair transfer values. The good unintended consequence was that members are now more aware of their vulnerability at retirement and that various steps now have to be taken to resolve what is wrong in the industry. The bad unintended consequences were that pensioners were left out in the cold and service providers stepped in and took control of the industry.

The overall result is poorer retirement benefits. Members are underfunded for retirement and also need to pay for ancillary benefits. There is also a reduction in retirement provision because members took their money on withdrawal and spent it. There is a great lack of member knowledge and employer responsibility has reduced. The surplus was not intended, nor was poorer returns. Intergenerational cross-subsidisation is a major issue. Member's benefits now depend on how markets perform during their own working life span. How much is required for income replacement is now vitally important, as is member education. Trustee education, the costs of compliance and investment conservatism are cause for concern.

#### **4.3.1.6 Redress**

##### ➤ **Leakage**

In the early 1980s, there was an attempt to force members to preserve their retirement funds on withdrawal. Strikes and work stoppages followed and the idea was abandoned. Various respondents have speculated that compulsory

preservation will be a feature of the revised pension funds act. Others have suggested that pension funds will replace provident funds. If this becomes the reality, then leakage from cash withdrawals on withdrawal and retirement would be eliminated.

➤ **Service provider dominance**

Prevailing conditions in the industry were discussed in the orientation to the research. The trade unions and FSB in particular took issue with perceived service provider dominance in the IRF. Their argument was that the IRF represented funds and that funds were represented by trustees, therefore the IRF should be a body for trustees only.

There was also resistance to a service provider driven trend towards umbrella funds. Umbrella funds are established by service providers, who appoint the trustees, the administrator and investment providers. Thus, umbrella funds provide all of the services of a stand-alone fund under the brand of one insurer. Various employers participate within the umbrella arrangement and their role is often limited to paying contributions on a monthly basis. The unions in particular have resisted the further proliferation of umbrella funds and the FSB has raised concerns over these structures especially with regard to the appointment of trustees and the ability of members to influence the management of the fund.

Trade unions have suggested that sector funds should be established where members who work in a particular sector would be required to join. The perception remains that service providers are disempowering trustees and that asset managers are in control of the fund assets. More developments in this regard can be expected.

➤ **Surplus apportionment legislation**

The Second Amendment to the Pension Funds Act came into effect on 7 December 2001. This amendment gave current members, former members, pensioners, deferred pensioners and employers the right to share in any surplus that had been built up in the fund. If a fund has a surplus, former members, who

did not previously receive minimum benefits as set out in the amendment, will receive a cash payout and pensioners who did not receive adequate increases will receive a pension top-up. After former members and pensioners have been reimbursed the balance of the surplus must be shared out between all of the stakeholders, including former members, pensioners, employers, current members and deferred pensioners. Thus, former members and pensioners may receive a further cash payout or pension top-up.

Once the surplus apportionment scheme has been drawn up, all stakeholders must be notified and they have twelve weeks from date of notification to lodge an objection. All funds are required to submit a surplus apportionment scheme to the FSB for approval. If the fund is not in surplus, it must submit a “nil apportionment scheme”. The amendment requires funds to consider former members who left the fund from 1980 onwards. The surplus only requires apportionment if the fund is evaluated as holding a surplus at the surplus apportionment date. A total of 75 per cent of the trustees must approve the scheme. A Board of Trustees must address all complaints from members, former members and pensioners and obtain approval from the FSB before the surplus can be distributed.

The amendment sets out various activities that would be considered improper use of the surplus and if this occurred, the employer is required to make a re-payment to the fund. A shortcoming of the amendment is that it requires the surplus to be apportioned only if it exists at a specified date, which varies from fund to fund. It also does not consider contribution holidays taken by the employer prior to the effective date of legislation.

Although the cut-off date for submission is 1 April 2006, fewer than ten per cent of funds have submitted surplus apportionment schemes.

➤ **Social benefit erosion**

In its white paper on pension fund reform, the National Treasury identified occupational pensions as one of the pillars of a retirement funding system. The

National Treasury hopes to develop a retirement system where member reliance on the state for provision for old age can be minimised.

➤ **Consumer education**

After the conversions, companies realised that on-going member education would be required (refer to cases A–E). Members require far more education than before. Now some companies have quarterly newsletters and spreadsheets for members to determine their retirement needs. This is required to ensure that members understand the risks that they bear. The FSB is driving consumer awareness campaigns and supports initiatives to improve trustee education.

➤ **Risk management**

Various asset managers have developed products that can be purchased by the fund to manage risk. These are structured portfolios and can be very complex and costly.

➤ **Unclaimed benefits**

The National Treasury white paper proposed a national savings fund where unclaimed benefits would be retained and applied for by members who subsequently surface to claim the benefit. It was argued that members whose benefits remained unclaimed would eventually turn to the SOAP for support, therefore, it seemed reasonable that the state should have access to the funds. Although it has been suggested that the current Pension Funds Act should be amended to resolve the matter of unclaimed benefits, no draft legislation has yet been published.

➤ **Pension fund reform**

Respondents were unanimous that the existing Pension Funds Act is outdated and requires amendment. A revised act has been promised for several years and the process is taking a long time. The first white paper was issued in December 2004. Submissions were made by various industry stakeholders and there was a general expectation that a second paper would be issued in 2005. This did not happen and it is expected that the second white paper will be issued in 2006.

#### 4.3.1.7 Relative power of stakeholders

Respondents were asked to rate the relative power of the stakeholders during the conversion drives and at present. Results are as follows:

Table 1: Relative power of the stakeholders

<b>Stakeholder</b>	<b>1980s</b>	<b>Mid-1990s</b>	<b>2006</b>
Trade unions	5	3	2
Regulatory framework	0	1	2
Employer/business	3	3	1
Service providers	2	3	4
Members	0	0	0
Trustees	0	0	1

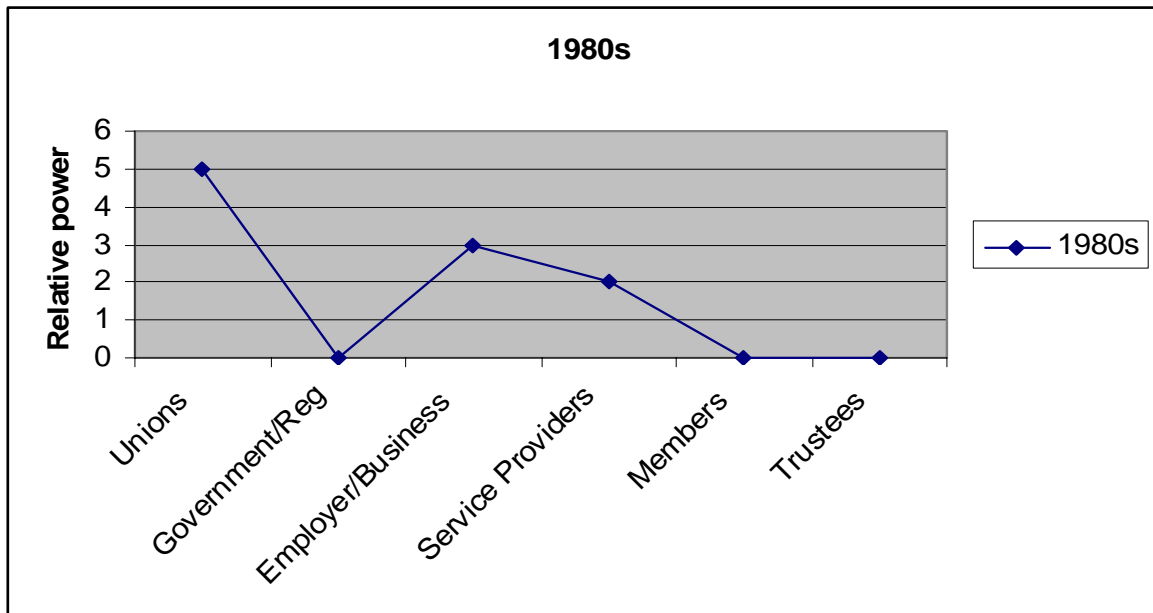
This reflects how the industry dynamic has evolved over the period under review.

##### ➤ **First conversion wave**

In the 1980s, the emerging trade unions were exerting much influence in their role as proxies for the government-in-waiting and disenfranchised members. The regulatory framework in place at the time was not effective in protecting member rights and the appointment of trustees was not a legal requirement. Employers acceded to union demands. Political and union activity were key drivers of union member transfers to defined contribution provident funds. Although it seems unlikely that employers did not recognise that investment risk would shift when members converted to defined contributions, evidence indicates that this matter was not tabled. Trade unions were demanding pension structures featuring better withdrawal benefits and lump sum payments on retirement and were creating labour unrest to achieve this objective. Business wanted to restore order to the workplace to ensure on-going profitability.

The graph below details a graphical representation of relative stakeholder power.

Graph 1: Relative power of the stakeholders in the 1980s



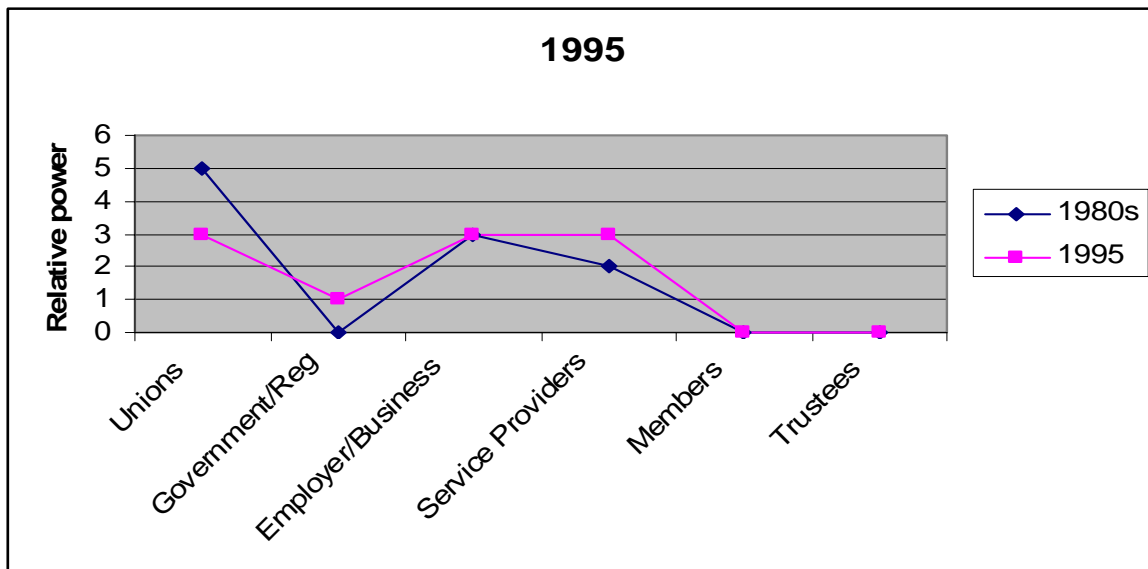
➤ **Second conversion wave**

Trade unions exercised less of an influence in the mid-1990s because their members transferred in the first conversion wave and it was predominantly white, non-unionised office workers who converted in the second wave. Employers, and their service providers, were the key drivers. Unions were involved with negotiating benefit “enhancements” where their members were party to conversions. They also influenced the regulator, who had experienced a change in government, to enact legislation to provide for Boards of Management, at least 50 per cent of whom were required to be member elected. Thus, some union power was redistributed to the regulator and to service providers who were consulting to all stakeholders.

The graph below shows the changing dynamic.



Graph 2: Relative power of the stakeholders in the mid-1990s



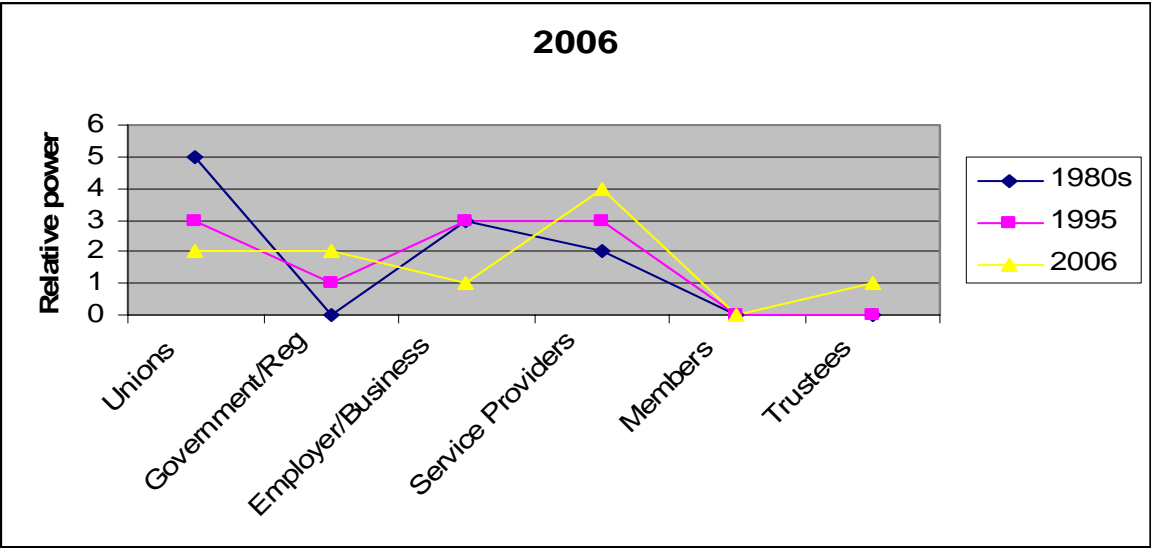
➤ **Current situation**

Trade unions have stepped down in favour of the FSB in various areas of industry activity. Employers gave up power to trustees and service providers. Where employees are members of defined contribution funds, employers are less interested in the management of the fund. They also rely more heavily on service providers who manage all aspects of funds on their behalf. At present, the FSB is seeking more power since its power is still limited.

Service providers have largely replaced employers and control the industry – often by having a persuasive influence over trustees. Government is working on updating legislation, the adjudicator has taken a firm stance against member exploitation and is making rulings that are reducing unacceptable business practices. Trustees are now more conscious of the division between boards and collective bargaining structures. They are not really empowered, but there are exceptions. In general, too much is left to the service provider. Members are more aware of rights and complaint mechanisms.

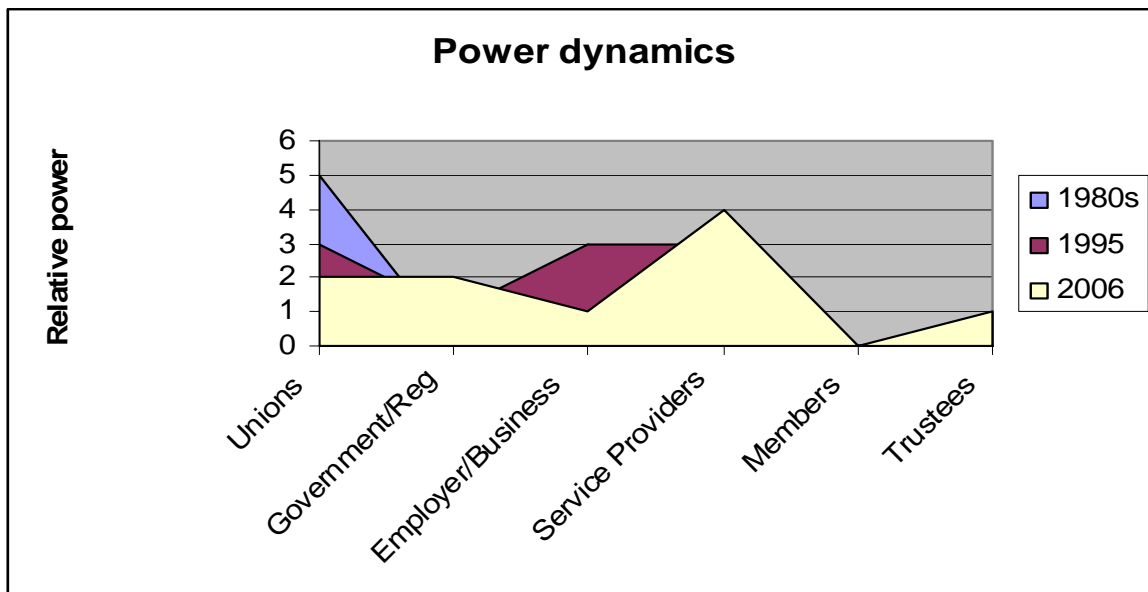
Research results clearly indicate the industry dynamic – manifested in the relative influence of the various stakeholders at various times during the period under review. This provides a strong pointer to future industry developments.

Graph 3: Relative power of the stakeholders in 2006



The graphical representation below indicates power lost by the trade unions and the employer/business stakeholders. It is evident that the regulator, service providers and trustees gained power. It is interesting to note that the combined power of the trade unions, trustees and regulator FSB now equals the power of service providers and employer/business.

Graph 4: Power dynamics between 1980–2006



Case F is a good example of a fund where the employer is no longer in control of the fund – it is in the hands of the trustees. The members are more interested in the process and expect protection from the FSB. The unions will defend the defined benefits fund. Trustees will ensure that they act in the best interests of the members.

#### 4.3.1.8 Ethical considerations

##### ➤ Members worse off

At the time of data collection between March and November 2005, markets were not performing as well as in the past and it was often stated that the low inflation, low investment return environment was a further shock to the environment. Markets have firmed since then and members in defined contribution structures would have seen their asset values rise. Members cannot lock-in any profits until they retire, withdraw or switch investment portfolios. One of the principles of market behaviour is that markets will rise (and member values will go up) and fall (and member values will go down). This is the investment risk.

Members who converted in the mid-1990s suffered the market correction of 1998 soon thereafter. Members due to retire at that time were often unable to defer their retirement and were obliged to disinvest at the bottom of the market. These members sustained heavy losses and were much worse off than if they had remained in defined benefit structures.

One of the trustees pressed the issue of what was “fair and reasonable” at the time (refer to case E). There is no evidence of Boards of Management considering “is this the best thing to do?” The Boards of Management were more concerned to follow due process and protect themselves. They were implementing decisions that had already been taken by company boards.

Members took over investment risk from employers and lost the social benefit of employers underwriting the funds. The rule of thumb is: if a member converted and then withdrew, the member is better off; if a member converted and stayed, the member is worse off; if a member did not convert and withdrew, the member is worse off (although minimum withdrawal benefits set out in legislation have now resolved this problem), if a member did not convert and stayed, the member is better off.

➤ **Member protection**

For members to be equipped with “information equilibrium” will take a long time. The solution is to implement some minimum educational standard for each and every employee. Give people a reason to learn more – for example, a small salary increase can be given if they pass the investment course. A concerted and conscious effort must be applied.

Members made choices. The employer and actuary knew about the issues and ethics should have intervened, but never did. The life offices are slow to change and the element of trust has been lost. Members made uninformed choices and did not understand. The former FSB was not interested in members. Under the cover of individualism, the process was not equal. Employers may have planned in some instances to get hold of the surplus.

The FSB is seeking more power to become a “member protector”. The evolutionary process is not yet over and confrontation may be looming. Complaints are still rising, with members now more aware of their rights. Pension complaints are now going to the pension fund adjudicator.

If the process moved slower, it might not have happened at all – speed was better for the employer (refer to cases A and B). The markets were running and members were eager to take the sweetener and benefit from future market upside. For members, slower would have been better, because they would have had the time to grow in their understanding of what was happening.

The process of conversion for Fund E (refer to case E) took from August 2000 to March 2001 – only eight months. Prior to this, no mention had been made of converting the fund. This period was inadequate for members to digest the implications. An emerging brokerage took the gap. (The organisational structure of others prevented them from moving so quickly.)

➤ **Employer concern**

It became evident from the case studies (refer to cases A, B, C and E) that conversions impacted on organisational culture. Employers appear to be less interested in members. Members felt that employers were trying to distance themselves from providing a caring family environment as they had done in the past. The employer is no longer viewed as the last port for destitute beneficiaries.

Some knew what was going on, especially actuaries and consultants. Many employers recognised that conversions could result in problems, and did not want to make conversions. They raised questions, but the tide was turning and the unions pressed the issue. Some took a stand, but were unable to persuade the unions otherwise. All employers cannot be grouped together – some cared, others did not. Most proceeded ethically, but some took unfair advantage of the situation.

- **Fund A and B**

From the employer's perspective the process needs to be facilitated and members educated. From the members' perspective – they have seen the consequences, they are not knowledgeable enough and do not want to manage their own retirement provision. With cost-to-company, it is now just a financial transaction. Even closed pension schemes are off-loading their liabilities. The world of work has changed and the culture of the company has been impacted. Employees previously stayed for ten to fifteen years, now the average is three years.

- **Fund C**

Ethical considerations were not raised. The company controlled the message and put on a positive spin. Members signed documents stating that they had received communication. Of interest is the fact that many senior managers chose to remain on the fund after the first conversion offer. Many only converted after the second offer because the environment was less certain after major company changes. The crucial factor was timing. If the conversion was left until 2000, member response may well have been different.

- **Fund D**

At the time of the first wave, the managing director said that the company had a moral obligation. The board dragged its feet because of this, but there is no valid reason to argue that ethics was not considered. Global profits were high on the corporate agenda. Corporate USA wanted sustainability, so there was a drive to get risk costs out. USA companies have strict audit provisions and had to indicate fund liability, thus the defined benefit fund impacted on the bottom line.

The style of management changed in 1997. The rise of the unions changed the balance of power. Employees did not understand what they were doing and everyone was uncertain. Employees thought they could control their own money and did not think about the control in the recipient fund. They are more willing to listen to the company now that they have had difficulties with

disability benefits and see the consequences of disability benefits not being paid.

- **Fund E**

The feeling in the passageways at the time was that the company was less concerned about the employees and expected them to fend for themselves. The idea of Big Brother – the employer as life mentor – no longer exists. There appeared to be a culture change with the company concerned about what was best for the company.

There was no union involvement – prior, during or after the conversions. The Board of Management of Fund E and Board of Directors never clashed or disagreed. There was no struggle. The structure has remained the same – the employer has been dominant, but that is not blatantly obvious. (It is important to note that very senior people were on the Board of Trustees as employer nominated trustees and member elected trustees may have been intimidated or reluctant to make “career limiting statements”.)

- **Surplus**

Members who transferred in the first wave received their own contributions plus interest or an amount equal to the fund’s actuarial liability to the member. They did not know about the surplus and did not share in any part of it. Employers and actuaries did a disservice to members. Part of the surplus was sourced from withdrawal profits that arose when members who withdrew from the fund did not receive their full value.

Members who moved during the second wave did get part of the surplus, but in calculating transfer values, they were underpaid. Legislative change highlighted the surplus issue. The inclusion of the investment reserve in the surplus raised ethical concerns about the practices followed by South African actuaries as opposed to

those of their counterparts in the UK. There was some deliberate unethical behaviour. In particular, the Pepkor case<sup>18</sup> was totally unethical.

#### **4.4 CONCLUSION**

Research results reveal the successive “waves” of pension fund conversions. In the 1980s the first wave was politically motivated and driven by the trade unions. They strongly asserted their demand for improved withdrawal benefits and lump sum benefits at retirement. There was a strong desire to exert political influence and the struggle for control over pension fund assets was a manifestation thereof. In the first wave, black union members transferred from defined benefit pension funds to defined contribution provident funds. There is no evidence that the potential consequences of transfers for members were considered. The matter of defined contribution structures versus defined benefit structures did not feature on the agenda. When members transferred, they received minimal transfer benefits and no part of any “surplus” that may have existed in the fund at the time. This wave occurred largely in the metal industries and other industries that were heavily unionised.

The second wave was employer driven and advised by service providers. There was concern over the potential increase in costs associated with defined benefit funds and over legislative changes that would require Boards of Trustees to be established and 50 per cent of the trustees to be member elected. Because many unionised members had already converted in the first wave, the second wave involved members in non-unionised sectors, especially in the financial sector. Although there were communication exercises to allow members to choose whether they wanted to convert from defined benefit to defined contribution structures, the message was biased towards conversion. Members transferred with a value equal to the funds’ actuarial liability towards them and a “sweetener” to encourage their conversion.

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<sup>18</sup> Pepkor Retirement Fund v FSB unreported case 198/2002 (SCA). The Supreme Court of Appeal upheld a decision of the court *a quo* to allow the Registrar to rescind a Section 14 certificate. It was alleged that information provided in the Section 14 documentation regarding the size and allocation of the surplus was incorrect.



After the members converted there were substantial amounts left over in the surplus. In some instances there was deliberate manipulation and unethical behaviour by employers and service providers to allow the employer to access surplus funds. In other instances, the motivation for the conversion was to enable employers to access the surplus. Although some employers did exercises to compare the various options, most only gave members a choice between remaining on existing defined benefit funds or converting to defined contributions in other existing or new funds.

The conversion process appears to have proceeded faster than an effective thought process required for a change of this magnitude. The process was complex and the legislative framework was inadequate to provide the necessary guidance. There was no strategy and adversarial relationships precluded collective thought, especially in the first wave. There were steep learning curves.

The outcome of the conversion process was of fundamental importance to members. They would be required to understand a great deal more than they had before and take on substantial responsibilities that they previously were not required to bear. In particular, they acquired investment and interest rate risk. Employers off-loaded their previous social responsibility of underwriting the investment risk in defined benefit funds and the structure of the industry changed fundamentally. The members' needs did not enjoy priority. Members were worse off in many conversion instances and remain in need of protection. The deliberately unethical behaviour in some instances will go unpunished, but some may be highlighted when surplus apportionment schemes are presented for consideration.

As a result of these consequences, action was required to resolve particular difficulties that had arisen. Following union pressure, legislation was enacted in 1998 to set out rules for surplus apportionment between the various stakeholders. Because members who had transferred as far back as 1980 had been shortchanged, legislation included in apportionment considerations any former member who had left the fund from 1980 onwards. To date, this legislation has yielded limited results. Attempts are being made to educate trustees and members

to sufficiently understand the challenges posed by defined contributions. Pension fund reform is being considered and developments in this regard are expected shortly.

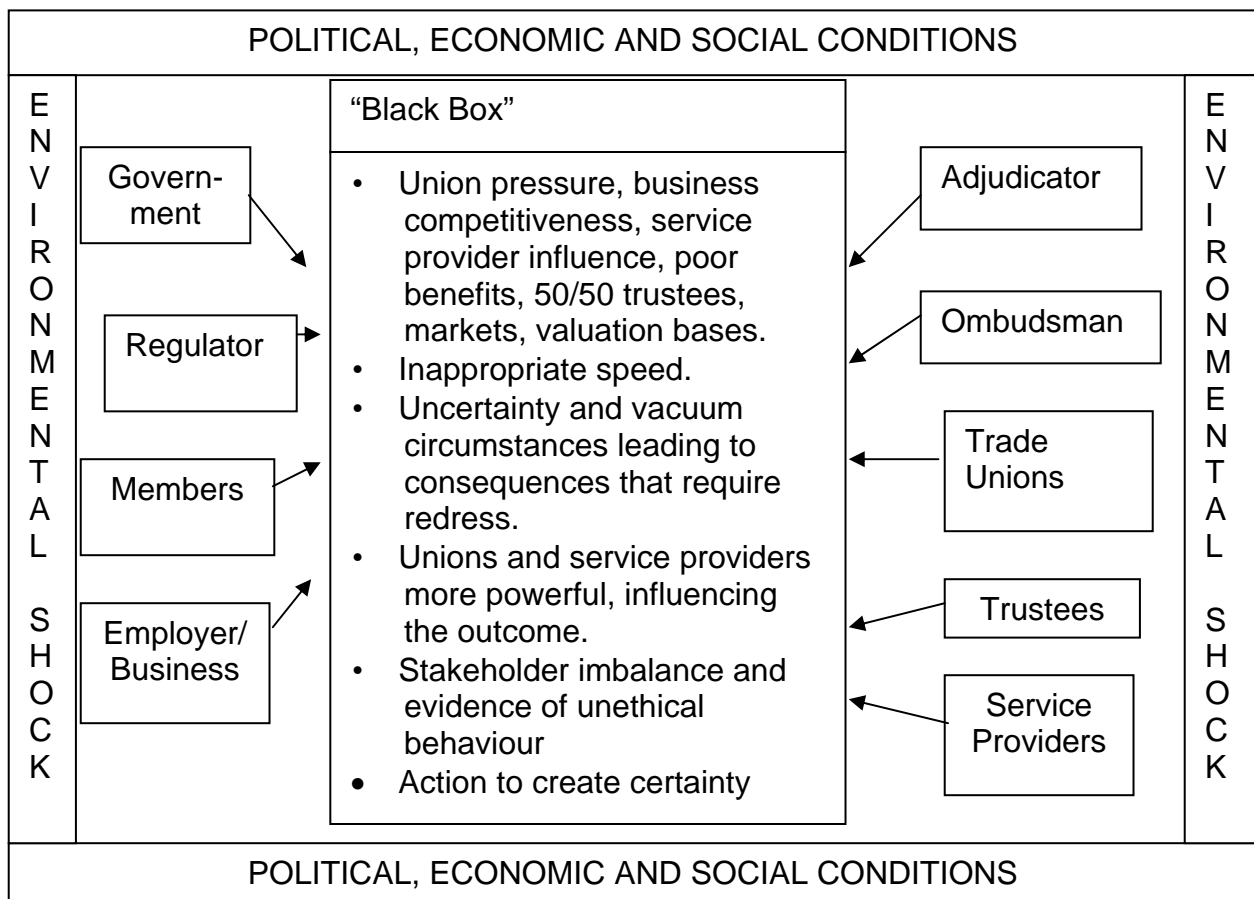
Over time, the power dynamic between the various stakeholders shifted and today there is a stand-off between service providers on the one hand and trustees/unions and the FSB on the other.

Many of the funds subjected to the first and second conversion waves remain in existence today and their members are aging. A third conversion wave is gathering momentum against the backdrop of improved markets and employer concern about rising costs involved with defined benefit funds closed to new members. It does seem, though, that any unilateral conversion attempts by employers will be resisted.

**CHAPTER FIVE**  
**DISCUSSION, RECOMMENDATIONS AND CONCLUSION**

**5.1 DISCUSSION OF RESEARCH PROPOSITIONS**

A model emerged from the analysis of pension fund conversions between 1980–2006. As set out in the research framework, the dynamics occurring in the “black box” became evident.



**5.1.1 Environmental shock**

Pension fund conversions occurred within an environment<sup>19</sup> that was experiencing an environmental shock that changed the “rules of the game<sup>20</sup>”. From the analysis,

<sup>19</sup> Conditions within which an organisation operates.

<sup>20</sup> The framework within which the various stakeholders operate.

it is evident that fundamental political, economic and social change was taking place in the environment. Politically, in the 1980s, following extensive labour law reform, trade unions became the proxy of the government in exile and agitated for control over black members' assets in pension funds. The resulting hostility in the workplace placed employers under substantial pressure given that international sanctions were also impacting on profitability. Later, in the 1990s, legislation to introduce member elected trustees was a further shock. It presented the reality that decision-making regarding pension funds would be shared with members. Economically, the cost of providing benefits was increasing and the risk involved in underwriting defined benefit funds was reducing certainty for sponsoring companies.

It can thus be accepted that pension fund conversions occurred in circumstances of environmental shock, where the rules of the game were changing and existing rules were proving inadequate. Several observations regarding organisational behaviour during environmental shock were made and can be considered in terms of the research propositions.

### **5.1.2 Proposition one: Factors combine to drive evolution (i.e. adaptation to the environment)**

Within the environmental shock, organisations were evolving (i.e. adapting to their environments). Revised legislation and social pressure released trade unions into the environment where they immediately asserted their power in an industry where they had a concentration of members – the metal industries – and over an issue that would reach into the heart of the organisation – the pension fund. Company reaction was initially to resist and then to accept that the rules had changed and permit union members to transfer to defined contribution provident funds. Pension funds evolved with the changing environment – defined contribution funds became more prominent and several defined benefit fund membership profiles changed and retained surpluses from members who had transferred. Unions remained dissatisfied with employer control over pension funds and successfully pressured the government to legislate the member election of at least 50 per cent of the

trustees. This made employers uneasy and, encouraged by consultants, triggered a drive by the employers to convert members to defined contribution structures.

Research results indicate that various factors drove the process. Taken in isolation, the factors would have had an impact; their combination served to drive the change in a particular direction. It is evident that the trade unions acted to empower their members – this was a political and social factor – and the employer acted to reduce uncertainty<sup>21</sup> – an economic factor.

### **5.1.3 Proposition two: Organisational evolution speeds up**

The phenomenon was triggered by various factors and, once initiated, spread rapidly. It is evident from the research that, as the environment was changing, organisations were taking steps to react to the environment.

There were difficulties with defined benefit funds and it was becoming evident that the world of work was changing and that employees would not work at one company for their entire working career. It was thus inevitable that pension funds would have had to change at some point. Research shows that the environmental shock speeded this process.

The conversion phenomenon occurred over 26 years and continues today. Respondents were almost unanimous<sup>22</sup> that the process went too fast. Twenty-six years is not fast. It is possible that excessive speed in this instance does not refer to the excessive pace of chronological events, but to the inability of organisations and members to process the change as it unfolded. An environment of defined benefit pension funds is fundamentally different to one of defined contributions. A transition of this nature requires substantial thought and gradual transition. This did not happen.

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<sup>21</sup> Employers were uncertain about rising benefit costs and the impact of shared decision-making with member elected trustees.

<sup>22</sup> Business/employers suggested that there was a “pressing need”.

Research indicates that, in this instance, the speed of the process exceeded that required for necessary thought processes to occur, for all stakeholders. Yet it is not necessarily the speed of the change that is important. The important factor is whether or not the matter has been properly thought through in terms of its potential consequences and the impact on stakeholders. The issue is whether the speed of the change is appropriate for sufficient thought.

The proposition can thus be stated more accurately as: organisational evolution exceeds the speed required for sufficient thought.

#### **5.1.4 Proposition three: Uncertainty and vacuum circumstances arise, leading to unintended consequences that require redress**

The complexity of issues relating to conversions created uncertainty. From the research results (refer to consequences) it is evident that the conversion phenomenon did not merely entail a transfer of members from one type of structure to another. There were significant implications for members and for the entire industry. The phenomenon re-structured the retirement fund industry. The various stakeholders were not certain of the outcome.

It was proposed that vacuum circumstances refer to circumstances where no precedent exists and the existing rules are inadequate. This clearly occurred in this instance. The regulatory framework was inadequate and no guidelines existed for actuaries in terms of surplus apportionment. The UK had rules that prevented substantial surplus from arising, but South Africa did not. Thus, it was a situation where the stakeholders were uncertain of how to proceed and what the outcome would be and did not have a functional set of rules to apply.

Had there existed a framework (such as the proposed model) to apply as a guideline or for the purpose of analysis, there may have existed an element of certainty. This may have alleviated the inadequacy of the existing rules. It may also have provided an opportunity to consider and evaluate potential consequences so that the impact could have been better managed.

Although the question to respondents was phrased around “unintended consequences” it became apparent that there were intended consequences and unintended consequences and that these were categorised as “good” or “bad”. Thus, there are good and bad intended consequences and good and bad unintended consequences. The Pareto criteria is a useful guide in this regard. Where all stakeholders are better off, the consequences are “good”. Where some stakeholders are worse off, the consequences are “bad”.

Research indicates that several consequences, intended and unintended, arose that are now being redressed. It is thus more appropriate to state the proposition differently: uncertainty and vacuum circumstances arise, leading to consequences that require redress.

#### **5.1.5 Proposition four: relative power of stakeholders changes and determines the strategic outcome**

As evidenced over time, the relative power of the stakeholders changed. This change was a manifestation of the broader environmental changes. The unions were very powerful in the 1980s given their role as proxy for the government in exile. Their power reduced as the regulator, government and trustees began to emerge as a force worthy of consideration and shared their power. Service providers took over many functions formerly performed by the employers, and thus increased their own influence. Employers abdicated.

The strategic outcome is determined by the relative power of the stakeholders. If trade unions did not apply pressure for the establishment of provident funds, the first wave would not have occurred. The second wave may have been slower if employers were not concerned over the member election of 50 per cent of the trustees. The rise of union power influenced the strategic outcome. The relative weakening of the employer position provided an opportunity for service providers to increase their influence over the industry.

Employers successfully off-loaded defined benefit risk and withdrew from the fray. Now it is unions and service providers that are at loggerheads. The power dynamics between the various stakeholders changed and influenced the outcome.

Had the relative power remained static, it is likely that defined benefit funds would have evolved in any event, but the outcome would most certainly have been different. The process would have been gradual and member interests higher on the agenda.

#### **5.1.6 Proposition five: An imbalance in stakeholder interests<sup>23</sup> arises and ethical considerations become more consequential<sup>24</sup>**

Research indicates that the stakeholders had different interests. The regulatory framework exists to protect members, but this failed in the conversion process. Trade unions were asserting their newly acquired power and wanted greater influence. Service providers wanted to make profits and generate new business opportunities, and employers wanted to ensure their own ongoing viability.

The stakeholders did not share a common objective, that could have been articulated as “act in the members’ interests”. They were pursuing their own agendas. This led to an imbalance in stakeholder interests, with the more influential players being able to promote their particular objectives. Although the stakeholders all made reference to members, it was in terms of each stakeholder’s own objectives. Members’ needs were not the primary motivation behind the conversion phenomenon.

In this environment, ethical considerations become consequential. The research analysis identified the substantial consequences of conversions. The consequences of the actions of the stakeholders are now open to moral scrutiny.

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<sup>23</sup> An imbalance occurs where one or more stakeholders are exerting a disproportionate influence.

<sup>24</sup> Consequentialism is the doctrine that the morality of an action is to be judged solely on its consequences.



The question is whether stakeholders adhered to a particular, acceptable, code of behaviour.

If stakeholders are to be judged on the consequences of their actions, it is clear that several stakeholders will be judged harshly. Research indicates that the process was not properly considered and proceeded largely outside of the constraints of existing rules and regulations. There were intended consequences and unintended consequences and these require evaluation in terms of their impact on the members. Some deliberate unethical behaviour<sup>25</sup> occurred where stakeholders set out to access monies held in surplus.

#### **5.1.7 Proposition six: Business seeks certainty**

It became evident from the research that employers acted to create certainty for themselves. They acted to stabilise their environment. When the unions demanded access to provident funds in the 1980s they initially resisted, but then relented because they wanted to end the strikes and work stoppages to get production back on track. In the 1990s, the second wave was driven by employers, on the advice of consultants, who wanted to restore certainty to potentially increasing costs and wanted to be certain that any decisions from Boards of Trustees, whose members were 50 per cent member elected, could not be to the detriment of the business.

Thus, during an environmental shock, business acted to restore certainty and stability. They did not necessarily undertake an extensive search for alternatives in the best interests of all stakeholders, they settled for the solution that restored certainty for themselves.

## **5.2 ENFOLDING LITERATURE**

Chapter two of this research thesis concluded with answers to the research question obtained from the existing literature. From an analysis of results, it is

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<sup>25</sup> Refer to Pepkor case at footnote 17.

evident that, in one instance, the research results contradict the answers from the literature and in several instances do not adequately explain the phenomenon under investigation.

### **5.2.1 Conversion decisions by boards of trustees**

From the available literature, it was concluded that Boards of Trustees made the conversion decisions. Research results indicate that this is incorrect. In all specific manifestations of the phenomenon that were case studied, decisions to convert were made by the company board, not the trustees of the fund. This was confirmed by the experts interviews. Trustees implemented the decisions. This raises important questions regarding trustee fiduciary responsibilities. If they merely implemented a decision made by the sponsoring company's Board of Directors, questions may arise regarding whether they were acting in the best interest of the members whom, as trustees, they are required to serve.

### **5.2.2 Existing theory**

Existing theory does, to a certain extent, explain the phenomenon.

#### **5.2.2.1 Competitive shocks**

According to Ghemawat and Khanna (1998), organisations will respond to competitive shock. They define an economy-wide "competitive shock" as sweeping changes in a panoply of policies that significantly expand the role of competitive processes in determining business success or failure. They studied business reactions when India, in 1991, embarked on significant changes to its industrial policies which led to policy distortions, informational imperfections and entrepreneurial scarcity. Their studies indicated that business restructured in response to the competitive shock. This was to ensure their ongoing competitiveness and survival. Ghemawat (1997) suggests that we are living through an unprecedented experiment in social engineering – an experiment involving harnessing the power of competition through sudden, significant policy changes that are referred to as competitive shocks.

Research indicates that the conversions occurred in an environment that was experiencing a shock greater than a competitive shock. It was a fundamental change to the existing rules, but in the absence of a substitute policy framework.

#### **5.2.2.2 High turbulence**

Cameron, Kim and Whetton (1987) investigated organisational attributes commonly associated in the literature with organisational decline and turbulence. They identified a common theme that organisations place a premium on predictability and stability in transactions with the environment. They suggest that turbulence exists when changes faced by an organisation are nontrivial, rapid and discontinuous. Turbulence usually creates uncertainty, so that uncertainty is best thought of as an outcome of turbulence rather than a synonym. Their research results suggested that top managers tend to respond differently under conditions of high turbulence than under conditions of low or medium turbulence. When high turbulence is experienced there is: significantly more centralised decision-making; absence of long term planning; nonselective cuts in resources; top-administrator turnover; and loss of leader credibility. During times of turbulence, the brunt of the consequences of uncertainty falls on the top-management cadre.

Research results on the outcome of conversions indicate that leaders did not recognise or discounted or ignored potentially negative outcomes. In the first wave, consequences were not considered. In the second wave, consequences were ignored and in some instances exploited.

#### **5.2.2.3 Organisational evolution**

Hayden, Ruvinsky, Gilgoff and Sobel (2002) state that many creatures still appear quite suddenly in the fossil record, and therefore there is a growing suspicion that evolution sometimes leaps rather than crawls. Scientists, they suggest, have learned that our planet has been rocked periodically by catastrophes. Once conditions improved, the survivors found a world of new opportunities. Valle (2002) concludes that organisational evolution is directed by a process of adaptation to the environmental evolution.

Co-evolution of the firm and pension funds occurred. According to Weick (1995), as quoted by Aldrich (1999), interruptions in organisational routines disrupt communication activities triggering intensified sense-making.

Results indicate that organisations acted to create certainty and stability. In the second wave, employers were strongly influenced by consultants, who they perceived to be “guides” in the process of their own sense-making.

#### **5.2.2.4 Decision-making speed**

Eisenhardt (1990) suggests that strategy making has changed. The premium now is on moving fast and keeping pace. Fast strategic decision-making is essential. She suggests that people can make fast choices by skimping on the analysis, limiting the conflict and being autocratic. She explored how managers actually make fast, yet high quality, strategic decisions. Overall, fast decision-makers use simple, yet powerful tactics to accelerate choices: track real time information on firm operations and the competitive environment; build multiple, simultaneous alternatives; seek the advice of experienced councillors; use consensus with qualification to resolve conflicts; integrate decisions with other decisions and tactics.

Gladwell (2005) suggests that you need to know very little to find the underlying signature of a complex phenomenon and this can speed the decision-making process. The key is to find that signature. Too much information, he argues, only confuses the issue. Research evidence suggests that the underlying signature was not recognised. The drivers were not recognised and therefore the process outpaced the thought process.

#### **5.2.2.5 Strategic outcome**

John Nash (1950) introduced the distinction between cooperative games, in which binding agreements can be made and non-cooperative games, where binding agreements are not feasible. Nash developed an equilibrium concept for non-cooperative games that later came to be called the Nash equilibrium. In a Nash equilibrium, all of the player’s expectations are fulfilled and their chosen strategies

are optimal. According to the *Scandinavian Journal of Economics* (1995), Selten introduced the concept of the “trembling hand” equilibrium. The analysis assumes that each player presupposes a small probability that a mistake will occur, that someone’s hand will tremble.

Information disequilibrium resulted in a “trembling hand” and less than optimum outcome for various players (stakeholders).

#### **5.2.2.6 Ethical considerations**

Johansson (1991) states that a policy change is socially desirable if everyone is better off (the weak Pareto criterion) or at least some are made better off, while no one is made worse off (the strong Pareto criterion).

Thus, if the pension fund conversion phenomenon is evaluated against these criteria, it would not be socially desirable. It fails both the strong and weak Pareto criteria. Everyone is not better off – some are better off while others are worse off.

#### **5.2.2.7 Theory of the firm**

Penrose (1959) saw the firm as the organised combination of competences and more than an administrative unit; it is also a collection of productive resources the disposal of which is determined by administrative decision. A firm needs a variety of reserves for its operation, whether they be financial reserves, inventory reserves, or labour reserves. Implicitly, such reserves are required in order to cope with uncertainty. Kochan and Rubinstein (2000) identified propositions of the general stakeholder theory. They suggested that, for stakeholder firms to emerge, stakeholders must: have sufficient power to compel influence and sufficient trust must be present among shareholder and stakeholder leaders to believe a partnership can work. Incentives under which leaders are employed must motivate them to be responsive to the interests of all the stakeholders.

Firms utilised pension fund assets as if they were the firm’s own resources. This is no longer possible in terms of amendments to the Pension Funds Act. Various

elements required to ensure that actions were in the interests of all stakeholders were missing.

### **5.2.3 What the literature does not explain**

The literature does not explain how organisations respond to fundamental environmental change<sup>26</sup>.

## **5.3 CONTRIBUTION TO THEORY**

Research on the pension fund conversion phenomenon suggests various contributions to theory:

### **5.3.1 Definition of environmental shock**

Pension fund conversions occurred against the backdrop of fundamental change in South Africa. The political dispensation was changing, and major social change was occurring as the country transformed from apartheid to constitutional democracy. It was a transition from control by the minority to control by the majority and the economy was opened up to globalisation after decades of isolation and sanctions. An economy-wide “competitive shock” is defined (Ghemawat & Khanna, 1998) as “sweeping changes in a panoply of policies that significantly expand the role of competitive processes in determining business success or failure”.

Environmental shock can be defined as “a condition that arises where business or societal rules are inadequate, or do not exist, to deal with unfolding events”. An environmental shock has greater magnitude than a competitive shock, and can include several competitive shocks. In an environmental shock, as evidenced in the research on pension fund conversions, various dynamics occur, as set out in the

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<sup>26</sup> The literature refers to competitive shocks and high turbulence, but not to environmental shock. Feedback from a paper on the proposed research submitted to the Eastern Academy of Management included the comment: “Some very interesting ideas that promise to shed new light on a very important topic that pertains to institutional developments that arise from environmental shocks and fundamental external changes.”

research propositions above, that eventually result in a modified or new set of rules.

### **5.3.2 Under environmental shock, organisations seek certainty**

The research indicates that business acted to create certainty in both the first and second waves. During the first wave, they acted to reduce the uncertainty of strikes and work stoppages by permitting union members to convert. This created a greater level of certainty that production would continue. In the second wave, they acted to reduce the consequences of the uncertainty of decisions that would possibly be made by Boards of Trustees, 50 per cent of whom would be member elected. By converting the funds, business would be certain of their financial obligations to the fund. The third wave of encouraging remaining members of defined benefit funds who did not convert previously to convert now, is driven by the uncertainty of rising costs to the employer.

Cameron, Kim and Whetton (1987) identified a common theme that organisations place a premium on predictability and stability in transactions with the environment. They suggest that turbulence exists when changes faced by an organisation are nontrivial, rapid and discontinuous. An environmental shock may create turbulence.

### **5.3.3 Fast decision-making is essential, provided it does not exceed the thought process**

Most of the stakeholders considered the process of conversions to have been too fast. On closer analysis, they perceived excessive speed because there was information disequilibrium and insufficient thought given to the potential consequences of the conversions and the actions required to mitigate negative consequences.

Eisenhardt (1990) suggests that fast strategic decision-making is essential and the premium now is on moving fast and keeping pace. She suggests that people can

make fast choices by skimping on the analysis, limiting the conflict and being autocratic.

The research indicates that none of the stakeholders, with the possible exception of one of the service providers, developed a formal strategy. Research suggests that the speed of the process exceeded the speed required for sufficient thought regarding the consequences. Thus, evidence suggests that fast decision-making should not exceed the speed required for sufficient thought. As such, pension fund conversions proceeded at an inappropriate speed.

#### **5.3.4 Guidelines for managers to deal with fundamental environmental change**

Managers can deal with fundamental environmental change by taking the following actions:

- \* Recognise the environmental shock – when existing rules become inadequate or no rules exist.
- \* Understand the various factors that are combining to drive adaptation of the business to the environment.
- \* Note the speed of change and whether it is appropriate for sufficient thought.
- \* Consider what is uncertain, which rules are changing and where rules are absent.
- \* Explore the potential consequences of possible changes to the rules or new rules and possible redress that may result.
- \* Assess the relative power of the stakeholders, including their own.
- \* Develop and adhere to a code of conduct.



## **5.4 AN EMERGING MODEL**

### **5.4.1 Recognising an environmental shock**

Managers need to recognise and plan for conditions that may arise where business and societal rules are inadequate, or do not exist, to deal with unfolding events. Managers can do this reactively by analysing events that occur in the environment that may disrupt “business as usual”. Managers can do this pro-actively by identifying the various stakeholders that influence the business and monitoring their activity. In the current environment, proposed legislative changes in particular may cause an environmental shock.

In the pension funds industry, access to capital for government growth and development objectives is a crucial issue. Although pension funds are not bound by the Financial Sector Charter, it has been suggested that R40 billion in empowerment financing should be funded by pension funds and that members should be encouraged to engage in shareholder activism to encourage black economic empowerment. This may well create an environmental shock and lead to further evolution of pension funds as mechanisms for economic liberation, now that their role in political liberation has run its course.

### **5.4.2 Factors driving organisational adaptation**

Research indicates that several factors drive organisational adaptation. Once managers have identified that an environmental shock exists or may arise, they need to consider the driving forces.

It is possible to identify the various stakeholders in a business, but it is not always possible to identify their driving forces. In the pension funds industry, it is possible to consider the various stakeholder driving forces:

- \* Government – to create a stable legislative framework.
- \* Regulator, adjudicator and ombudsman – to protect the members.
- \* Members/trustees – to provide adequate retirement benefits.

- \* Business/employers – to create certainty.
- \* Trade unions – to promote their members' interests.
- \* Service providers – to make a profit.

Once these drivers have been identified, it is possible to speculate on what actions the various stakeholders may take. Managers can identify the various pressures being applied to the business and the driving forces for its adaptation to the environment. The organisation can then determine how it should act and consider the potential consequences.

### **5.4.3 Appropriate speed**

Research indicates that pension fund conversions proceeded at an inappropriate speed that did not permit sufficient thought on the consequences of the conversions. This implies that if a matter is not given proper thought, any speed would be inappropriate.

Business and employers stated that there was a pressing need for the conversions. The speed did not, however, provide stakeholders with an opportunity to fully understand the ramifications. If the speed is more appropriate for one stakeholder than for others, this may imply an inappropriate outcome in favour of one of the stakeholders.

A possible test to determine whether the speed is appropriate is to consider the question of consequences. Have the various consequences of a course of action for the various stakeholders been considered and what will be the possible impact.

### **5.4.4 Determining what is uncertain**

All of the stakeholders suggested that the process was complex and that there was no specific strategy. Managers can determine what is uncertain by identifying which rules are changing or where there are no existing guidelines for action. The legislative framework for pension fund conversions was inadequate and several

stakeholders were aware of this. A current example for management is Broad-Based Black Economic Empowerment where there is uncertainty and business does not have an existing framework within which to operate.

Scenario planning could be useful in making sense of the various possible alternatives. There was a desire by business to reduce uncertainty. When their actions are considered, parties acted rationally. There was no precedent or process to follow.

In the case of legislative changes, it is fairly easy for managers to identify the actual rule that is changing and consider the implications for the business.

#### **5.4.5 Potential consequences and redress**

As evidenced from the research, various consequences arose for stakeholders during the conversion process that now require corrective action.

Managers need to understand that consequences will arise, whether intended or not, either “good” or “bad”. It is here that business opportunities also arise. In understanding potential consequences, managers can create certainty by ensuring that the business can manage the consequences, should they arise and also possibly benefit from business opportunities arising from the consequences and remedial action. Managers need to consider “good” and “bad” intended consequences and “good” and “bad” unintended consequences. “Bad” consequences may require redress.

#### **5.4.6 Change to relative power and impact on the strategic outcome**

Power is the ability to influence the outcome. Research indicates that the relative power of stakeholders changed during the period under review. The relatively stronger stakeholders were able to exert more influence on the outcome of the process – to their own benefit.

Over time, the relative power of stakeholders changes and managers need to be aware of the changing dynamic. In particular, they need to consider their own power and know if they are able to influence the process to a greater or lesser degree. In developing a pattern of the dynamic power relationships, managers can determine who of the stakeholders is “rising” and who is “declining” and, in this manner, possibly predict the strategic outcome of future activities.

#### **5.4.7 Code of conduct**

Research indicates that the various stakeholders acted in what they perceived to be their own best interests during the conversion process. They did not consider the “greater good” or the broader impact that their actions would have on other stakeholders. Deliberate unethical behaviour, that should have been illegal, occurred where employers “raided” pension funds to gain access to the surplus for a few members who remained members of the funds after the majority of members had transferred. Consultants exploited the gaps that existed and generated business by advising employers to convert the funds and then providing all of the additional services that were required in a world of defined contributions as opposed to a world of defined benefits.

Managers can ensure that their actions are ethical by developing a code of ethics to be applied in environmental shock circumstances. This code can set out how the organisation will respond to environmental shocks in terms of its reaction and exploitation of potential business opportunities that may arise.

### **5.5 RECOMMENDATIONS**

This research was conducted in the South African pension funds industry and several recommendations for the industry can be suggested. The phenomenon of pension fund conversions is a manifestation of organisational behaviour during environmental shock and thus can be generalised to other instances of environmental shock where managers are required to ensure ongoing business viability.

### 5.5.1 Pension funds industry

During the course of the research, respondents were asked to suggest any further questions for research. They listed many questions<sup>27</sup> that require future consideration, which included:

- \* Why did the government fund not convert?
- \* Will members be better off in the new scenario?
- \* Will what is being done now ensure that members are better off in retirement?
- \* What is the view of the employer?
- \* How is reform of retirement funds linked to BEE?
- \* The government pension fund is fully funded and they still contribute 15 per cent. Why?
- \* Do pension funds actually deliver?
- \* Do participants feel anyone is to blame for the problems they perceive and what they might do about it?
- \* Has the market become more volatile as a result of defined contributions?
- \* What is to happen with pensioners?
- \* Can the trend be changed?
- \* What is the influencing game of the big players – driving the business agenda through BUSA and NEDLAC?
- \* Layers of governance are good from an ethical point of view, but who pays?
- \* What is the actual cost of choice?
- \* In the process of shifting, at what point did proper reflection begin to happen?
- \* What is the motivation of the unions?
- \* What was the role of the actuarial society over the decades?
- \* How can the FSB suddenly hide behind “legislation”?
- \* Have labour negotiated provident funds been a success?
- \* Why did management convert – especially if they were not the owner of the business?

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<sup>27</sup> Quoted verbatim.

- \* How can things be explained to members in a defined contributions environment so that they understand?
- \* What was the influence of the actuaries and personal agendas (gains)?
- \* What was the impact of conflict between lawyer and actuaries?
- \* How will transformation be funded from pension funds?
- \* When does saturation point arise – when do people become aware that something is changing/paradigm is shifting?
- \* When is there going to be a level of maturity between labour and employers?
- \* What is the power game – the political economy of retirement funds?
- \* Statistics of how many people lost out – how many won?
- \* Is knowledge in the hands of the consumer always a good thing – they then feel compelled to do something that could be to their detriment?

These questions indicate that much further research is required in the industry to inform stakeholders and to assist them in thinking about the issues that the industry currently faces.

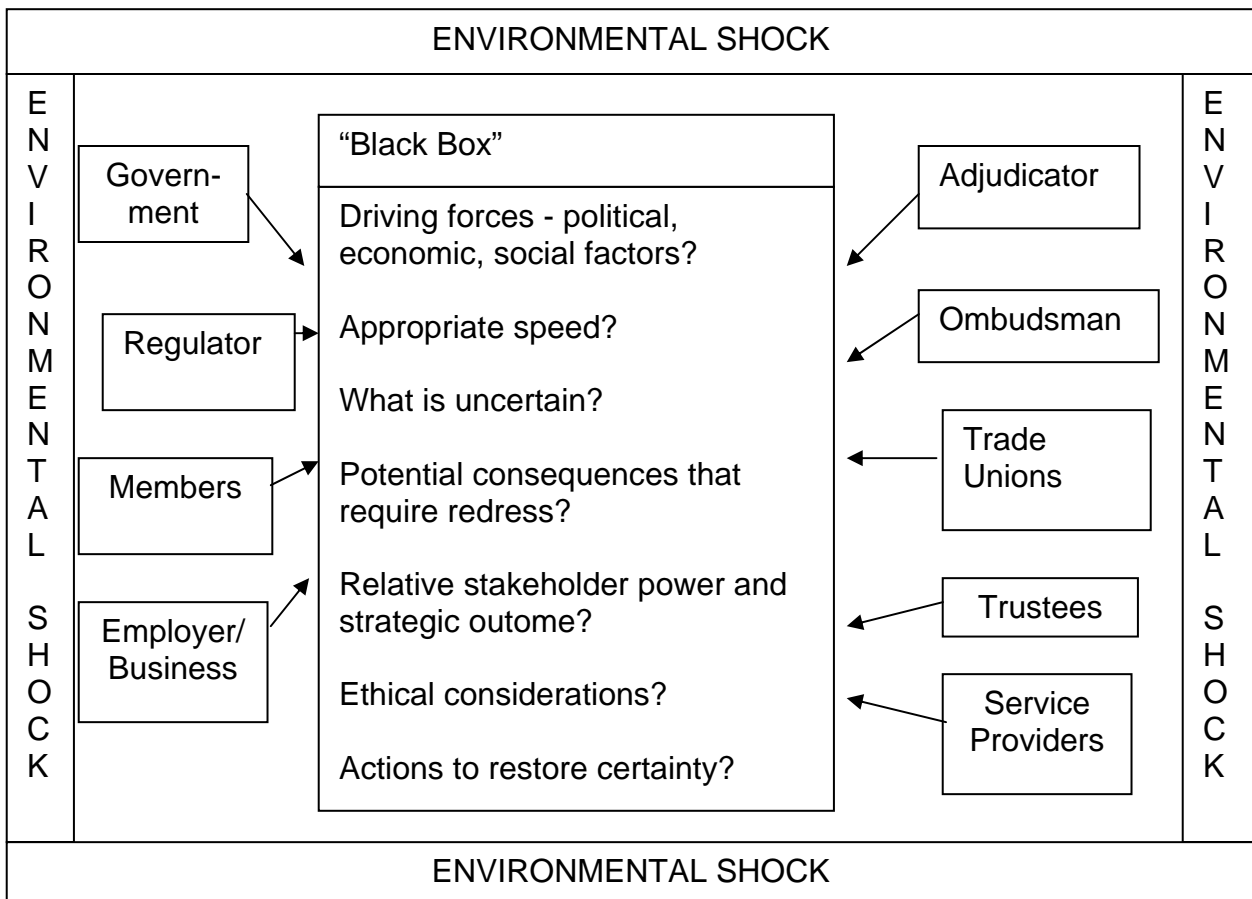
### **5.5.1.1 Application of the model to pension fund reform**

#### **➤ Environmental shock**

An environmental shock can be defined as “conditions that arise where business or societal rules are inadequate, or do not exist, to deal with unfolding events”. The industry fits this definition. At present, there is concern that members are not adequately protected and that the struggle for control over fund assets will disrupt the environment. The Financial Sector Charter, signed by the Institute of Retirement Funds, but not binding on pension funds, refers to required empowerment financing of R75 billion. It has been suggested that R40 billion would be sourced from pension funds. There is also the question of whether indirect ownership by black members of pension funds should be recognised for purposes of the B-B BEE ownership scorecard<sup>28</sup>.

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<sup>28</sup> In terms of Codes of Good Practice issued by the Department of Trade and Industry, a company can evaluate the extent of its ownership by black people in order to obtain credit on a scorecard that



➤ **Factors driving organisational adaptation**

Research indicates that two conversion waves have occurred and that a third may have begun. If the third wave takes hold and runs its course, defined benefit funds will largely disappear from the South African retirement fund environment.

The waves can be considered part of a pension fund investment evolution. Under defined benefits, employers controlled the investments. Under defined contributions, trustees control the investments, but largely under the influence of asset managers. Member activism, however, may disrupt the status quo. The Financial Sector Charter refers to member activism in asserting control over asset allocation. The inclusion or exclusion of black member ownership of pension funds for the purposes of the Broad-Based Black Economic Empowerment (B-B BEE) ownership scorecard will also influence how pension funds further evolve. Thus, there are political, economic and social factors involved.

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will determine the company's overall black empowerment status. The codes do not mention ownership of companies by black members of pension funds.

➤ **Appropriate speed**

Unlike other legislative changes that are occurring in South Africa, the pension fund reform process is proceeding relatively slowly. Revised legislation has been promised for several years. More than a year has elapsed since the publication of the first white paper on pension fund reform. The Department of Trade and Industry (DTI) has recently requested industry input into the question of whether black member ownership through pension funds should be included in the scorecard. It is also possible that an attempt is being made to align pension fund reform with the objectives of B-B BEE<sup>29</sup>.

➤ **Determining what is uncertain**

There is much uncertainty. In particular, three important issues will result in consequences for the industry. First, the question of which stakeholder will emerge stronger from the IRF/IRI disengagement. Secondly, the contents of the pending re-write of the Pension Funds Act. Thirdly, the outcome of the struggle for control over pension fund assets.

➤ **Potential consequences and redress**

It is acknowledged by industry stakeholders that the industry is in need of reform. The National Treasury issued a white paper in 2004 proposing various reform measures and identified three pillars of retirement funding:

- \* Voluntary savings arrangements.
- \* Occupational retirement funds in the formal sector.
- \* Social old age pension grants.

The government's retirement policy recognises these pillars within its objectives:

- \* Encourage individuals to provide adequately for their own retirement and the needs of their dependants.

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<sup>29</sup> "Broad-Based Black Economic Empowerment is an integrated and coherent socio-economic process that directly contributes to the economic transformation of South Africa and brings about significant increases in the number of black people that manage, own and control the country's economy, as well as significant decreases in income inequality." DTI Draft B-B BEE Codes of Good Practice – November 2005.



- \* Encourage employers and employees to provide for retirement funding as part of the remuneration contract.
- \* Provide, through social assistance, an assured basic income entitlement to elderly persons without means.

Key features of the white paper include:

- A national savings fund for low income earners. Members would be able to make irregular contributions, access funds prior to retirement and receive the state old age pension in addition to their pension from the NSF. There would be low charges, exemption from retirement funds tax and employees who earned below the tax threshold would be encouraged to move from occupational funds to the NSF.
- A view that there is no need to make retirement provision compulsory by law. Instead it recommends that employers be required to provide payroll deduction facilities to employees should they wish to a member of a fund and that they educate employees on the importance of retirement savings.
- A prescribed minimum percentage of contributions in respect of a member should go to retirement saving. This aims to prevent contributions available for investment from being eroded by the cost of risk benefits and other fees.
- If an employee changes employment, their retirement benefits must be transferred to another fund of their choice. This compulsory preservation aims to prevent leakage from retirement funds.

The contents of the re-written pension funds act will determine the future direction of the industry. Member protection is likely to be a key feature. There are various contentious issues that were highlighted in the white paper that require consideration, such as a national savings fund. This will influence industry activities.

The outcome of the DTI codes regarding black member ownership of pension funds will impact on how fund assets are invested. Regulation 28, which sets out the rules for pension fund investments is also being amended.

Any of these activities may lead to consequences that require redress. The new act in itself is a form of redress. Its success, however, depends on how the stakeholders are treated.

#### ➤ **Relative power and strategic outcome**

A balance is required in the IRF/IRI equation. If trade unions emerge as the dominant force, there will be a demand for industry sector funds. If the service providers emerge as the dominant force, there will be a drive to umbrella funds. Either of these scenarios will have consequences in the industry that can be subjected to further debate – which is beyond the scope of this thesis.

The regulatory framework, which has failed in the past, needs to take the lead in ensuring that whatever the strategic outcome, member interests are properly protected.

There are various possible outcomes, depending on how the various stakeholder interests are considered. Three possible scenarios may arise:

- \* Justice for all – A member-centric view prevails where stakeholder interests are balanced.
- \* Jaws – Excessive costs and fees feed off member benefits. Members are afraid of and distrust the industry.
- \* Jurassic Park – Social interventionist policies get out of control. Overregulation tramples member interests.

#### ➤ **Ethical considerations**

It is argued that “ethics is in the eye of the beholder”. A simple test as suggested by the Pareto criteria can be applied. The purpose of a pension fund is to provide benefits to members in old age. Actions in the pension fund industry are desirable if all members are better off, or if some are better off and no-one is worse off.

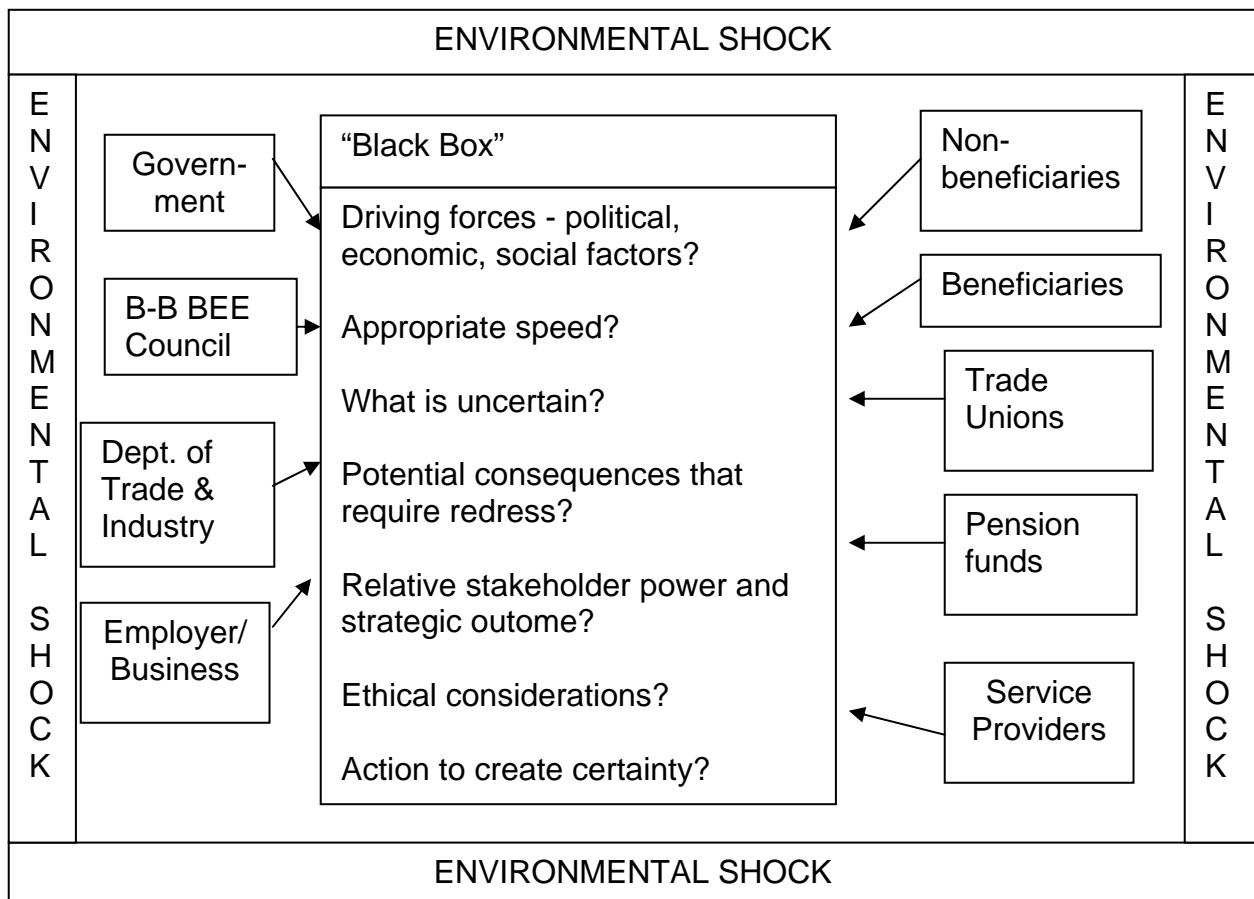
### **5.5.2 Managing a country or a business**

For government, an environmental shock has implications in terms of its executive function to formulate and implement policy. The transition from apartheid to constitutional democracy was an environmental shock of significant proportion. In developing policy, the interests of all stakeholders should be considered and the various elements as set out in the model can serve as a framework for policy analysis.

For management, the entire business or various functional areas of the business may be impacted by an environmental shock. Research indicates that management can deal with fundamental environmental change by taking the following into consideration:

- \* Know that environmental shocks will occur.
- \* Recognise the environmental shock.
- \* Identify which rules are changing.
- \* Know that your hand is going to tremble.
- \* Identify the stakeholders.
- \* Follow due process.
- \* Identify conflicts of interest.
- \* Identify driving forces and their relationships.
- \* Apply a specific brand of leadership.
- \* Implement an effective analysis process.
- \* Know that strategic thought can influence the outcome.
- \* Analyse the likely consequences and their impact.
- \* Consider the stakeholders and their relative power.
- \* Do the “right thing” even where unfair advantage can be obtained.
- \* Know there will be redress that can create competitive advantage.

**5.5.2.1 Application of the model to a pension fund perspective on broad-based black economic empowerment (B-B BEE)**



The phenomenon of B-B BEE is another example of environmental shock. B-B BEE is “a condition where business or societal rules are inadequate, or do not exist, to deal with unfolding events”. Given that pension funds are major intermediaries in the South African economy and own assets in excess of R1 trillion<sup>30</sup>, they are key stakeholders in the economy. For this reason, pension funds can be considered as separate stakeholders as detailed in the model above.

An analysis of B-B BEE is beyond the scope of this research. However, the emerging model was used as a framework to consider B-B BEE from a pension funds perspective, to determine the model’s general applicability.

<sup>30</sup> Forty-Sixth Annual Report of the Registrar of Pension Funds, 2004.

## ➤ **Definition of Broad-Based Black Economic Empowerment**

Since 1994, several pieces of legislation have been enacted to facilitate the process of black economic empowerment. These include:

- \* 1996 – National Small Business Act;
- \* 1998 – Employment Equity Act;
- \* 1998 – Skills Development Act;
- \* 2000 – Preferential Procurement Framework Act; and
- \* 2004 – Broad-Based Black Economic Empowerment Act.

The Broad-Based Black Economic Empowerment Act, 2004, allows for the establishment of a B-B BEE Advisory Council appointed and chaired by the president and sets out certain duties for the Minister of Trade and Industry, that include:

- \* publication of a strategy for B-B BEE;
- \* publication of codes of good practice; and
- \* publication of sector charters.

In its codes in November 2005, the Department of Trade and Industry (DTI) defined Broad-Based Black Economic Empowerment as:

an integrated and coherent socio-economic process that directly contributes to the economic transformation of South Africa and brings about significant increases in the number of black people that manage, own and control the country's economy, as well as significant decreases in income inequality.

The codes have been published in a series of documents. Each code sets out the measurement criteria to be accumulated on a scorecard and accredited to an enterprise's overall empowerment score.

The codes measure various aspects of business activity:

- \* Code 000 – Framework for measurement.
- \* Code 100 – Ownership.
- \* Code 200 – Management and control.
- \* Code 300 – Employment equity.

- \* Code 400 – Skills development.
- \* Code 500 – Preferential procurement.
- \* Code 600 – Enterprise development.
- \* Code 700 – Residual contributions.
- \* Codes 1000–1700 – Measurement for small business enterprises.

Government will apply B-B BEE criteria as set out in the scorecard when:

- \* contracting goods and/or services;
- \* granting licenses for regulated activities;
- \* granting a concession to operate an asset or enterprise on behalf of the state;
- \* selling an asset or state-owned enterprise;
- \* entering into a public-private partnership; and
- \* engaging in an economic activity.

Although there is no legal requirement for enterprises to have scorecards, there is significant pressure on business to comply with the codes and to measure their performance against the scorecard.

### ➤ **Financial Sector Charter (FSC)**

Prior to the codes being developed, various industry sectors agreed sector charters. In the mining and petroleum industries, the charters acquired legal status through the Mining and Petroleum Resource Development Act, although it appears that the Petroleum Charter may require considerable amendment given its almost exclusive focus on ownership.

Other charters do not have the force of law and existing and planned charters will not acquire legal status unless they are sufficiently in line with the codes of good practice. Ownership deals already made under charters may now not qualify for full points as anticipated. Published codes and scorecards will have status in law, but charters may not. Sector codes may, thus, be preferable to charters.

The Financial Sector Charter (FSC) was voluntarily developed by the sector and was finalised in October 2003. This occurred prior to the finalisation of the codes of good practice. The FSC constitutes a framework and establishes the principles upon which B-B BEE will be implemented in the financial sector. It provides the basis for the sector's engagement with other stakeholders including government and labour and establishes targets and responsibilities in respect of each principle.

- **The Financial Sector Charter Council**

The Charter Council established an executive to, among other things:

- \* receive, consider and approve annual audits from each financial institution;
- \* issue guidance notes;
- \* prepare an annual review for submission to the BEE Advisory Council for publication;
- \* undertake the reviews identified in terms of the charter;
- \* accredit agencies to perform audits; and
- \* engage with government, public sector finance institutions, the BEE Advisory Council and other regulatory agencies to promote the implementation of the charter.

- **Signatories and application**

Signatories to the charter are:

- \* Association of Black Securities and Investment Professionals (mandated by the Black Business Council).
- \* Association of Collective Investments.
- \* Banking Council of South Africa.
- \* Bond Exchange of South Africa.
- \* Foreign Bankers Association of SA.
- \* Investment Managers Association of SA.
- \* Institute of Retirement Funds (IRF).
- \* JSE Securities Exchange South Africa.
- \* Life Offices' Association of South Africa.

- \* South African Reinsurance Offices' Association.
- \* South African Insurers Association.

The charter applies to the South African operations of the financial sector and targets apply from 1 January 2004 until 31 December 2014. In 2009, the Charter Council will undertake a comprehensive mid-term review and in 2011 ownership provisions will be reviewed. The Charter Council will undertake a second comprehensive review of progress in 2015 and it was agreed that the charter's applicability will extend beyond 2015.

The charter states that all provisions of the charter are to be achieved in a manner consistent with sound business practice.

- **Elements to the charter**

Various aspects of business are set out for measurement:

- \* Human resource development.
- \* Procurement policies.
- \* Enterprise development.
- \* Access to financial services.
- \* Empowerment financing.
- \* Ownership and control.
- \* Shareholder activism.
- \* Corporate social investment.

- **FSC application to pension funds**

If a retirement fund has less than 50 staff members, it will be exempt from all the provisions of the charter other than paragraphs 9 and 12. If a retirement fund has more than 50 staff members, it will be exempt from all the provisions of the charter other than paragraphs 5, 11.3 and 11.4, and paragraphs 9 and 12.



- **Paragraph 5 – human resource development**

Only applicable if the retirement fund has more than 50 staff members; there is a special emphasis on increasing the participation of black people in skilled, strategic and operational leadership in the sector. The objective is to reach a target of 20–25 per cent black people at senior management level by 2008 and a minimum of 4 per cent black women at senior management level by 2008.

At least 1,5 per cent of total basic payroll per annum should be spent on training of black employees and learnership programmes should be implemented. There is also an objective to introduce training programmes in line with the NQF requirements and establish undergraduate and post graduate diplomas and degrees in financial services.

- **Paragraph 11 – control**

If a retirement fund has more than 50 staff members, paragraphs 11.3 and 11.4 apply as follows:

- \* (11.3) Based on an estimated ratio of 15 per cent for 2002, each financial institution will have a target of a minimum of 25 per cent black people at executive level by 2008.
- \* (11.4) Based on an estimated ratio of 2 per cent for 2002, each financial institution will have a target of a minimum of 4 per cent black women at executive level by 2008.

- **Paragraph 9 – empowerment financing**

It is estimated that new empowerment financing from the financial sector could exceed R75 billion. All parties agreed to working together to meet the objective of increasing the total amount of empowerment financing. Pension fund trustees, fund managers and consultants play a critical role in influencing the flow of funds. Initiatives will therefore be developed to enhance their understanding of investments in general and specifically their participation in

targeted investments and BEE transaction financing and to make a material contribution to shareholder activism.

- **Paragraph 12 – shareholder activism**

Financial institutions undertake to:

- \* promote increasing levels of influence of direct black owners at board level;
- \* encourage training and awareness programmes for all shareholders regarding the impact of indirect shareholding;
- \* encourage shareholder awareness through triple bottom line reporting, reporting on performance in terms of the charter and information about the institution and the sector; and
- \* facilitate, where possible, black companies or individuals voting on behalf of indirect owners.

Fund managers and asset consultants commit to comply with the above provisions and to improve their knowledge and that of union trustees regarding BEE transactions and targeted investment. Pension fund trustees are encouraged to play an increasingly active role in promoting the objectives of the charter on their respective boards and in the entities in which they have taken significant investments.

- **Signatory by the Institute of Retirement Funds (IRF)**

The IRFs co-signatory does not bind the industry or its members to comply with the provisions of the Charter. The participation mandate given to the chairman of the IRF board at the time was:

- \* to add value to the Charter from a retirement industry perspective;
- \* to assist in the drafting and resolution of retirement industry related issues encountered in the drafting process;
- \* that the IRF cannot commit its members to the implementation of the Charter; and

- \* that the IRF takes part in the process based on being a representative body of the retirement industry, but subject to the three points above.

➤ **Environmental shock**

B-B BEE can be described as “a circumstance that arises where business or societal rules are inadequate, or do not exist, to deal with unfolding events”. Thus, it can be argued that B-B BEE will be experienced as an environmental shock.

➤ **Factors driving organisational adaptation**

Although compliance with the codes is voluntary at present, with the exception of the mining and petroleum industry, there is considerable pressure on business to comply. If companies do not comply, they risk not obtaining government business and being excluded from doing business with other companies who aim to improve their empowerment spend when procuring for their business operations. Broader political, economic and social pressure is thus influencing organisations to adapt to the changing environment.

Pension funds are not bound by the charter, but there will be pressure for this to change. The various stakeholders in pension funds should now start considering the implications of this next evolutionary leap in the industry.

➤ **Appropriate speed**

The process is gathering momentum. The B-B BEE Council, which has yet to be established, will guide the process. It is in this forum where the various issues surrounding the implementation of B-B BEE will be debated amongst various stakeholders. Given the delay in the B-B BEE Council establishment, there are already signs that the regulatory framework may fail or be inadequate as occurred with pension fund conversions.

➤ **Determining what is uncertain**

There are many uncertainties. In particular, the question of the source of empowerment funding. According to the Financial Sector Charter, R75 billion is required for empowerment funding and it has been suggested that R40 billion

would be sourced from pension funds. Another key question is the economic impact of B-B BEE activities on beneficiaries and non-beneficiaries. Also uncertain is what effect B-B BEE will have on markets and the market for final goods and services. How pension funds will evolve to comply with the provisions of the Financial Sector Charter is another key uncertainty.

➤ **Potential consequences and redress**

Recognition of ownership by black members of pension funds for purposes of the B-B BEE ownership scorecard is currently being debated. There are arguments for and against including black members as owners via pension funds. These require careful consideration and analysis.

The “no” argument can argue that: ownership by black members cannot be measured; members cannot demonstrate control over investment decisions; asset managers as the registered shareholder precludes member activism; and investment chain complexity. The “yes” argument can argue that: ownership by black members can be measured; control can be demonstrated through investment mandates; members as the beneficial owners can exercise control via trustees and mandates; and the investment chain can be simplified.

The potential consequences of exclusion of pension fund ownership include: disempowerment of black fund members; an increase in income inequality rather than a decrease; less available empowerment finance; and lack of enthusiasm for shareholder activism.

The potential consequences of recognition of pension fund ownership include: a more complex role for trustees; disruption of the investment supply chain; more union control over assets via trustees; onerous administrative requirements and re-evaluation of existing BEE transactions.

If pension funds take action to comply with the provisions of the Financial Sector Charter, various consequences will arise.

➤ **Relative power and strategic outcome**

Political power in South Africa has shifted to the majority and black economic empowerment aims to shift control of the economy. There will be dynamic between the various stakeholders, because the stakes are high. From the model it can be expected that the power dynamic will shift over time and the relatively stronger players will influence the process in their favour. The outcome remains uncertain at this point.

Pension fund assets are largely controlled by investment consultants and asset managers. A focus on compliance with the provisions of the Financial Sector Charter will disrupt this dynamic.

➤ **Ethical considerations**

There are arguments for and against including black members as owners via pension funds. These require careful consideration and analysis.

The actual extent of black fund ownership is not completely known. Therefore, any number currently being suggested as indicating real black ownership in the South African economy is not sufficiently substantiated.

It may be necessary for the retirement fund industry to develop a sub-sector code or charter. Retirement funds are exempt from various provisions of the FSC, although these are areas in which they may well be able to contribute, such as procurement, enterprise development and access to financial services.

The white paper on retirement fund reform was issued in December 2004 and various stakeholders made representation to National Treasury. A second white paper was expected in 2005, but it did not materialise. It is possible that the delay may be due to the need for determining how to align pension fund reform with the objectives of B-B BEE. If these are not aligned, it is unlikely that sufficient funds will be available in the economy to drive the various empowerment objectives.

Research indicates that, in the 1980s, pension funds served as mechanisms for political liberation when union members demanded, and won, control over their own assets. There is little doubt that pension funds can serve as mechanisms for economic liberation – it is merely the detail of how they will be mobilised that remains to be seen. The revised Pension Funds Act may well provide an answer and be drafted to complement existing empowerment legislation.

## **5.6 CONCLUSION**

Pension funds reflect a microcosm of the South African experience, given the number of stakeholders and the economic impact of more than R1 trillion under management.

The first conversion wave was union driven and saw black union members transfer to defined contribution arrangement. The second wave was employer driven and saw other members transfer to defined contribution funds. Most of the funds remained in existence, closed to new members and open to those remaining members who did not convert. A third wave, to close down defined benefit funds completely, appears to have now begun. The political struggle is mostly over – now the struggle is economic in nature.

As the lines are drawn in the looming clash over control of pension fund assets, we should not lose sight of members' interests. It is the member's money and his or her well-being at retirement is at stake. To balance stakeholder interests, it is necessary to achieve a more balanced power structure. To achieve, this service provider power needs to be reduced and trustee power increased.

Two questions were posed at the outset of this research project: even if we accept as given that the nature of pension funds was required to change, why did the outcome of converting defined benefit structures to defined contribution structures arise? And: did the circumstances of the political transition, economic restructuring, globalisation and world markets change relative stakeholder power, accelerate organisational change and influence the outcome?

The research has answered both questions. The answer to the first question is that other alternatives<sup>31</sup> were not seriously considered and there was insufficient thought given to the consequences, in particular the impact on members. The answer to the second question is that peculiar environmental circumstances did influence the outcome and that an environmental shock occurred.

A model was developed for management to apply in dealing with fundamental (i.e. underlying forces) environmental change. It was applied to pension fund reform and to the pension fund perspective on B-B BEE. Indications are that the model serves as a workable analytical framework that could also be applied in an analysis of land redistribution, sanctions and constitutional development.

It remains to be seen as to whether or not the pension funds industry will take another evolutionary leap, this time driven by legislation aimed at aligning pension fund reform with B-B BEE.

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<sup>31</sup> The Economist, 18 February 2006, p. 66, refers to a book recently published by the World Bank entitled "Pension Reform: Issues and Prospects for Non-Financial Defined Contribution (NDC) Schemes)", edited by Robert Holtzmann and Edward Palmer. It sets out how several European countries, led by Latvia and Sweden, have in the last decade or so been trying out a new style of pensions.

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## 8.0 APPENDICES

### 8.1 APPENDIX 1: LIST OF EXPERTS INITIALLY INTERVIEWED

Stakeholder	Expert	Date
Members/pensioners	Bruce Cameron, Editor Personal Finance	7 March 2005
Service providers	Neil Lloyd, Countrywide Head of Retirement Fund Consulting, Alexander Forbes	10 March 2005
Adjudicator	Naleen Jeram, Deputy Pension Funds Adjudicator	11 March 2005
Ombudsman	Jenny Preiss, Deputy Ombudsman for Long Term Insurance	11 March 2005
Service providers	Kobus Hanekom, General Manager, Employee Benefit Consulting, SANLAM	18 March 2005
Service providers	Jonathan Mort, President, Pension Lawyers Association	18 March 2005
Regulator	Jeremy Andrew, former Chief Actuary of the FSB	23 March 2005
Government	Baron Furstenburg, Director, Financial Sector Policy Unit of the National Treasury	19 April 2005
Employers/business	Dorothy Coston, Business Unity South Africa	20 April 2005
Service providers	Rosemary Hunter, Pension Lawyer, Edward Nathan & Friedland	20 April 2005
Members/trustees	Anesh Soonder, Chief Executive Officer, Institute of Retirement Funds	25 April 2005
Trade unions	Jan Mahlangu, Spokesman on Retirement Funding, COSATU	4 May 2005

## 8.2 APPENDIX 2: INTERVIEW GUIDE – INDUSTRY EXPERTS

This instrument assisted in the exploration of the research question, and included the following:

### ➤ **Environmental shock**

1. What was happening in the social, political or economic environment at the time of the conversions? (Probes: Was anything changing? Was there an awareness of the changing environment?)

### ➤ **Factors combine to drive evolution (i.e. organisational adaptation to the environment)**

2. Did you consider what other organisations were doing? (Probes: Herd instinct.)
3. Who made the conversion decisions?
4. How did the organisation recognise the need for change?
5. What drove the decision process?
6. What action steps were taken to adapt to the environment?
7. Was the outcome evaluated afterwards?
8. Is environmental shock universally applicable across an industry?
9. What are the driving factors and how do they combine?
10. Do some organisations move faster than others?
11. Are some factors more important than others?

### ➤ **Organisational evolution speeds up**

12. Was the evolution slower before the environmental shock?
13. Did it gather momentum?
14. If action steps are quickly implemented – is there a fear of being “left behind”?
15. Does evolution always speed up?
16. Should it rather slow down?
17. Can the infrastructure cope?
18. Is a slower pace better?
19. What or who sets the pace?
20. Can the process be managed?

21. Did the changing power base speed up the evolution?

➤ **Uncertainty and vacuum circumstances arise, leading to unintended consequences that require redress**

22. Was there uncertainty?

23. Was there a precedent to follow?

24. What were the unintended consequences?

25. How is this recognised?

26. No “rules” to follow or usual rules don’t apply – is this tested?

27. Does the decision-making framework change under these circumstances?

28. Does redress lead to “other problems” that need to be fixed?

29. Does “fix” occur when “new rules” emerge and “gaps” are identified and filled?

30. Can it be fixed?

31. Did anyone consider the unintended consequences?

32. Is the re-write of the Pension Funds Act an example of redress?

➤ **Relative power of stakeholders changes and determines the strategic outcome**

33. Maybe relative power doesn’t change and existing power positions influence the outcome?

34. Is power required to “influence” the new rules?

35. Is power required to resist change?

36. Did new dynamics arise between stakeholders?

37. How did power change?

38. What is the result of the shift?

39. What can be done to re-balance?

40. Does a “power vacuum” arise?

41. Does power continually shift?

42. What results from the power shift?

43. Stakeholders will be asked if, and how, their power changed during the process – possibly to rate their power on a scale of one to ten, before, during and after the evolution. Results can be tabulated and represented in a graph. This will indicate how the “playing field” is changing and will highlight possible



“vacuum” areas (i.e. areas of the graph that are now not covered or where coverage has changed).

➤ **An imbalance in stakeholder interests arises and ethical considerations become consequential**

44. Why are the stakeholders interested?
45. Are some stakeholders now less interested (e.g. the employer)?
46. Does anyone recognise the ethical gaps?
47. Did arbitrage opportunities arise?
48. Does this drive competition?
49. Can “ethics” holds opportunists at bay?
50. How did stakeholder interests change?
51. Is this related to the power shift?
52. Do stakeholders proliferate when a gap arises?
53. Does a balance eventually arise?

➤ **General observations – rational man**

54. What was your role in the conversion process/were you in favour of the process?
55. Did it have implications for you/your business?
56. What factors influenced your view?
57. Has your view changed?
58. Would you do anything differently?
59. Did you benefit from the process?
60. What do you think will happen next?

➤ **General**

61. Any other questions I should ask?
62. Any other people I should contact?

### 8.3 APPENDIX 3: CONTACT SUMMARY FORM

This summary form was utilised after each interview.

Site and contact date:

1. What were the main issues or themes that struck you in this contact?
  
2. Summarise the information you got (or failed to get) on each of the target questions:
  - Environmental awareness
  - Factors driving evolution (i.e. adaptation to the environment)
  - Organisational evolution speed
  - Uncertainty and vacuum circumstances
  - Unintended consequences that require redress
  - Relative power of stakeholders
  - Ethical considerations
  
3. Is there anything else that struck you as salient, interesting, illuminating or important in this contact?
  
4. What new (or remaining) target questions do you have in considering the next contact with this site?

#### **8.4 APPENDIX 4: DOCUMENT SUMMARY FORM**

This summary form was utilised to categorise documentation received.

1. Site: Name of Fund/Expert:
2. Document number:
3. Date received:
4. Name or description of document:
5. Event or contact with which the document is associated:
6. Significance or importance of the document:
7. Brief summary of contents:
8. Central or crucial to a particular contact?

## **8.5 APPENDIX 5: CASE ANALYSIS FORM**

1. Main themes, impressions, summary statements about what is going on at the site.
2. Explanations, speculations, hypotheses about what is going on at the site.
3. Alternative explanations, minority reports, disagreements about what is going on at the site.
4. Next step for data collection.
5. Any implications for coding?

## 8.6 APPENDIX 6: CASE ANALYTICAL FRAMEWORK

### ➤ **During environmental shock**

1. Did the organisation perceive an environmental shock?
2. What was the shock?
3. How did they perceive the shock?

### ➤ **Factors combine to drive evolution (i.e. adaptation to the environment)**

4. Did you consider what other organisations were doing?
5. Who made the conversion decisions?
6. How did the organisation recognise the need for change?
7. What drove the decision process?
8. What action steps were taken to adapt to the environment?
9. Was the outcome evaluated afterwards?
10. Is environmental shock universally applicable across an industry?
11. What are the driving factors and how do they combine?
12. Do some organisations move faster than others?
13. Are some factors more important than others?
14. What factors did the organisation consider in deciding to convert or not to convert.

### ➤ **Organisational evolution speeds up**

15. How long did the process take?
16. Was the evolution slower before the environmental shock?
17. Did it gather momentum?
18. If action steps are quickly implemented – is there a fear of being “left behind”?
19. Does evolution always speed up?
20. Should it rather slow down?
21. Can the infrastructure cope?
22. Is a slower pace better?
23. What or who sets the pace?
24. Can the process be managed?
25. Did the changing power base speed up the evolution?

➤ **Uncertainty and vacuum circumstances arise...**

26. Was there uncertainty?
27. Was there a precedent to follow?

➤ **...leading to unintended consequences...**

28. What were the unintended consequences?
29. How is this recognised?
30. No “rules” to follow or usual rules don’t apply – is this tested?
31. Does the decision-making framework change under these circumstances?
32. Does redress lead to “other problems” that need to be fixed?
33. Does “fix” occur when “new rules” emerge and “gaps” are identified and filled?
34. Can it be fixed?
35. Did anyone consider the unintended consequences?

➤ **...that require redress**

36. Is redress required/taking place?
37. What form is the redress?
38. Is the re-write of the Pension Funds Act an example of redress?

➤ **Relative power of stakeholders change...**

39. Maybe relative power doesn’t change and existing power positions influence the outcome?
40. Is power required to “influence” the new rules?
41. Is power required to resist change?
42. Did new dynamics arise between stakeholders?
43. How did power change?
44. What is the result of the shift?
45. What can be done to re-balance?
46. Does a “power vacuum” arise?
47. Does power continually shift?
48. What results from the power shift?
49. Who was in control of the conversions?

➤ **...and determines the strategic outcome**

50. What was the outcome?
51. Stakeholders will be asked if, and how, their power changed during the process – possibly to rate their power on a scale of one to ten, before, during and after the evolution. Results can be tabulated and represented in a graph. This will indicate how the “playing field” is changing and will highlight possible “vacuum” areas (i.e. areas of the graph that are now not covered or where coverage has changed).

➤ **An imbalance in stakeholder interests arises...**

52. Why are the stakeholders interested?
53. Are some stakeholders now less interested (e.g. the employer)?
54. Who are the stakeholders?
55. What were the interests of the stakeholders?

➤ **... and ethical considerations become consequential**

56. Does anyone recognise the ethical gaps?
57. Did arbitrage opportunities arise?
58. Does this drive competition?
59. Can “ethics” holds opportunists at bay?
60. How did stakeholder interests change?
61. Is this related to the power shift?
62. Do stakeholders proliferate when a gap arises?
63. Does a balance eventually arise?
64. In the process of shifting, at what point did proper reflection begin to happen?
65. Were the ethics considered?
66. What were they?
67. Has anything arisen in this regard?

➤ **General**

68. What do you think will happen next?
69. Any other questions I should ask?
70. Any other people I should contact?

## 8.7 APPENDIX 7: MACRO VIEW INDUSTRY EXPERT INTERVIEWS

### Government

Name	Designation	Date
Baron Furstenburg	Director, National Treasury	19 April & 13 July 2005
Elias Masilela	Former Director, National Treasury	29 September 2005
Gill Marcus	Former Deputy Minister of Finance	20 October 2005
Jonathan Dixon	Chief Director, National Treasury	13 July 2005

### Regulator

Name	Designation	Date
Dube Tshidi	Deputy Registrar of Pension Funds	9 June 2005
Hoppie Wasserval	Former Manager, FSB	21 June 2005
Jeremy Andrew	Former Chief Actuary, FSB	23 March & 21 June 2005
Mike Codron	Chief Actuary, FSB	22 June 2005
Walter Cingo	Former Deputy Registrar of Pension Funds	8 July 2005

### Ombudsman

Name	Designation	Date
Jenny Preiss	Deputy Long Term Insurance Ombudsman	11 March & 5 August 2005

### Adjudicator

Name	Designation	Date
Naleen Jeram	Deputy Pension Funds Adjudicator	11 March & 10 August 2005



### **Business/employers**

<b>Name</b>	<b>Designation</b>	<b>Date</b>
Barry Shipman	Legal Councillor, Chamber of Mines	15 November 2005
Brian Angus	Executive Director, SEIFSA	28 September 2005
Dave Carson	Industrial Relations Director, SEIFSA	28 September 2005
Dorothy Coston	Co-ordinator, Business Unity SA	20 April 2005
Mike Jackson	CEO, Professional Provident Society	1 July 2005
Rod Stevenson	Legal Advisor, Old Mutual	10 August 2005

### **Trade unions**

<b>Name</b>	<b>Designation</b>	<b>Date</b>
Andrew Levy	Labour Consultant	7 July 2005
Chez Milani	General Secretary, FEDUSA	29 July 2005
Jan Mahlangu	Spokesman on Retirement Benefits, COSATU	4 May & 8 July 2005
Neva Makgetla	Economist, COSATU	29 July 2005
Piet du Plooy	Deputy Head, Solidarity Trade Union	17 June 2005
Moenedi Kipadisa	Spokesman on Retirement Benefits, NACTU	27 July 2005

### **Members and trustees**

<b>Name</b>	<b>Designation</b>	<b>Date</b>
Allan Greenblo	Editorial Director, Today's Trustee	29 July 2005
Allison Roode	Director, Principal Officers Association	11 July 2005
Anesh Soonder	CEO, Institute of Retirement Funds	25 April & 28 June 2005
Basil Kransdorff	Applicant, Sentrachem Case	22 November 2005
Bruce Cameron	Editor, Personal Finance	7 March & 8 August 2005
Peter Mengel	Pensioner Representative, IBM	12 July 2005

## Service providers

<b>Name</b>	<b>Designation</b>	<b>Date</b>
Des Partridge	Pension Lawyer, Alexander Forbes	27 June 2005
Jonathan Mort	Pension Lawyer, Edward Nathan Friedland	18 March & 12 August 2005
Rosemary Hunter	Pension Lawyer, Edward Nathan Friedland	20 April & 15 June 2005
Ant Lester	Actuary, 5 <sup>th</sup> Quadrant	19 August 2005
David Gluckman	Actuary, Simeka	15 July 2005
Mickey Lawther	Actuary	11 August 2005
Alan McCulloch	Divisional Director, Liberty Life	17 June 2005
Chris Newall	Actuary, Formerly Old Mutual	17 August 2005
Greg Morris	CEO, Glenrand-MIB Employee Benefits	7 October 2005
Jacques Malan	Actuary, Jacques Malan and Associates	6 July 2005
Kobus Hanekom	Executive Consultant, SANLAM	18 March & 9 June 2005
Max Maisela	CEO, NBC Benefit Consultants	30 September 2005
Neil Lloyd	National Head of Retirement Fund Consulting, Alexander Forbes	10 March & 11 August 2005
Reg Munroe	Former consultant, Old Mutual	15 August 2005
David Weil	Trustee Trainer	30 June 2005

## 8.8 APPENDIX 8: CASE STUDIES

<b>Case</b>	<b>Economic sector</b>	<b>Conversion date</b>
A	Metal industries	Early 1980s
B	Metal industries	Early 1990s
C	Financial services	Mid-1990s
D	Metal industries	Late 1980s
E	Financial services	Early 2000s
F	Public utility	Currently being debated
G	Manufacturing	Considered, remains partly open
H	Metal industries	Considered, but did not convert

## **8.9 APPENDIX 9: CASE ANALYSIS FUND A AND FUND B**

### **8.9.1 Facts and history – Fund A**

Company A, established in 1933, operated in the metal industries and was internationally owned. In 1958, Company A sponsored the establishment of Fund A, a defined benefit pension fund. Only white employees were permitted to join.

During the 1970s, international publications publicised what appeared to be serious inequities in South Africa's labour situation, and there were significant reactions around the world. In the USA, corporations with South African subsidiaries were ordered to adopt the far-reaching Sullivan Principles with a view to improving wages and working conditions for black employees. In Europe, member states of the European Economic Community (EEC) proposed a "code of conduct" for South African subsidiaries of European parents. The EEC code was to be adopted on an entirely voluntary basis, but the British government took it seriously and asked British companies with South African subsidiaries to adhere to it. The British parents were invited to file regular reports on their offsprings' progress towards the EECs ideals, and in particular towards equality of opportunity. The reports were to be circulated among parliamentarians, trade unionists, churchmen and others who might be interested, and copies were to be sent to the European Parliament and the United Nations.

Company A decided to co-operate and every year since 1977 it prepared a detailed account of its personnel policies. The company stated that they were facing up to the challenges and were happy to make changes. Some of these changes related to fully paid annual leave, sick leave where appropriate, subsidised meals and membership of the medical aid and pension fund. There was a home-loan scheme and an education scheme. These benefits were made available regardless of race or seniority. Thus, from the late-1970s black members were permitted to join Fund A.

Work councils or “committees” had been part of the company since the 1940s, but these were challenged and eclipsed by the emerging trade unions by the early 1980s.

Company A disinvested from SA in 1982 and its business was taken over by Company B.

With the emergence of the black trade unions, labour relations at the company were becoming increasingly hostile. In 1987, following strikes and protracted negotiations between the union and management, an employer sponsored defined contribution provident fund was established at Company A. Consultants were actively involved with Company A and the trade union to develop a negotiated benefit fund. All employees, including lower level job grades and existing members of trade union sponsored provident funds were permitted to join. In all, 4000 members transferred from Fund A. The members’ contributions, plus interest, were transferred. Around 2000 members remained on Fund A.

### **8.9.2 Facts and history fund B**

Company B was locally owned and operated in the metal industries. Fund B, sponsored by Company B, was a defined benefit pension fund registered in 1975. At the time of registration, only white employees could join.

In 1989, Company B registered a defined contribution provident fund. This happened after Company B employees who were trade union members had complained that employees at Company A, owned by Company B since 1982, had joined a provident fund since 1987. Fund B members had a different union to Fund A members. After company and union negotiations, a defined contribution provident fund was established for all employees in various, lower level job grades. Union members from Fund B transferred to the defined contributions fund in 1989. They received a transfer value equal to the fund’s actuarial liability at the date of transfer.

Thus, by 1989, there existed Fund A and Fund B, both structured as defined benefit pension funds, and two defined contribution provident funds for Company A and Company B respectively.

### **8.9.3 Merger of Fund A and Fund B**

In 1992, Fund A merged with the defined benefit pension fund sponsored by Company B, Fund B, and became a merged group pension Fund A/B. The structure remained as defined benefit pension fund.

### **8.9.4 Conversion of merged Fund A/B**

In 1996, the respective defined contribution provident funds were opened to all employees at Company A and B – irrespective of job grade – because the merged Fund A/B, a defined benefits pension fund, was to be converted to a defined contributions pension fund. Members were offered a choice of whether they wanted to join the existing defined contributions provident fund or remain on the converted defined contributions pension fund. The rules of the fund were amended to provide defined benefits for those who did not convert and defined contributions to those who did.

The Board of Directors of the company had initiated the conversion, which was then implemented by the Board of Trustees of Fund A/B. The process began at the beginning of 1996 and was actioned at the end of 1996. There was a communication programme and members attended presentations and seminars. Consultants assisted in the process and members signed letters when they elected to convert. Members received a transfer value equal to the fund's actuarial liability plus a "sweetener" of over 30 per cent from the "surplus".

### **8.9.5 Outcome of the conversion exercise**

Exactly 5,25 per cent of members elected to remain on the defined benefits fund. In a letter to members in March 1997, the chairman of the Board of Trustees stated

that the creation of the defined contribution section of the pension fund was in keeping with the general trend in South Africa of many large funds to move away from defined benefit schemes. In addition, he stated that it was also in the spirit of the new democracy in the country to offer the freedom of choice and the greater sense of ownership and responsibility for the individual. He stated that the retirement benefits of members who transferred to the defined contribution section would be dependent on the growth and returns earned on the investments of the fund and therefore the trustees are committed to ensuring that the assets are invested in such a way as to maximise returns with as little risk as possible.

The rules were amended to alter the structure and the fund still exists today as the merged group pension fund. Today, 25 members remain on the defined benefit structure. Several of the members who did not convert were new members who were not entitled to any “sweeteners”. Many of those who did not convert already had over ten year’s service with the company. “Sweeteners” in excess of 30 per cent were offered, with amounts depending on the member’s accrued fund value. Members who had transferred in the “first wave” did not receive any enhancement from the surplus.

The fund remains a pension fund, but has a defined contribution structure – the defined benefit structure is closed to new members. There are no plans to close the defined benefit section until all the remaining members have either withdrawn or retired.

Thus, the first wave was mostly black union members converting to defined contribution provident fund. This resulted in better withdrawal benefits and lump sums at retirement. The second wave was members converting from a defined benefit pension fund to a defined contribution pension fund or to the existing defined contributions provident fund. This provided better withdrawal benefits and, in the case of the provident fund, lump sums. The defined contribution provident funds of Company A and B are identical in structure, but sponsored by different unions who have resisted attempts to merge the funds to save on costs.

### **8.9.6 Funding and surplus apportionment**

In 2000 the company agreed to union demands to pay higher contributions into the provident funds. The provident funds are externally administered. The surplus apportionment exercise is not yet complete. When the fund converted in 1996, the surplus was distributed. There are approximately 40 000 former members, but the valuation has not yet been completed. It does appear likely that a surplus will exist for distribution.

### **8.9.7 Employer perspective**

The company is quite old fashioned and its decision-making processes are slow and hopefully well thought through. The union push was the catalyst – the company itself would never have initiated this process otherwise.

In the early to mid-1980s, at Company A, there was intense union pressure to offer members a provident fund instead of a pension fund. In 1985 there was a massive strike at a plant where all workers downed tools. The company did not need or want to have unnecessary conflict with the union. The company at first resisted the change because it was felt that members would be better served with a pension fund. After labour unrest, strikes and hostility in the workplace, it negotiated a change with the union. The union members subsequently transferred to a provident fund.

The union at Company B was less assertive than the one at Company A. It was after its merger with Company A that workers at Company B started demanding a provident fund, although they were members of different unions. There was a negotiation process whereafter their members also transferred to a provident fund. The environment was less hostile. The unions were actively involved within the management of the funds from the outset. The company decided that, although it was contributing to the funds, it would play a less active role and focus on more important business issues, such as making a profit.



In the mid-1990s, the company decided to convert the existing pension fund from defined benefit to defined contribution. This was done to manage costs. There was concern about the potentially open-ended liabilities that the company faced in sponsoring a defined benefit fund. By converting the fund to defined contribution, there would be certainty about future costs.

Other large companies were also converting in the mid-1990s. The company indicated that the proposed conversions were in line with what other big companies were doing and in the spirit of the new democracy. In 1996, markets were running, and so it was a good time for employers to off-load the defined benefit fund risk – members were eager to take the “sweetener” and benefit from possible future market upside.

Members who converted from defined benefit pension to defined contribution pension do now complain about benefits. But in 1996 they could have chosen differently. Things could have gone the other way, if so they would not now offer to return an “overpayment”. Some members did not convert, some were fairly new to the fund and did not get much of a “sweetener” – that could be the reason why they did not convert.

The process was ethical, the enhancement was substantial. Members received a form specific to themselves detailing their fund value and the value after the enhancement.

#### **8.9.8 Member perspective**

When Fund A was opened to all employees, many joined. Union members complained that the pension fund was run by the company. Union members asked for their own fund, but not necessarily a union fund. They did not specifically ask for defined contribution structures, they wanted three things: to manage their own fund, to have better withdrawal benefits and a lump sum when they retired. Negotiations took place and a defined contribution provident fund was established.

Union unrest threatened production and members were making demands regarding their retirement funds. The relationship between the union and the company was hostile. In the 1980s there were sanctions and extensive union activity, which drove the conversions. The conversions in the 1980s were very swift after the unions started to agitate.

The black members were represented by the unions, who negotiated their transfers. There were instances where members received their lump sum benefits at retirement, spent all of it and then turned to the company in the hope of receiving assistance. When members from Company A transferred in the 1980s they received their own contributions, plus interest. They lost out on employer contributions and any part of the surplus. Members from Company B received an amount equal to their actuarial liability in the fund. Although this was more generous than that received by Company A members, they also did not receive any part of the surplus.

When the company decided to convert the fund in the mid-1990s, members of the fund were mostly white and non-union members. There was an extensive communication process which was pro-conversion. Members received an amount equal to their actuarial liability and were encouraged with the “sweetener” of an additional 30 per cent, funded from the surplus. The conversion in the 1990s took approximately one year.

For members, it would have been better if the process had been slower. With such a rapid change, it is over and done before members can think clearly. Members do complain informally that they are now worse off, but no formal complaints have been received. Members did have a choice and signed documentation that remains on record.

The company’s culture used to be based on the concept of a family. There was a quarterly pensioner newsletter, pensioners met in the major centres for regular lunches subsidised by the company, and from time to time they were entertained at the factories. With outsourcing, this came to an end. People used to feel wanted

and appreciated and therefore they stayed at the company. This is no longer the case. Subsequent to the conversion, some members feel that the company “cares less” about them, especially after market returns were poor. Members feel as if they are worse off after conversion. This is a culture change from the past where the company used to be appreciated as a family environment.

#### **8.9.9 Other stakeholders**

Consultants were involved in the process in the 1980s. They advised both the unions and the company. In the 1990s consultants were advising the company on how best to convert the fund and distribute the surplus.

#### **8.9.10 Problems and issues**

The union driven conversion was done in the early days and there was no precedent to follow. By 2000, however, the unions must have considered the outcome. They negotiated with the company for higher contributions, which the company paid.

After the transfers in the 1980s and the establishment of the provident funds, the unions began to realise that they had lost out on the benefit of the employer underwriting the fund. There was still hostility on the Board of Trustees between the union and employer trustees. The union trustees were black and employer trustees were white. Over time, the company has appointed black trustees to serve on the board. The unions regularly request increases to company contributions to the fund because of the rising cost of risk benefits and the corresponding decrease in the amount of money available for investment in the retirement benefit.

The employer, however, is much less interested now because of the defined contributions nature of the fund. The pension fund membership is 80 per cent white and the provident fund membership is almost entirely black. The pension and provident funds are administered by different administrators.

Throughout the process there was uncertainty on all sides. The company was uncertain about the consequences if it did not yield to union demands, as well as future costs.

Part of the surplus was sourced from withdrawal profits that arose when members who withdrew from the fund did not receive their full value. When the merged fund converted in the mid-1990s, union members who had transferred in the 1980s did not receive any part of the surplus that was distributed at the time. This was raised as an issue and will need to be resolved during the surplus apportionment exercise. The surplus apportionment is a legal requirement, but the view is that the company was fair during the conversion process. The power has not changed. The employer and the union are still on opposite ends.

The outcome was not evaluated, this was left to the trustees.

The company now holds pre-retirement seminars every second year, conducted by an independent trainer. From the members' point of view, they have seen the consequences – they are not knowledgeable enough and do not want to manage their own retirement provision. With cost-to-company, it is now just a financial transaction. Even closed pension schemes are getting rid of their liabilities. The world of work has changed and the culture of the company has been impacted. Employees previously stayed for ten to fifteen years, now the average is three years.

## **8.10 APPENDIX 10: CASE ANALYSIS FUND C**

### **8.10.1 Facts and history**

Fund C was established in 1922. Its sponsoring employer, Company C, operated in the financial sector. Membership of Fund C was restricted to employees who were under age 40 on appointment. This was a defined benefit pension fund, 100 per cent controlled by the employer. In 1938 a Widow's Fund was established to provide a benefit to a spouse and orphans in the event of death of member. Membership was, initially, voluntary. In 1943, a Provident Fund was established for employees who were age 40 and older on appointment. The Provident Fund and Widow's Fund (later renamed Spouse's Fund) merged with Fund C in 1955.

A Superannuation Pension Fund was established in 1965 for non-white office and field staff. Members were given the option of transferring to Fund C in 1976. At that time, members were given the option of receiving a cash benefit or electing a paid-up benefit in the fund. A pension would then be purchased on retirement. The Superannuation Fund was liquidated in 1983 and all members joined Fund C. The actuarial reserve was not transferred, neither was service.

There were two types of members of Fund C: office staff and field staff (consultants on commission). There was a hybrid situation. The fund operated a defined contribution structure for commission staff, in respect of their retirement benefit only, because their income fluctuated. Conditions were changed in 1979 and again in 1989.

### **8.10.2 Conversion**

In 1995, the company board started talking about defined contribution structures. A project team was established to work on the conversion. The team was driven by the company, rather than the fund. An offer was also made to pensioners for their pension to be outsourced.

Member education was considered to be a key issue – the aim was to get the maximum number of members to transfer. Videos were produced and sent to each branch, there were roadshows and a help-desk facility to answer any enquiries from members.

The company's employee representative body (affiliated to a union) was consulted. They objected to a proposed 10 per cent enhancement for medical benefits, and this was withdrawn by the company.

#### **8.10.2.1 First offer**

The first conversion offer was at 1 January 1997. Members and pensioners were offered a once-off opportunity to move. A 30 per cent “sweetener” was offered (i.e. transfer of a members' actuarial liability plus 30 per cent). Of the approximately 14 000 members of the fund, excluding pensioners, the majority converted (approximately 350 remained on the defined benefit structure). As at January 1997, pensioners would get an increase, but there would be no increase in additional voluntary contribution (top-up) pensions. Those pensioners who elected to outsource their pensions on 1 January 1997 received the 30 per cent increase on 1 January 1997 and pro-rata pension increases on 1 July 1997. Additional voluntary contribution pensions did not benefit from the enhancement.

In 1998, the fund name was changed when Company C was restructured.

#### **8.10.2.2 Second offer**

In 1999, a second conversion offer was made. There had been retrenchments in 1998 following a major restructure and this penalised members who had remained on the defined benefit structure with the intention of remaining employed at Company C until retirement. This second offer was pushed by members, prior to minimum benefits legislation that came into effect on 7 December 2001.

A 27,5 per cent “sweetener” was offered. A group – mainly actuaries – complained that members who had converted after the first offer were better off. The matter was referred to the most senior level in the company. The company's response

was to explain the rationale for the second offer and to point out that some members had gained from the second offer through, for example, salary increases.

After the second offer, about 150 members remained on Fund C. Predominantly longer serving, older employees, stayed. Some field staff stayed. For the second conversion offer, the communication programme developed for the first offer was updated.

Individual member choice is not yet offered, but a limited choice will be offered from 2006.

### **8.10.2.3 Surplus apportionment and funding**

On transfer, monies went to members' investment accounts. This included an actuarial reserve and an enhancement. A 30 per cent enhancement was transferred to an employer reserve account in the defined contribution fund. Surplus that remained in Fund C was very small in relation to the number of members who stayed on the fund. Members who converted were considered to be former members – but will not share in the surplus distribution from Fund C because they have already received their equitable share. The surplus apportionment scheme for Fund C, as required by the Pension Funds Second Amendment Act, has been submitted to the FSB and approval is awaited. Of the 35 000 former members, 25 000 qualify for a top-up. Some former members will never be found. If legislation had not required an apportionment, the surplus would not have been apportioned. Company C was on contribution holiday on the basis of the adequate surplus.

Risk benefits are good – age bands reduce the benefit as members get older, but members can retain the cover at a small fee. When the defined contribution fund was implemented, Company C stated that they would contribute a maximum of 12 per cent (2 per cent to life cover; 1 per cent to disability cover, 1,5 per cent for administration and the remainder to retirement funding). Disability costs did go over this limit in the post-conversion, but were funded from the surplus within the benefit fund and steps were taken to ensure early identification of potential incapacity.

### **8.10.3 Employer perspective**

A key factor was limiting liability into the future – there was a feeling that defined benefit structures were excessively expensive. The cost of providing benefits was escalating and there was less certainty going forward. The potential cost of HIV/AIDS and risk benefits was a factor and being considered by top management – many of whom were actuaries.

Company C was considered to be at the cutting edge, and it was felt that its retirement fund structure was outdated, so it looked at international as well as the South African experience. The key driver was cost.

Once Company C had decided to convert the fund, the process began immediately. There was no “escape clause” for the company. Company C off-loaded risk and created certainty regarding its future contributions. The crucial factor was timing. If the conversion was left until 2000, member response may well have been different. Members now carry the risk and require education. Investment choice will be offered to members at the end of December 2006.

### **8.10.4 Member perspective**

Given the non-unionised environment, there was no union action in the 1980s. One division of the company, now outsourced, employed members who were members of a union. In 1994, a company sponsored negotiated fund was considered for these members, but was not established. The trade union established a general fund at national level and most of the union members transferred from Fund C to this fund in 1995.

The conversion process took two years. It was pushed by Company C, who kept up the momentum by letting members attend roadshows, watch videos and receive information. Members were not, however, sufficiently educated in the process. The employee representative committee at Company C was weak. The employer made all of the decisions, although they backed down on the issue of medical liabilities.



The company controlled the message and put on a positive spin. Members signed documents stating that they had received communication. Of interest is the fact that many senior managers chose to remain on the fund after the first conversion offer. Many only converted after the second offer because the environment was less certain after major company changes. Company C is now less interested in the fund, given that they no longer carry the risk.

To date nobody has asked to go back to the defined benefit structure. Some members who did not convert have asked whether there will be a third conversion offer. Members received substantial amounts of information, but many were not sure about the actual consequences. They now demand far more education than before, and as a result there is a quarterly newsletter and spreadsheets for members to determine their retirement needs. (But who will bear the cost of this education is still a bone of contention.)

#### **8.10.4 Other stakeholders**

There was no involvement from stakeholders other than the employer and the members.

#### **8.10.5 Problems and issues**

Now that the fund is structured as a defined contribution pension fund, actuaries have set up spreadsheets for members to use to determine retirement funding shortfalls. After the conversions, the project was evaluated, but not the outcome for members. Now, ten years later, there is a drive to educate members on replacement ratios and the need to obtain additional retirement fund investments.

Legislative change highlighted the surplus issue. Members who converted during the first and second offers queried why they would not benefit from the surplus apportionment exercise. Legal opinion was that the source of surplus was not withdrawal profits. With the benefit of hindsight, the second offer should have been

based on values as at 1 January 1997. This would have removed the concerns raised by members at the time of the second offer.

Group life cover became a problem later on. It is now an age band scenario and members need to be offered different options to ensure they are not worse off. Company turnover has been higher since the conversion.

## **8.11 APPENDIX 11: CASE ANALYSIS FUND D**

### **8.11.1 Facts and history**

Company D was established in 1932, in the metal industries, and sponsored a defined benefit pension fund, Fund D. Only white employees were permitted to join the fund. The fund was established to benefit employees and was considered to be part of the employer's social contribution.

From 1973, black employees were permitted to join the Metal Industries Pension Fund. The company CEO was keen on everyone having a home of their own and in 1991 Company D applied to the industry bargaining council to get all hourly paid operatives (i.e. black workers) to join Fund D, rather than the industry fund. The exemption was granted because Fund D's benefits were better than the industry fund. If the company controlled it, they argued, they could enforce the push to give all people loans for houses. When the black members transferred to Fund D, their fund value was retained in the Metal Industries Pension Fund and the company bought back service in Fund D to when the member joined the company or when the fund was established, whichever was earlier. All employees were considered equal and they secured home loans for black members using the pension fund as surety.

### **8.11.2 Union member transfers**

In the late 1980s, hourly paid employees (i.e. black members) wanted the company to establish a provident fund. The company did not agree to the request and stated that since they did not have the expertise to operate a defined contributions provident fund, they would agree to members transferring to the Metal Industries Provident Fund. Unions started talking to members about the surplus and there was much political activity in the workplace.

In the late 1980s employees developed a belief that they could withdraw their retirement funds. Legal and actuarial advice was obtained, other companies were

investigated, and it was determined that this perception was incorrect. In 1993, members transferred from Fund D to the Metal Industries Provident Fund. Members received their actuarial liability, with no enhancement.

### **8.11.3 Fund conversion**

In 1993, salaried employees (i.e. mostly white members) requested that they should be offered a provident fund. They wanted the market growth of a defined contribution fund because they believed that their returns in the defined benefits fund were insufficient. They felt that the Metal Industries Provident Fund was driven by the unions and did not want to join it. The managing director and financial director had to present the proposal to the parent company board in the USA. The USA board felt that it was a wrong decision to offer a provident fund. It was not a defined benefits versus defined contributions issue, it was a pension versus provident fund issue. The USA board questioned what would happen to the remaining pension fund. The employer's consultant suggested that Fund D should be closed, but the board disagreed and it remained open to members who decided not to transfer.

In 1993, the company embarked on a programme to improve efficiency and several retrenchments occurred. In 1996 legislation was enacted to require 50 per cent of trustees to be member elected – this had to be implemented by 1998. In 1997, the company managing director retired and was replaced. Company D opened a defined contributions pension fund in 1998, and offered members a choice to transfer from Fund D to the new fund or to the Metal Industries Provident Fund. A 10 per cent enhancement was offered on transfer, in addition to the member's actuarial liability. Pensioners were also outsourced. Fund D will now eventually wind down as members exit, for various reasons.

### **8.11.4 Conversion process**

When union members transferred, four information sessions were held per day for three days, of which nine sessions had a translator for translations into African

languages. The differences between pension and provident funds were explained. Presentations were also sent to the metal industries for comment and members were given forms to sign.

The same information process was followed when the office staff transferred. The company sponsored defined contribution pension fund was self-managed until it was felt that legislation was becoming too complex and members joined an umbrella pension fund. This occurred after intense communication to-and-fro and member voting.

The result was a retirement fund framework as follows: Fund D, with less than ten members remaining; a defined contribution pension fund – umbrella with an advisory body; and the Metal Industries Provident Fund. New employees can become members of the umbrella pension fund or the Metal Industries Provident Fund. (Fund D now has only six members and the company is driving for its closure as a result of high administration and auditing costs.)

#### **10.11.5 Surplus apportionment**

A surplus exists – a surplus apportionment scheme has been proposed and has been communicated to members. Their comment is awaited during the twelve week inspection period.

#### **10.11.6 Employer perspective**

Global profits were high on the corporate agenda. Corporate USA wanted sustainability, so there was a drive to get risk costs out. USA companies have strict audit provisions and had to indicate fund liability, thus the defined benefit fund impacted on the bottom line.

There was social change and media hype regarding perceived poor returns in defined benefit funds. Local management wanted to move members out of the

defined benefit fund. Some managers opposed the conversion – they felt that members were not sufficiently financially literate. Others were in favour.

Much background work was done before the final decision was made by the company board. The aim was to achieve local control so that funds could also be used for education, not only housing. The Metal Industries Fund was slow to pay out (it sometimes took six months). Metal Industries also required a lot of documentation that members were unable to produce or obtain.

As there was no precedent to follow, the company was uncertain as to whether or not they were doing the right thing. The company thus moved very slowly, especially during the second conversion. They had not expected the request by office staff to transfer to a provident fund. Human resource management and the consultant sounded warnings.

#### **10.11.7 Member perspective**

The rise of the unions changed the balance of power. Employees did not understand what they were doing and everyone was uncertain. Employees thought they could control their own money and did not think about the control in the recipient fund. They are more willing to listen to the company now that they have had difficulties with disability benefits and see the consequences of disability benefits not being paid.

#### **10.11.8 Other stakeholders**

The company consulted professionals throughout the process.

#### **10.11.9 Problems and issues**

In 1998, the defined benefit fund had a problem when market returns were poor. There was a lack of pension increases and pensioners complained. Youngsters

who belonged to the union spoke to their parents who were not on pension and compared benefits.

Although the overall outcome has not been consciously evaluated, it has been raised in certain circumstances, for example in disability cases where metal industries criteria apply and members turn to the company for assistance because the fund will not pay the benefit.

Surplus is only being addressed because of legislation. There was a rise of the unions and a change to employer paternalism. All parties are now less interested – it is no longer an issue and the matter has stabilised.

## **8.12 APPENDIX 12: CASE ANALYSIS FUND E**

### **8.12.1 Facts and history**

Company E, the sponsoring employer, operates in the financial sector. Fund E, a defined benefit pension fund, was established in 1980. Until 1998, the fund was managed by senior executives appointed by the company. Thereafter, the Board of Management (also known as the Board of Trustees) of the fund consisted of member elected and employer appointed trustees.

In August 2000, a document was tabled at a meeting of the Board of Trustees of Fund E. It detailed new retirement fund arrangements for employees of Company E and had been approved by its Board of Directors. A sub-committee of the Board of Directors had been formed in this regard. The company wanted to implement the proposal as soon as possible. Essentially, the plan detailed a conversion of members from the defined benefit pension fund, Fund E, to a defined contributions provident fund. The defined contributions provident fund was already in existence and its members were mostly consultants and members who had joined the company after age 40. The conversion plan had been initiated by the employer and approved by the Board of Directors. This plan was now being put to the Board of Trustees of Fund E.

The Board of Trustees considered the proposal and raised some issues, such as how existing pensioners would be protected and whether individual investment choice would be offered to members who converted. It was agreed that the Board of Trustees would seek independent actuarial and legal advice. The company also retained the right to abort the process under certain circumstances that would have resulted in the exercise being considered as too expensive by the employer.

### **8.12.2 Conversion process**

In September 2000, documentation from the Board of Directors of Company E stated that, in the interests of the employer, the conversion would be subject to a



minimum conversion rate (i.e. how many people would convert) and that a 25 per cent “sweetener”, funded by the surplus in the fund, would be offered to members. It was agreed that existing pensioner members would remain on the fund and that members would be offered a choice of whether they wanted to convert to the provident fund. It was also agreed that individual member choice would be offered and that members would be permitted to select from one of two portfolios. The fund conversion became a regular item on the agenda of meetings of the Board of Trustees.

In November 2000, a note was sent from the group human resources executive to all managers. All staff was to receive a copy of the circular by early December 2000. This was a notice of the proposed voluntary conversion of Fund E from defined benefit to defined contribution. It set out the planned implementation date of 1 March 2001 and the conditions on which the conversion would go ahead: if investment returns continued to be favourable in the period leading up to implementation date and if there was sufficient take-up by the membership to make the conversion viable.

In mid-December, members received a communication pack containing an explanatory booklet, information on investment management, comparative benefit statements, an option selection form and a schedule setting out conversion presentation dates. Pensioners also received a letter detailing an increase in their benefits to provide for increases 100 per cent in line with inflation, backdated to the date of retirement.

### **8.12.3 Conversion outcome**

Member education sessions had been held and would be continued into the future. It was noted that formal approval from the registrar was required. A sub-committee was established to determine pensioner enhancements.

In March 2001, a memo submitted by the valuator stated that 3356 members had elected to convert. Fund E was closed to new members and 663 members

remained on the fund. In terms of an amendment to the rules of the fund, members would make an irreversible election regarding their conversion from the fund by 31 March 2001.

In May 2001, pension enhancements post-conversion were discussed and the surplus bill was mentioned. More information was required before pensioner enhancements could be agreed. In August 2001, the chairman of the board of trustees submitted a final report on the conversion. It was recommended that pensioners be offered an enhancement if the pensioner liability moved to the member.

In November 2001, rules of Fund E were amended to provide for an option to purchase annuities (i.e. pensioner outsourcing). Some pensioners took up the offer.

#### **8.12.4 Surplus apportionment**

In March 2002 surplus legislation was considered, and it was agreed that steps would be taken to give effect to the legislation – subject to legal opinion being sought on its effect. The surplus apportionment scheme has not yet been submitted to the FSB. A substantial surplus is available for apportionment and surplus amounts will remain after all legislative requirements have been met. Surplus would not have been distributed if the legislation did not require it.

#### **8.12.5 Employer perspective**

The board of Company E made the conversion decisions. Other organisations were not considered, but expert opinion was obtained from an international consulting firm. It is also possible that the conversion at a large financial institution in the banking sector was considered.

Action was taken by Company E to off-load pension fund risk and obtain certainty on costs of retirement funding. The outcome was not sufficiently evaluated after the conversion.

The remuneration committee of Company E was anxious for the conversion to proceed. There was an “escape clause” to not proceed with the conversion if there was insufficient take up by members and if market conditions were unfavourable. As a compromise, an amount would be set aside for existing pensioners. Pensioners would not receive a “sweetener”, nor would they be told that an amount had been set aside for application to increases.

For Company E there was uncertainty whether members would move. They had a goal in sight, but no guarantee up-front. The conversion fitted into Company E’s financial plan. The company is not as focused on the retirement fund process anymore since some stresses and concerns have been removed.

#### **8.12.6 Member perspective**

The process took from August 2000 to March 2001 – only eight months. Prior to this, no mention had been made of converting the fund. It is possible that other companies were converting or had converted and that Company E was simply following suit.

The process went too fast and other factors should have been considered. It should have been for the benefit of members. The matter should have been raised much earlier and members should have been given an opportunity to think about the matter for longer – to contemplate and get of feel for the process and implications. Company E’s remuneration committee were driving the process and wanted to wrap up the conversion by giving tight deadlines.

For members there was the uncertainty about what was best for themselves. At the time there had been retrenchments and people were wondering whether they would be employed until retirement. If members had known they would stay at

company, they would not have converted. Many members who converted are financially worse off and have to focus on investment issues. They have seen how the company protected itself.

For members to be equipped with “information equilibrium” will take another 20 years. The solution is to implement some minimum educational standard for each and every employee. Give people a reason to learn more – for example, a small salary increase can be given if they pass the investment course. A concerted and conscious effort must be applied.

#### **8.12.7 Other stakeholders**

In September 2000, the Board of Management obtained information on Note 34, issued by the UK Institute of Actuaries and obtained the services of independent legal council and a firm of actuaries. It was also agreed that one of the member elected trustees would discuss the conversion with the chief actuary of the FSB.

Legal opinion was obtained on whether or not the pensioners were also entitled to receive a “sweetener”. The opinion received was that the pensioners were not entitled to a sweetener given that the status quo would be maintained (i.e. they would continue to receive a pension in terms of the defined benefit fund rules) and that the current liability was known.

In November 2000, the trustees undertook to present their view on the conversion, but did not form a sub-committee specifically for this purpose. One member elected trustee, in particular, was adamant that all classes of members, including pensioners and deferred pensioners, should receive the 25 per cent enhancement if the investment risk was going to be for their own account.

A report from the independent actuaries concluded that the terms of the conversion were not detrimental to the members. The same trustee (as mentioned above) asked for an unequivocal statement that the proposals were fair and reasonable for all members, including pensioners. It was stated by the chairman of the board of

trustees (an employer appointed trustee) that the conversion was not a distribution of surplus and assets of the pension fund to all. Legal opinion was that all members, including pensioners, should participate in the distribution.

Post-conversion, trustees have noted that members are invested relatively high in cash and seem to be conservative investors – too conservative.

#### **8.12.8 Problems and issues**

There was an “escape clause” to not proceed with the conversion if there was insufficient take up by members and if market conditions were unfavourable. This was because the position of the “investment reserve” would be compromised. It was agreed that the conversion would proceed in terms of the proposals and that 25 per cent of the pensioner liability would be retained in a ring-fenced reserve.

The feeling in the passageways at the time was that the company was less concerned about the employees and expected them to fend for themselves. The idea of “big brother” – the employer as life mentor – no longer exists. There appeared to be a culture change with the company concerned about what was best for the company. Nobody considered the unintended consequences. Investment education was required all along – members would need it on an on-going basis.

There was no union involvement – prior, during or after the conversions. The Board of Trustees of Fund E and Board of Directors of Company E never clashed or disagreed. There was no struggle. The structure has remained the same – the employer has been dominant, but that is not blatantly obvious. (It is important to note that very senior people were on the Board of Trustees as employer nominated trustees and member elected trustees may have been intimidated or reluctant to make “career limiting statements”.)

One of the trustees raised the issue of what was “fair and reasonable”. There is no evidence of the Board of Trustees considering whether this was the best thing to do. The Board of Trustees was more concerned to follow due process and protect

themselves. They were implementing the decision that had already been taken by the Board of Directors of Company E.

## **8.13 APPENDIX 13: CASE ANALYSIS FUND F**

### **8.13.1 Facts and history**

Fund F was established in 1935 as a result of a special act of parliament. Company F, a parastatal, took all of the investment risk. The rules of the fund were amended in the 1970s. Fund F is operated by trustees in terms of the Pension Funds Act. Trustees are drawn from the employer and the trade unions. Unlike the other parastatal funds, Fund F must comply with the provisions of the Pension Funds Act.

The Board of Trustees comprises fourteen people. Seven are employer appointed, comprising a few experts and people who work for the employer. The chairman is non-executive and independent of the company. The other seven comprise two pensioner representatives; three union representatives, one from each of the unions; two representatives from non-unionised employees (usually from management level). The unions represent members in general.

The history of the fund indicates that it is a pure defined benefit fund, underwritten by the company. Lately, the company is saying that it does not have obligations – that Fund F is a hybrid. The fund sought legal opinion regarding the company's duty to underwrite it. The company feels confident that it has no responsibility to underwrite the fund, because the rules say that employer costs are capped. If something happens to the fund, members carry the risk – either in terms of reduced benefits or increased contributions. Members were told that there is a guaranteed formula and that they did not read the rules.

The conversion issue arose in 2001 when the company stated that it did not consider itself responsible for underwriting the fund. On that basis, the trustees of the fund set out to investigate whether the fund should be converted to reflect the factual situation.

Company F wanted to move to defined contributions. It argued that Fund F was a hybrid fund. The company then pushed through and registered a defined contributions fund. There were negotiations and it was argued that the company could not act unilaterally. Unions got actuaries to calculate the “buy-off” and they determined that members would be worse off. At present, the status quo prevails.

### **8.13.2 Trustee perspective**

The Board of Trustees needs to act independently and the behaviour of the fund is supposed to have a life of its own. Trustees should be separate from the employer.

Discussions began in 1999. In 2001, the fund considered itself to be defined benefit and wrote to the company regarding a shortfall (the fund is valued every year, although this is only required every three years). They asked the employer to increase contributions. The employer refused and said they had no duty to do so.

Now the fund wants clarity, given that the current situation is not acceptable. The trustees want to resolve the uncertainty. If members now retire, it is legally a defined benefit fund. It is just a matter of the risk. If markets are bad for 5–10 years in succession, problems will arise. There could be a view that the Board of Trustees is worrying about nothing of importance. Returns have been good – the aim is to achieve at least 4 or 5 per cent real return, and the fund achieved over 21 per cent for 2004 and 30 per cent to June 2005.

The trustees’ view is that if the employer has no obligation, then the fund cannot provide the benefits as promised. If members take the risk, it is actually a defined contribution fund, and the fund needs to be converted so that the trustees can manage it as such.

### **8.13.3 Union perspective**

In 2001, the unions argued that the company was liable. They had a duty to underwrite the fund. Detailed information was obtained from board meetings and



company reports. The legal opinion concluded that you need to look beyond the rules of the fund and look at behavioural patterns. The union sought legal opinion from the same senior council who had previously said that the company had no obligation. Now it concluded that the employer is probably liable.

One of the rules of the fund state that if you change a benefit in a manner that negatively affects members, you need to get the member's mandate. Given the legal opinion obtained in 2004, the Board of Trustees said they were no longer in a position to convert the fund. (They were going to force members to defined contributions because they take the risk anyway.) If senior council says that the employer is probably liable, then the fund structure cannot be changed.

#### **8.13.4 Member perspective**

There is an increased level of awareness of members – they want to be continually informed about how their assets are performing. The fund would like to see their members aware of their retirement funds within an overall portfolio of assets. Members need to see the complete picture and when they retire know how to manage their personal finances.

Investment education should be provided – at age 18, members should be made aware that they can increase their contributions. If employees have a higher level of awareness it will not be necessary for them to haggle over annual increases in the hope that it will improve their financial predicament. They need to take a broader view.

Unfortunately it is difficult to find individuals who provide good advice and do not simply push products. Consumer education is required to ensure advice remains independent and is not profit driven.

### **8.13.5 Employer perspective**

The fund went back to the company and advised that they would prefer not to enforce a conversion to defined contributions, given that the company should underwrite the fund. The idea was to create a new defined contribution fund and give members a choice. Administration would be elsewhere. The fund thinks it is the company's obligation to create an incentive for defined contributions.

The employer is not happy because of the obligation and is concerned about the risk presented by potentially increasing costs.

### **8.13.6 Other stakeholders**

The employer, union and the fund have taken separate legal advice. The FSB has also been consulted given the employer's registration of a defined contribution fund without consulting with the members.

### **8.13.7 Problems and issues**

The fund did not convert to defined contributions because of the legal opinion that the fund is a defined benefit fund. The trustees decided to work with the union and company to create a new fund. At present, it appears that trustees are sitting with risks that cannot be underwritten. However, investment returns have been good enough to fund the liabilities. Returns have been in the top quartile.

The three main issues were:

- It was felt that there was no reason to convert the Fund, but a few things needed to be restructured. People at the highest levels at Company F are now working on a resolution.
- Many funds converted at a time when people thought returns would always be good. Many people are now in defined contribution funds because of the market run. In 2003–04 people have had to retire in a low return environment.

Pensions can be blown away by a market correction prior to retirement. Although market upside is possible, people do not realise the risks.

- People were driven to defined contributions largely because in a defined benefits environment they did not get employer contributions; only their own contributions. Minimum benefits as set out in the Pension Funds Second Amendment Act provides that you get almost what you would get in a defined contributions fund. Thus, there is no longer a risk of getting poor withdrawal benefits. There is now no encouragement for members to convert. Any fund that now converts must consider “what is in it for the member?”.

## **8.14 APPENDIX 14: CASE ANALYSIS FUND G**

### **8.14.1 Facts and history**

Fund G, a defined benefit pension fund, is sponsored by Company G, operating in the manufacturing industry. The company consists of four major divisions and resulted from a merger. The conversion process took place between 1994–96.

In July 1995, the company board decided to consider converting from defined benefits to defined contributions. It was proposed that both existing and new employees could join a defined contributions provident fund or a defined benefits pension fund.

The company asked if there was an alternative to the provident fund route. A report from consultants was requested and they reported on a proposed transfer to a defined contributions fund. They suggested that existing members of Fund G should transfer to a new defined contributions fund and suggested the basis for transferring values. The report stated that the employer needed to decide whether the motivation behind the establishment of the new fund was to limit pension costs to a specified contribution rate or to provide a choice to its employees of what type of fund to join. If the primary motivation was to limit costs, members should be encouraged to transfer to defined contributions and enhancements would be justified. Various scenarios were detailed and the consultants recommended a defined contributions pension fund rather than a defined contributions provident fund. A pension fund would offer better tax advantages for the employer and members.

To transfer to a provident fund, a new fund would be required. To transfer to a defined contributions pension fund, the rules of Fund G could be amended. The consultants gave several reasons why they preferred to establish a new fund. The report did mention that members would carry the risk. They recommended that various reserves should be retained for contribution holidays, retrenchments and other purposes.

A communication programme was proposed. Members would be offered an option of transferring their actuarial liability plus a “premium” to a new defined contributions fund. The consultants stated that communication must be easily understood by the great majority of members. The consultants would take responsibility for all communication.

In October 1995, a follow-up report was submitted to the company. It was produced by an employee of Company G whose specific role was to consider the pension fund conversion. The report pointed out that the trend in Europe and the UK (supported by trade unions) was in fact away from defined contributions and back to defined benefits.

The needs of the company were identified as:

- \* competitive retirement options to attract good new employees – low withdrawal benefits were a problem;
- \* capping employer liabilities – there was no clear picture of liability; and
- \* an increase in “risk benefits” – AIDS.

The needs of the trustees were for an equitable surplus apportionment. Employees needed improved withdrawal benefits; easily understandable retirement fund benefits; and more flexibility.

The report mentioned imminent changes to tax legislation and new boards of trustees (i.e. pending legislation requiring at least 50 per cent of trustees to be member elected).

Several options were explored:

- **Option one**  
Don't change. This option would neither address the needs of members nor cap liability for the employer.

- **Option two**  
Retain and amend. This option would allow members choice and improve withdrawal benefits to equate to provident funds. Contributions would also be limited. The negative aspects of this option were that liability would not be capped and the viability of the fund would be in question. Pursuing such an option would also result in the “splitting of the fund” and would complicate surplus apportionment.
  
- **Option three**  
Retain fund for “remaining” members who do not transfer and open new defined contributions fund for all new members. This option would limit options for members and would create a surplus apportionment problem.
  
- **Option four**  
Convert to defined contributions pension fund and guarantee at least as good a benefit as defined benefits, with improved withdrawal benefit limits and lump sums. This option answered all the employee needs. A disadvantage is that SARS hold a negative view of cash withdrawal equal to retirement benefit for members who are over 55 years of age. Complexity and cost would also be an issue.

#### **8.14.2 Conversion process**

Following the analysis, Company G decided that a new defined contributions provident fund would be formed and that members of Fund G would have an option to move. New employees could select to join either of the funds and current pension benefits would remain the same. A communication plan was developed by the fund consultant and it set out definitions of the different fund structures as follows:

- \* Defined benefit fund – the employer pays the balance of cost to provide the promised benefit, after the member’s contribution has been taken into

account, i.e. the employer does not pay a fixed percentage of salary in respect of each member. The retirement benefit is guaranteed.

- \* Defined contribution fund – the employers contribution is a fixed percentage of salary and is specifically allocated to each member. The retirement benefit is not guaranteed.

The communication encouraged members to transfer.

### **8.14.3 Employer perspective**

Other big firms had already completed a conversion process and Company G wanted to ensure that it explored all of its options. In converting, the benefits for the company were identified as being:

- \* attractive options for attracting employees;
- \* more certainty regarding benefits; and
- \* ensuring the defined benefits fund remains viable.

During its analysis, the company considered the reasoning behind other major corporations converting their funds. They found the following:

- **Company 1 (manufacturing)**

They converted to defined contributions mainly due to pressure from the trade union. There was also a realisation what AIDS would cost and they wanted to cap their liability. Concern existed that current levels of political violence could add to company costs.

- **Company 2 (manufacturing)**

They wanted to cap liability and reacted to pressure from members regarding unfair withdrawal benefits.

- **Company 3 (manufacturing)**

They converted as a result of employee pressure and economic considerations.

- **Company 4 (financial services)**

They aimed to cap future liabilities and minimise perceived potential risk. Pending amendments to legislation was also a factor.

- **Company 5 (mining)**

Employees felt that withdrawal benefits were inadequate and the inherent subsidy of the old by the young was not equitable. There was also an open-ended risk factor from the employer's viewpoint and a concern that the cost of death benefits would escalate dramatically.

Company G is usually a follower and prefers to move slowly. This is part of the company culture. Its human resources policy is to be the employer of choice and to attract talented employees, and so they wanted to be fully informed. It was a self-administered fund and far away from service providers. There was a view of "other people are doing it, let's check it out".

The Board of Company G made the conversion decisions. Other organisations were considered, and the conversion outcome was evaluated afterwards on an informal basis. The transfer to defined contributions was fundamental.

#### **8.14.4 Member perspective**

There was a great deal of uncertainty and a company employee was specifically assigned to work on the matter. Several examples were considered before the company decided not to follow. Union power was not strong.

The company ethos is that a defined benefit fund is a competitive advantage – it is a benefit of employment that will attract good senior managers. At present, new members from certain grades can join Fund G. The union is satisfied with this arrangement. No member has since requested a transfer back to defined benefits.



#### **8.14.5 Other stakeholders**

There was extensive input from consultants who were tasked to consider the various options and make recommendations.

#### **8.14.6 Problems and issues**

Nothing subsequently arose other than the issue of surplus. The issue did not arise because of the transfer, but it is an issue now. The company is less concerned about the performance of the defined contributions fund than that of the defined benefits fund. Very high level executives remain on both Boards of Trustees. Paternalism is still evident.

Legal opinion was sought to determine whether executive salaries could be withheld from member elected trustees. The opinion was that it could not be withheld. Different levels of employees had different outcomes. There was an expectation that conflict would arise from the surplus apportionment exercise, but it did not. Previously employers were the clients, now it is the trustees and there is much more awareness of conflict of interest.

AIDS is a big issue – people are often more interested in death and disability benefits and housing because they do not believe they will reach retirement age. “Retirement environment” is not just an old age issue.

## **8.15 APPENDIX 15: CASE ANALYSIS FUND H**

### **8.15.1 Facts and history**

Fund H, a defined benefit pension fund, was registered in 1958. It was sponsored by Company X, which was subsequently purchased by Company H. Company H operates in the metal industries and is a multi-national company with its head office in Europe.

Company H disinvested from South Africa in the 1980s and sold their interests to Company Y. In 1992, when the political situation was changing, Company H returned to South Africa. They purchased Company X and acquired their interest back from Company Y. Fund H already existed and was sponsored by Company X. Fund H accommodated employees at professional job grades, while other “scheduled” employees were members of the Metal Industries Provident Fund. The rules of Fund H were amended to accommodate members transferring in from Fund Y, a defined benefit fund sponsored by Company Y.

In January 1993, members transferred from Fund Y to Fund H. In 1997, Company H acquired a further part of Company Y. However, Fund Y had converted to defined contributions in 1996 and transferring members were now required to join Fund H, a defined benefits fund. At Company Y, members had been informed that defined contribution structures were superior to defined benefits and now (July 1997) they were required to transfer back to a defined benefit fund. Members were given a choice to purchase past service on transfer from Fund Y to Fund H or to retain their transfer amount as a money accumulation account in Fund H, with defined benefits in the future.

In 1998, the markets crashed. Members’ defined benefits did not fall, but defined contributions did. Prior to this, members with the defined contributions structure had been very happy as they saw their values increasing in bull markets. The 1997 Asian crisis had caused a “bit of a wobbly”. But the 1998 crash was a shock to members after a long history of upward market movement.

Around this time, Company H compared defined benefit structures with defined contribution structures. A consultant to Fund H prepared a report. The Board of Trustees of Fund H believed that defined benefit is “safer”. Company H's parent company in Europe subsequently performed an analysis of world wide funds and were shocked that many were underfunded. Head office management's view was to eliminate open ended liability. Company H operates in Europe and the USA. A division of Company H in the UK was run independently and in 1997 an actuarial report indicated that the fund was 97 per cent funded and the actuary anticipated that the gap would be closed within three years through market growth. The gap grew to 88 per cent and when the parent company sold off the business it had to refund the fund before the sale could take place.

### **8.15.2 Conversion discussions**

From 1989–90 Company H appointed a Board of Trustees, comprising of senior employees. After 1996, 50 per cent were member elected. In order to appoint an independent trustee in 2004, the number of board members was increased to ten. The chairman of the Board of Trustees is the company's second-in-command and the financial director also serves on the board. The other trustees, including member elected trustees, are fairly well trained in terms of retirement fund issues.

Company H's head office has not formally put the issue of conversion on the table. In 1997, the company human resources manager did suggest that the matter of conversion to defined contributions should be considered, but this was merely a process of going through the motions. It was not a serious consideration. They merely considered it because the rest of the industry was doing it. They concluded that the approximately 800 members would resist and that older members might be more concerned. There are also about 180 pensioners on the fund.

Turnover at the company has increased. Younger staff is leaving within five to six years. Previously, 30–40 years' service at Company X was not unusual.

The company head office is in Europe and does have a benefits manager, but the South African operation is fairly autonomous. The independent trustee has educated the members and they understand the benefits of defined benefits. The company also sponsors a top-hat provident fund. Its membership is older than the pension fund because older members are making additional provision for their retirement.

The South African operation is independent and the board of Fund H has argued that, under South African law, the Fund is independent of the company and is a separate entity. Fund H is currently under-funded at 94,7 per cent, and the reserve needs to be strengthened. The benefits of Fund H are generous in comparison with the market.

### **8.15.3 Surplus apportionment**

A nil certificate has been submitted to the FSB.

### **8.15.4 Employer perspective**

The company was not pressured to convert in the 1980s, because union members were not on Fund H. It did consider what other organisations were doing, but decided not to follow suit – the company understood the value of what they had. Benefits were good and death benefits were better than the average. The organisation was seen to be caring about the family unit. There was not much uncertainty. Converting was not a serious consideration. Company H is a very ethical group and promotes a supportive environment.

### **8.15.5 Member perspective**

It is possible that specific personalities were at play that wanted to retain the defined benefit structure.

### **8.15.6 Other stakeholders**

The consultant to the fund did not push for a conversion to defined contributions. The consultancy had several defined benefit funds as clients and lost clients who converted to defined contributions on the recommendation of an emerging brokerage whose business model was based on encouraging fund conversions.

### **8.15.7 Problems and issues**

There has not been any conversion to date. If costs continue to escalate it may become an issue.

## 8.16 APPENDIX 16: MACRO CASE ANALYSIS

Stakeholder	Environmental Factors	Forces for change	Pace of change	Uncertainty	Consequences	Redress	Power	Ethics
Government Regulator Adjudicator Ombudsman	Political factors Economic factors Legislation	Trade Unions Employers Consultants	Too fast Not thought through	Complexity not evaluated No legislative framework	Leakage Service provider dominance Surplus	Surplus legislation Pension fund reform	Unions Govern- ment	Members worse off and need protection
Trade Unions	Political factors	Strike activity Poor benefits Social change Control over assets	Gathered momentum very quickly	Complexity No strategy	Social benefit eroded	Trustee education Legislation	Unions FSB	Poor transfer benefits
Members/ Trustees	Political factors Economic factors Legislation	Trade Unions Employers Member benefits 50/50 Trustees	Very fast	Complexity No collective thought	Surplus Education requirements Risk & leakage	Surplus legislation	FSB Unions Service providers	Surplus/ investment reserve
Business/ Employers	Political factors Economic factors Legislation	Union pressure Costs and risk 50/50 Trustees Consultants	Pressing need	Complexity Adversarial relationships	Surplus Unclaimed benefits	Pension fund reform	Govern- ment	Transfer values Surplus
Service Providers	Political factors Economic factors Social factors	Trade Unions Employer/members Markets Consultants Valuation bases	Out of control	Complexity Steep learning curves	Inter-generational cross subsidisation	Pension fund reform Adjudicator oversees annuities	Unions Govern- ment	Some deliberate unethical behaviour

## 8.17 APPENDIX 17: CROSS-CASE ANALYSIS

Case	Union	1st wave	Method	Driver	Transfer value	2nd wave	Method	Driver	Transfer value	Fund now in surplus	Fund still in existence	Signs of 3rd wave
A	Yes	Yes	Union members transferred	Union	Member contribution plus interest	Yes	Rule amendment	Employer	Actuarial liability & sweetener	Yes	Merged with Fund B	No
B	Yes	Yes	Union members transferred	Union	Actuarial reserve	Yes	Rule amendment	Employer	Actuarial liability & sweetener	Yes	Merged with Fund A	No
C	No	No	N/a	N/a	N/a	Yes	Rule amendment	Employer	Actuarial liability & sweetener	Yes	Yes	No
D	Yes	Yes	Union members transferred	Union	Actuarial reserve	Yes	Transfer to new fund	Members/ Employer	Actuarial liability & sweetener	Yes	Yes	Yes
E	No	No	N/a	N/a	N/a	Yes	Transfer to other existing fund	Employer	Actuarial liability & sweetener	Yes	Yes	No
F	Yes	No	N/a	N/a	N/a	No	N/a	N/a	N/a	Yes	Yes	Yes
G	Yes	No	N/a	N/a	N/a	Yes	Transfer to new fund	Employer	Actuarial liability & sweetener	Yes	Yes	No
H	Yes	No	N/a	N/a	N/a	No	N/a	N/a	N/a	No	Yes	No

