OUR INDUSTRY IS CHANGING. ARE WE?

"Rights and obligations in an evolving Retirement Funds environment"

PENSION LAWYERS ASSOCIATION

THE **2006 PENSION LAWYERS ASSOCIATION CONFERENCE**

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LEGAL ISSUES ARISING FROM DOCTORAL RESEARCH ON SOUTH AFRICAN PENSION FUND CONVERSIONS: 1980 – 2006

DEVELOPING A MODEL FOR DEALING WITH FUNDAMENTAL CHANGE EMERGING FROM AN ANALYSIS OF SOUTH AFRICAN PENSION FUND CONVERSIONS:

1980 - 2006

PHENOMENON OF PENSION FUND CONVERSIONS

- In 1970's, most pension funds in SA were defined benefit funds (members received a guaranteed benefit at retirement based on years' service)
- Employer funded any shortfall, thus carrying investment risk
- 1980's and 1990's saw dramatic transfer of members from defined benefit to defined contribution funds (members received a benefit at retirement based on contributions made to the fund plus investment growth)
- Against the backdrop of fundamental change in South Africa

RESEARCH QUESTION

- Why did this particular outcome arise?
- Did environmental circumstances influence the outcome?
- Question of organisational behaviour during fundamental environmental change

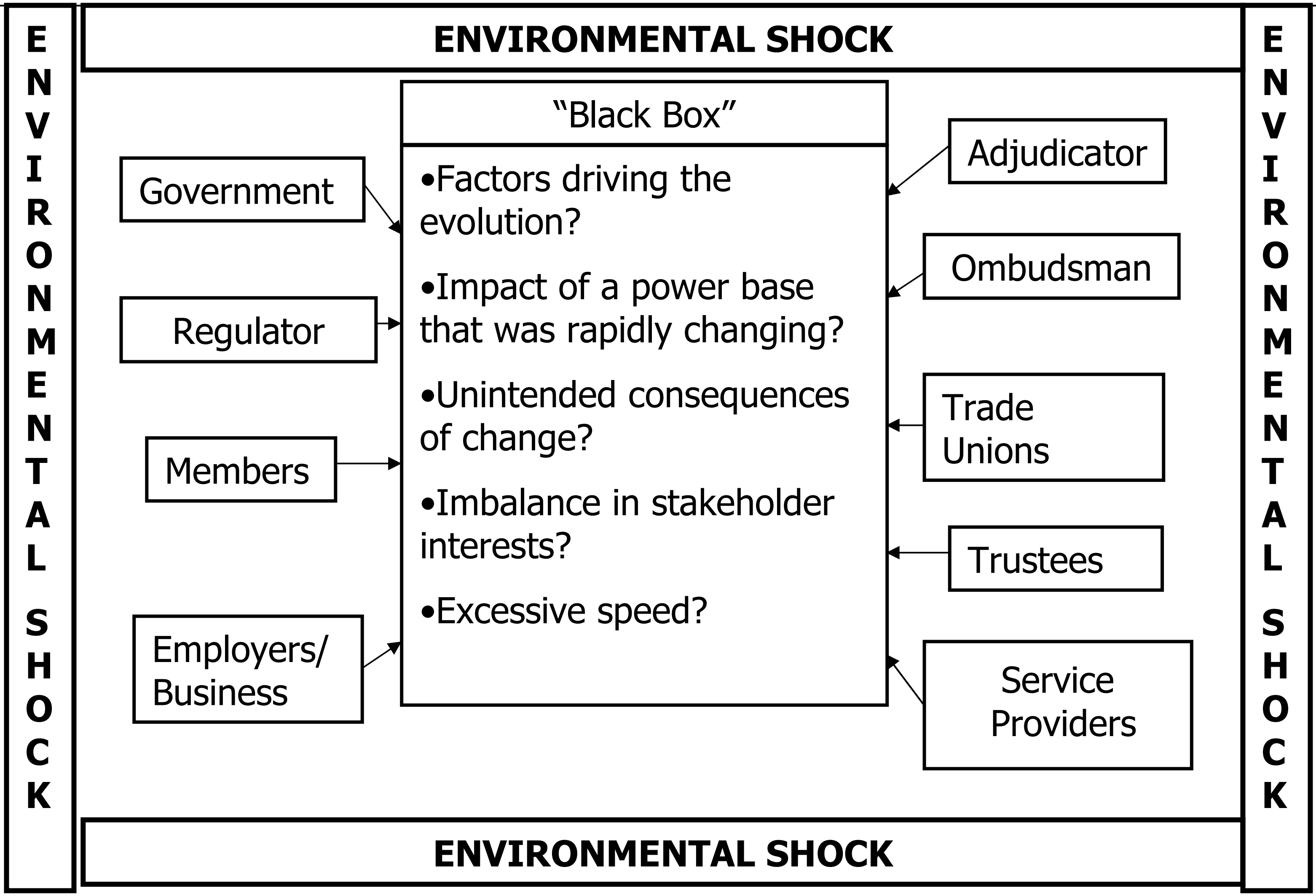
LITERATURE REVIEW

- Theory of Evolution
- Retirement Funding in South Africa
- Welfare Economics
- Financial Theory
- Theory of the Firm
- Ethics
- Decision making
- Strategy
- Leadership in turbulent times
- Organisational change

ANSWERS FROM THE LITERATURE

- 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 evolution was inadequate
- Firms offloaded contingent liabilities, members acquired investment risk
- Firms have evolved and should consider several stakeholders not just shareholders
- Benefit from the evolution was not equal – power positions were relevant
- Boards of Trustees made the conversion decisions
- Pension fund evolution is a non-cooperative game – stakeholders maximising benefit
- Leaders did not recognise or discounted or ignored potentially negative outcomes
- Co-evolution of firm and pension fund occurred

RESEARCH FRAMEWORK



QUALITATIVE RESEARCH METHOD

- Data collected between March and November 2005
- Interviews to obtain macro view of phenomenon
- Cases to investigate specific instances
- 55 interviews – snowball sampling
  - Government: 5
  - Regulator: 10
    - includes FSB, adjudicator and ombudsman
  - Business/employers: 6
  - Trade unions: 7
  - Members and Trustees: 8
  - Service providers: 19
- 33 interviews for case studies

CASE STUDIES

Case	Sector	Location	Date converted
A	Metal Industry	Gauteng	Early 80's and mid-90's
B	Metal Industry	Gauteng	Late 80's and mid-90's
C	Financial	Western Cape	Mid 1990's
D	Metal Industry	Gauteng	Late 80's and late 90's
E	Financial	Gauteng	Early 2000's
F	Public Utility	Gauteng	Current discussion
G	Manufacturing	KZN	Partial conversion mid-90's
H	Metal Industry	Gauteng	Not converted

Stakeholder	**Environmental factors**	**Forces for change**	**Pace of change**	**Uncertainty**	**Consequence**	**Redress**	**Power increase**	**Ethics**
Government Regulator Adjudicator Ombudsman	Political Economic 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	Strike activity Poor benefits Social change Fund assets	Speed-ed up Very quick	Complexity No strategy	Social benefit erosion	Trustee education Legislation	Unions FSB	Unfair transfer benefits
Members/ Trustees	Political Economic Legislation	Trade unions Employers Member benefits 50/50 trustees	Very quick	Complexity No collective thought	Surplus Education requirements Risk Leakage	Surplus legislation	FSB Unions Service provider	Surplus/ invest-ment reserve
Business/ Employer	Political Economic Legislation	Union pressure Cost and risk 50/50 trustees Consultants	Pressing need	Complexity	Surplus Unclaimed benefits	Pension fund reform	Govern-ment	Transfer values Surplus
Service providers	Political Economic Social	Trade unions Employer/ members Markets Consultants Valuations	Out of control	Complexity Steep learning curve	Inter-generational cross subsidisation	Pension fund reform	Unions Govern-ment	Some deliberate unethical activity

Case	Union	1st wave	Method	Driver	Transfer value	2nd wave	Method	Driver	Transfer value	Fund now in surplus	Fund still exists	Signs of 3rd wave
A	Yes	Yes	Union member transfer	Union	Member contrib. plus int.	Yes	Rule amend	ER	Actuarial liability + sweeten	Yes	Merged with fund B	No
B	Yes	Yes	Union member transfer	Union	Actuarial liability	Yes	Rule amend	ER	Actuarial liability + sweeten	Yes	Merged with fund A	No
C	No	No	n/a	n/a	n/a	Yes	Rule amend	ER	Actuarial liability + sweeten	Yes	Yes	No
D	Yes	Yes	Union member transfer	Union	Actuarial liability	Yes	Transfer to new fund	EE/ER	Actuarial liability + sweeten	Yes	Yes	Yes
E	No	No	n/a	n/a	n/a	Yes	Transfer to other fund	ER	Actuarial liability + sweeten	Yes	Yes	No
F	Yes	No	n/a	n/a	n/a	No	n/a	n/a	n/a	Yes	Yes	No
G	Yes	No	n/a	n/a	n/a	Yes	Transfer to new fund	ER	Actuarial liability + sweeten	Yes	Yes	No
H	Yes	No	n/a	n/a	n/a	No	n/a	n/a	n/a	No	Yes	No

ENVIRONMENTAL CHANGE

- Political factors
  - Union proxy for government in exile
  - Political struggle waged on the shop floor
- Economic factors
  - Globalisation
  - Rising cost of defined benefits
- Social factors
  - HIV/Aids
  - Rural pensioners
  - Withdrawal benefits
- Legislation
  - Amendments to the Pension Funds Act

FORCES FOR CHANGE

- Trade unions seeking political power
- Employers seeking certainty
- Consultants seeking profit and new markets
- Strike activity disrupting productivity
- Poor benefits questioning suitability of defined benefits
- Social change with HIV/Aids and employment relationships
- Distrust of member elected trustees
- Struggle for control over fund assets
- Potentially rising costs and investment risk
- Market strength
- Valuation bases inflating surplus available to employer

PACE OF CHANGE

- Too fast
- Not thought through
- Gathered momentum
- Out of control - frenzy
- Employers felt pressing need

UNCERTAINTY

- Complexity
- Not evaluated
- No legislative framework
- No actuarial guidelines
- No strategy
- No collective thought
- Steep learning curves

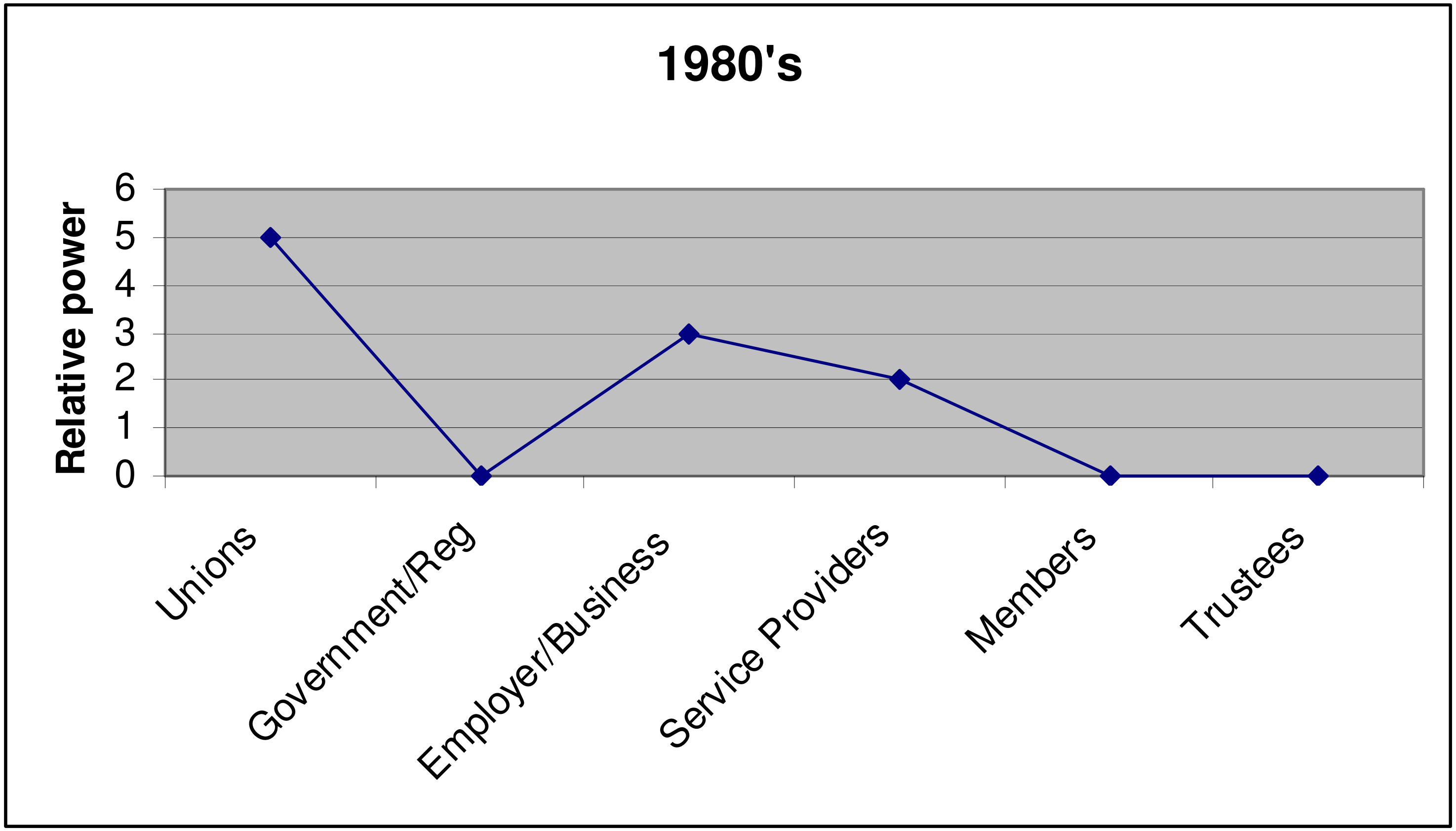
CONSEQUENCES

- Leakage – on retirement and death
- Service provider dominance – took over from the employer
- Surplus could not be accessed, abused by employers
- Social benefit eroded – employer no longer underwrites risk
- Education requirements substantially increased
- Risk passed to ill-equipped members
- Unclaimed benefits rising
- Intergenerational cross-subsidisation lost

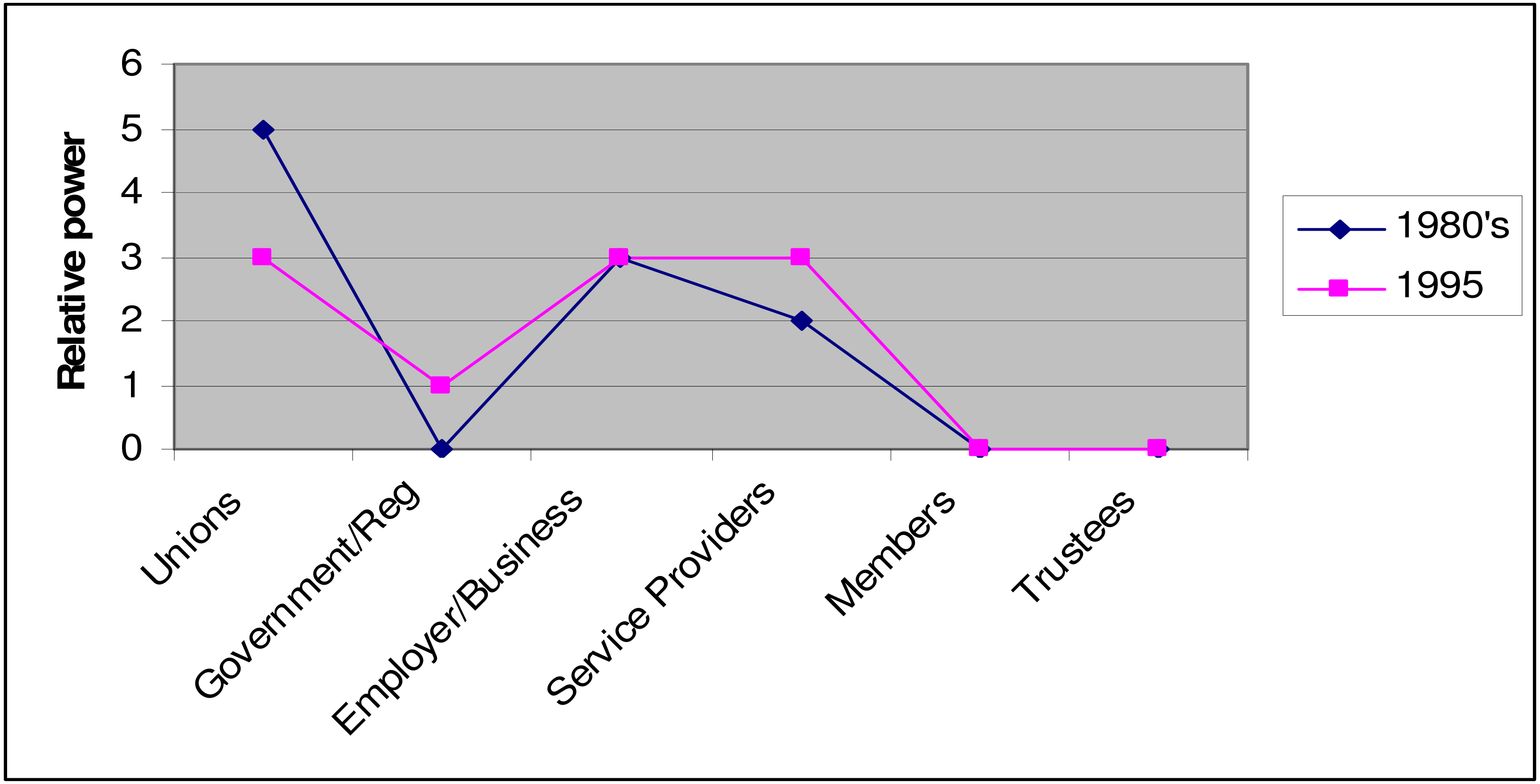
REDRESS

- Pension Funds Second Amendment Act
- Pension fund reform
- Trustee education
- Member education
- Adjudicator rulings

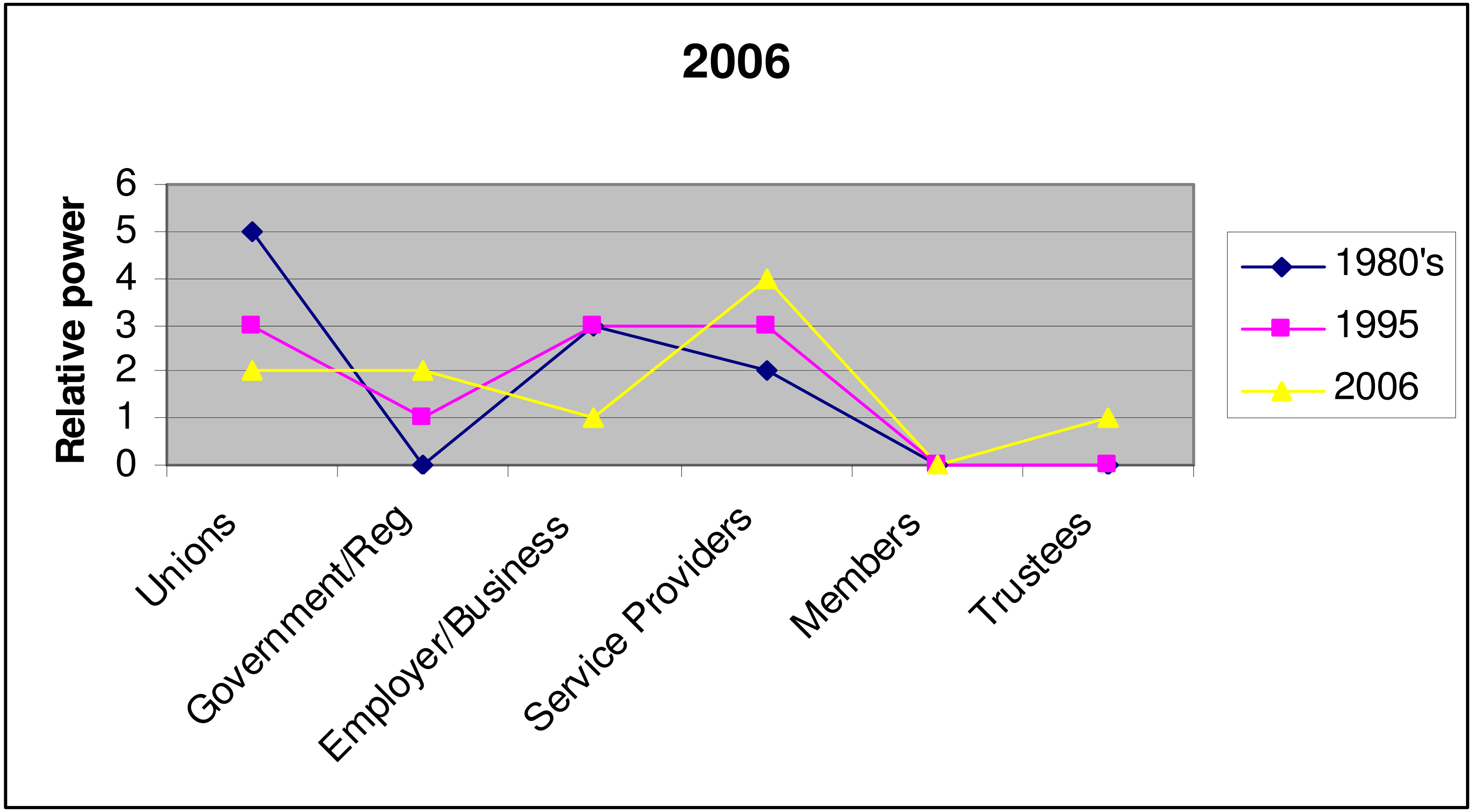
RELATIVE POWER OF STAKEHOLDERS – 1980's



RELATIVE POWER OF STAKEHOLDERS – 1990's



RELATIVE POWER OF STAKEHOLDERS - CURRENT



ETHICS

- Members worse off and needed protection
- Poor transfer benefits
- Investment reserve not distributed
- Surplus valuation manipulated
- Some deliberate unethical behaviour
- Policy change is socially desirable if:
  - Everyone is better off (weak pareto criterion)
  - At least some are made better off while no one is made worse off (strong pareto criterion)
- After pension fund conversions some members are worse off
- Conversions fail both the strong and weak criteria for social desirability
- Consequentialism – the morality of an action is judged solely on its consequences

RESULTS OF DATA COLLECTION

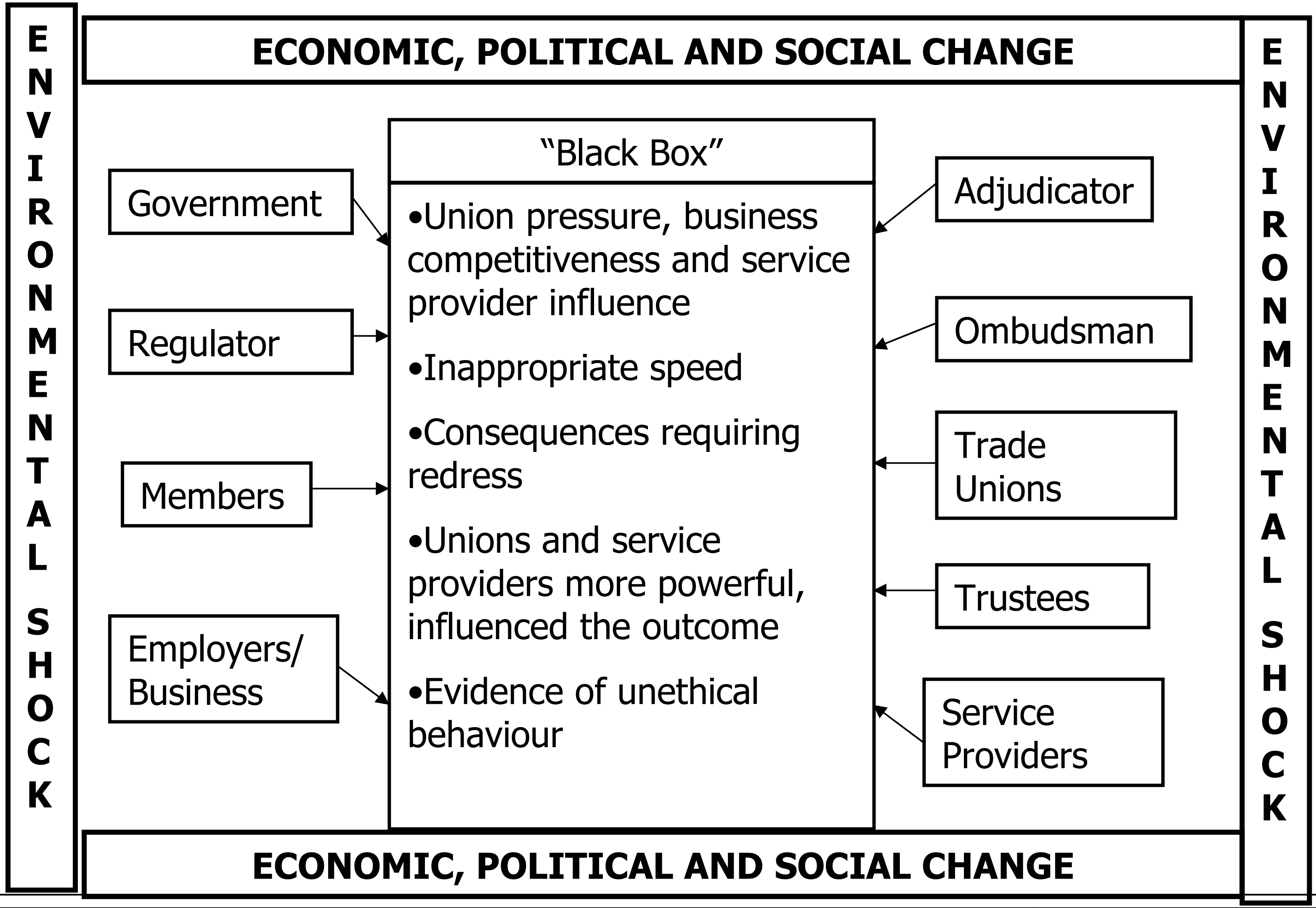
- There was an environmental shock: political, economic and social change – unions, employers and consultants responded
- Evolution was driven by political factors (union desire for political power – “first wave”) and economic factors (business competitiveness – “second wave”), signs of a “third wave”
- Inappropriate speed (insufficient for effective thought processes)
- There was uncertainty, no precedent to follow and several consequences arose that now require redress
- The relative power of stakeholders changed and is reflected in the strategic outcome – service providers, unions, regulators and the rise of consumerism
- Some unethical behaviour occurred

EMERGING PROPOSITIONS

- Emerging model indicates that:

- Economic, political and social change created an environmental shock where
  - Union pressure, business competitiveness and service provider influence drove pension fund conversions
  - at a speed inappropriate for sufficient thought
  - creating uncertainty, vacuum circumstances and consequences that require redress
  - Relative power of stakeholders changed and determined the strategic outcome
  - An imbalance in stakeholder interests occurred and ethical considerations became consequential

EMERGING MODEL



CONTRIBUTION TO THEORY

- George (2006) suggests:
  - Environmental shock: “a condition where business or societal rules are inadequate, or do not exist, to deal with unfolding events”.
  - Environmental shocks are of a greater magnitude than competitive shocks and may include a series of competitive shocks
  - Environmental shocks interrupt organisational routines and trigger activities to create certainty
  - Under conditions of environmental shock managers can make sense of the situation by applying an analytical tool emerging from the research
  - Fast decision making is essential, provided it does not exceed the thought process

LESSONS FOR RETIREMENT FUNDS INDUSTRY

- Conversion phenomenon occurred in the absence of sufficient thought and, in some instances, presence of ulterior motives
- The consequences are still unfolding
- Legislation and regulation subsequently required to protect members from an exploitative industry
- Many unanswered questions remain – raised by interviewees (verbatim):
  - 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?
  - 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?

QUESTIONS FOR RETIREMENT INDUSTRY

- 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?
- 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?

FURTHER QUESTIONS FOR RETIREMENT INDUSTRY

- Why did management convert – especially if they were not the owner of the business?
- 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 lawyers and actuaries?
- 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?

IMPLICATIONS FOR PENSION LAWYERS

- Some now wondering: “what happened?”
- Research has revealed some interesting patterns
- Pension funds are a microcosm of South African society and are indicators of broader influences
- There remains much conflict and vested interest
- The pension fund evolution is on-going
- Pension funds were successful tools for political liberation
- By taking control over pension fund assets, union members provided the capital that kick-started Black Economic Empowerment
- Pension funds will be mobilised for economic liberation
- Environment poised to take another evolutionary leap

LEGAL ISSUES ARISING FROM THE RESEARCH

- Regulatory framework
- Surplus
- Corporate governance
- Fiduciary responsibilities of Boards
- Third conversion wave
- Legal training
- Pension Fund Reform
- B-B BEE Codes of Good Practice
- South African legal environment

Employers, relying on the advice of consultants, began a process of redefining their liabilities towards their employees. The industry therefore commenced a process of restructuring, with many employers moving from defined benefit arrangements to defined contribution schemes. This 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.

REGULATORY FRAMEWORK

- John Murphy (2001)

- What were the pension lawyers doing at the time?
  - What is being done in preparation for the next leap?

- Is the regulatory framework suitable now?
  - What should pension lawyers be doing if it is not?

- What else is changing in the pension funds environment?
  - IRF/IRI split
  - Struggle for control over pension fund assets
  - Individual member choice
  - Adjudicator on RA’s – member trust in industry compromised
  - Umbrella funds vs Industry funds
  - One-stop shop for disputes

SURPLUS

- Actuarial liability
- Investment reserve
- Actuarial reserve
- Actuarial valuation
- Transfer values
- Surplus
- Funds remain in existence
- There were instances of deliberate manipulation
- Second Amendment Act “compromise legislation”
- Surplus apportionment schemes

SURPLUS

- Is surplus legislation failing its objective?
  - Act, regulations and circulars can conflict
  - Intent vs letter of law
  - No precedent from tribunals
  - FSB has threatened that 31.03.2006 is the final date for extensions
  - Arguments that members “negotiated” away their benefits
  - Actual examples (Neil Lloyd):
    - **5000 former members**
    - 60% get nothing
    - 5% : > 100K
    - One : R 1 million
    - **1000 transferees**
    - Only 20 get anything
    - One : R1 million

CORPORATE GOVERNANCE

- Du Plessis, McConvill & Bagaric (2005): “the process of controlling management and balancing the interests of all internal stakeholders and other parties (external stakeholders, governments and local communities) who can be affected by the corporation’s conduct in order to ensure responsible behaviour by corporations and achieve the maximum level of efficiency and profitability for a corporation”.
- Employers acted to create certainty for themselves – first wave to get members back to work; second wave to minimise risk of erratic decisions by member elected trustees and to create cost certainty
- Internal stakeholder interests were not balanced – “information dis-equilibrium” occurred and disadvantaged members
- External stakeholder interests were not considered – social benefit eroded

CORPORATE GOVERNANCE

- Corporate governance failed – in some instances deliberate attempts to hijack the “surplus”
- Boards of Directors, not trustees, made conversion decisions
- What about corporate governance now?
- Are some stakeholders more influential than others?
- Should employers/trustees protect fund members from service providers and unions?
- Code of conduct required for sponsoring employer?

FIDUCIARY RESPONSIBILITY OF BOARDS

- Boards of Management (Trustees) implemented conversion decisions made by company boards
- Evidence indicates that they acted to protect themselves, not the members
- Trustees must (Wright, 1995):
  - Act in good faith – not benefit personally
    - Some trustees benefited more than other members from conversions
  - Act as a prudent and reasonable person
    - Trustees now claim ignorance
  - Give effect to the trust instrument (rules) and intentions of the founder
    - Members were often worse off after transfer
  - Exercise their own discretion
    - Few trustees questioned conversion decisions

FIDUCIARY RESPONSIBILITY OF BOARDS

- Trustees claimed ignorance, is this acceptable?
- Can members now worse off take legal action against the trustees responsible for the conversions?
  - Funds remain in existence
  - Damages only become apparent when retirement benefits are calculated at retirement
- Have current Boards learned from this?
  - Abdicate to consultants
  - Permit one provider to control and provide all services
  - Distance from investment decisions via individual member choice

THIRD CONVERSION WAVE

- First wave – union members transfer from a defined benefit pension fund to a defined contribution provident fund
- Defined benefit fund retains remaining members
- Second wave – large majority of remaining members transfer to a new or existing defined contribution fund or existing fund rules are amended to create a "hybrid"
- Defined benefit fund remains in existence for members who did not convert but closed to new members
- Third wave has now begun
- Aims to "encourage" remaining defined benefit fund members and pensioners to convert so that the fund can be closed

THIRD CONVERSION WAVE

- Can remaining members be “forced” to convert from DB to DC?
- Operational reasons need to be justified
- What happens to the pensioners?
- Markets looking attractive for conversion
- Given that trustees know the implications of conversions, what steps should they take to mitigate the implications for members?
- Business opportunity for Pension Lawyers

LEGAL TRAINING

- Pension law grew out of labour law
- Pension lawyers bowed to the actuaries
- Law faculties weak on pension law
- Pension lawyers concentrated in consultancies rather than legal practice?
- Lawyers acted for specific constituencies within the fund rather than for the fund as a whole
- Legal opinions
  - Which opinion do you want?
  - Choose SC to provide required opinion?

LEGAL TRAINING

- Pension law should be a compulsory course for law students
- Centre for pension law excellence
- Academic think-tank required
- Principles for pension lawyers

PENSION FUND REFORM

- Environmental shock – existing rules are inadequate
- Political, economic and social factors driving the process
- Process is moving very slowly – unlike other legislative changes
  - To align pension fund reform with the objectives of B-B BEE
- There is uncertainty e.g. over unclaimed benefits
- Consequences will arise and require redress in the form of amendments
  - New act in itself a form of redress
- Stakeholders are jostling for position
  - Showdown between service providers and unions/FSB in the IRF
- Ethical considerations
  - Pareto criterion

PENSION FUND REFORM

- 3 potential consequential scenarios
- Justice for all
  - Stakeholder interests balanced
  - Member centric view
- Jaws
  - Excessive costs and fees feeding off member benefits
  - Members are exploited and afraid to venture into the water
- Jurassic Park
  - Overregulation and pension funds as political footballs
  - Members are trampled by outdated ideologies

B-B BEE CODES OF GOOD PRACTICE

- 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, final codes Nov 2005).
- Codes issued by the DTI - silent on pension funds, but mention trusts
- Recognition of ownership by black members of pension funds for purposes of the B-B BEE ownership scorecard is under debate

B-B BEE CODES OF GOOD PRACTICE

- Potential consequences of non-recognition:
  - A company 100% owned by a pension fund whose members are 100% black must sell a portion of the company to other black persons to get credit for its black ownership
  - Poor black workers pay for BEE transactions – example of Cape Joint Retirement Fund and FirstRand, H Herbst, Today's Trustee May 2005
  - Increase in income inequality rather than decrease – is this legal?
  - Why would members want to engage in shareholder activism if it dilutes their own assets?
- Potential consequences of recognition:
  - More complex role for trustees
  - Disruption of the investment supply chain
  - More union control over assets via trustees
  - Lack of funds for other BEE beneficiaries
  - Re-evaluation of existing BEE transactions

FINANCIAL SECTOR CHARTER

- Voluntarily developed by the sector – prior to DTI Codes
- Constitutes a framework and establishes the principles upon which B-B BEE will be implemented in the financial sector
- Charter provisions and scorecard
  - Human resource development
  - Procurement Policies
  - Enterprise Development
  - Access to financial services
  - Empowerment financing
  - Ownership and Control
  - Shareholder activism
  - Corporate social investment

ARE RETIREMENT FUNDS BOUND BY THE CHARTER?

- IRF's co-signatory does not bind the industry or its members to comply with the provisions of the Charter
- Participation mandate given to Chairman of IRF Board at the time:
  I. To add value to the Charter from a retirement industry perspective
  II. To assist in the drafting and resolution of retirement industry related issues encountered in the drafting process
  III. That the IRF cannot commit its members to the implementation of the Charter
  IV. 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
- Where will the R75 billion in empowerment finance be sourced?
- Major developments will arise in this area

SOUTH AFRICAN LEGAL ENVIRONMENT

- Transition from Apartheid to Constitutional Democracy – an environmental shock to the South African legal system
- Various factors driving legislative changes
  - Political, economic and social
- Some laws may be changing at an inappropriate speed (i.e. too rapidly in the absence of sufficient thought)
- Consequences will arise and require amendment
- Legislation will reflect the influence of the stronger players
- Ethical issues have arisen

PENSION FUND EVOLUTION

- Asset management more profitable than fund administration
- Pension funds are significant capital allocation mechanisms
- Defined benefit fund assets initially controlled by employers
- After union member transfers – defined contribution fund assets controlled by trade unions
- Kick-started BEE as source of funds for empowerment deals
- After the advent of boards of trustees – assets controlled by boards of trustees who were strongly under the influence of investment consultants
- Renewed struggle for control over pension fund assets
- Need for empowerment financing
- Desire for member activism
- Mobilisation of pension fund assets for economic liberation is inevitable – battle for control over fund assets has already begun

EVOLUTIONARY SURVIVAL TIPS FOR PENSION LAWYERS

- Recognise that the industry environment is in shock - existing rules are inadequate
- Understand the various factors that are combining to drive adaptation to the environment
- Note the speed of change – is it appropriate for sufficient thought?
- Consider what is uncertain and where precedent is absent
- Explore the potential consequences of proposed change
- Assess the relative power of the stakeholders including your own
- Develop a code of conduct

History doesn’t repeat itself,

but it rhymes