

PROTECTING MEMBERS' RIGHTS

(A paper to be delivered by MALCOLM WALLIS SC to the Annual Conference of the Pension Lawyers' Association to be held in Cape Town on Tuesday, the 17th February, 2004)

As this is the graveyard shift of the conference and some people in the farthest reaches of the room may be contemplating taking forty winks it is perhaps appropriate for me to start, as all good bedtime stories start, with the words : “Once upon a time”.

Once upon a time pension schemes were mainly the preserve of large, stable commercial enterprises the management of which saw themselves as exercising a benevolent concern for employees. As with many other things the notion of a private pension fund provided by an employer for its employees was imported into South Africa and they do not appear to have become widespread until after the Second World War.¹ However private pension schemes in a form roughly familiar to us today can, like public pension schemes, be traced back to the Victorian era and the tumultuous conflicts that attended the rise of trade unions, the development of Labour or Social Democratic political parties and the economic doctrines associated with the names of Karl Marx and Friedrich Engels.

Just as Bismarck - the Iron Chancellor - instituted a national pension scheme and

¹Whilst statutory pensions for some civil servants existed before the end of the 19th century one finds in 1910 (*Fichardt Limited v Faustmann* 1910 AD 168) and 1928 (*Stevenson v Morum Bros.* 1926 EDL 406) references to employers granting pensions to employees as a “remuneratory donation”. The subject was only regulated by statute by way of the Pension Funds Act, 24 of 1956.

compulsory social insurance in order to try and head off the rise of the Social Democratic Party in the new Germany, so employers in England and the United States and elsewhere established pension schemes in a bid to win the loyalty of their workers and keep them out of the clutches of the trade unions. The distant promise of a pension instead of the workhouse was intended to drown the siren call for better wages and working conditions. I am not sure when the first pension scheme was established in the United Kingdom, but in this area at least Canada can legitimately boast of having started before the USA. A pension fund was established for management by the Grand Trunk Railroad in 1874, one year before the first pension fund in the USA - that of American Express - in 1875. By 1900 when the Pennsylvania Railroad Company, then the largest employer in the USA, introduced a pension scheme for its employees their use had become widespread.

In the early days these pension schemes were non-contributory and justified to shareholders as promoting loyalty. With a fine disregard for the notion of contingent liabilities the intention was that they would be funded by the employer from current earnings as and when the employee retired, without being reflected in the annual financial statements. Initially in the USA there was resistance to the funds being constituted separately from the employer. In England they were, as they still are, set up by way of trusts and were made subject to the laws governing trusts. This meant that they were by and large invested in conservative investments such as bonds.

In both countries pension schemes became contributory and the idea grew that pensions were a form of deferred wages because workers gave up a portion of their wages “now” in return for a pension “later”. By and large, however, the question of protecting members’

rights did not arise. With most funds being defined benefit funds the risks were few and their nature well understood. From the member's point of view the principal risk was to avoid being fired or laid off - dismissed or retrenched to use the language of the lawyer. Provided he (and, because discrimination was endemic, only occasionally she) worked for the company until retirement or death a pension was paid in terms of the pension scheme rules.

Beyond staying employed the member had few concerns about the actual operation of the pension scheme. The financial risks of the scheme were borne by the employer. Unless the employer went into liquidation or suffered major financial setbacks so that it could no longer underwrite the scheme the pension was reasonably secure. Once pension funds were established as separate from the employer, whether in the hands of trustees or in the hands of trade unions, there was also a risk that the funds might be stolen. In 1923 the Morris Packing Company pension failed. In the late 1950's and early 1960's Jimmy Hoffa pillaged the Teamsters' Union's pension fund and in 1964 the United Auto Workers' pension scheme at Studebaker collapsed, thereby demonstrating that union management is not necessarily more secure than company management. By and large, however, these disasters were isolated and they brought with them regulators and regulations. In most cases, however, pensions were a relatively untroubled part of life. Members of schemes went to work and retired on pension and lawyers were not asked to attend conferences and deliver papers on protecting members' rights.

What changed this? Various factors were relevant. No longer were pension funds invested solely in "trust" assets, which are generally low income producing, boring and safe. Instead equities became the principal investment of pension schemes. Financial markets became much more complex and the ability of even experienced businessmen to manage

portfolios of investments outside the ordinary run of their own business was limited. Inflation hit hard in the 1960's and actuaries were justifiably cautious. The demands of workers and their unions for pensions to kept abreast of inflation were clamant. Then the world economy emerged into the uplands of a prolonged economic boom and unanticipated and unprecedented surpluses were generated. Greed set in as everyone fought for a share of the pie. The world according to the GAAP of accountants revealed future hidden perils and demanded that they be reflected in the annual financial statements of companies. The boom - as all booms do - lured ordinary people into thinking that they were an amalgam of Warren Buffett and George Soros. At first canny employers and the actuaries who advised them and eventually almost everyone, including the fund members themselves, rushed lemming-like from defined benefit to defined contribution funds. And scarcely a dissentient voice was heard telling workers in the words of King Lear : “Oh! That way madness lies; let me shun that”.

The end result of this collective folly by workers and their trade unions - some of which took the opportunity to lay their own hands on the collective savings of their members - has been to leave the member of the average pension scheme in South Africa naked and exposed to a mass of risks that they are ill-equipped to cope with. After all if we as a society genuinely believed that the majority of workers had the capacity to make complex financial decisions (with or without the benefit of advice) and provide for their own futures and retirement, workers and their trade unions would not demand and employers would not provide pension schemes. In that Utopian world we would trust workers to take their 7½% contribution and add it to the 7½% matching contribution of their employer (no doubt with some assistance from the tax man) and invest it to provide themselves with a pension sufficient to sustain them and their dependants in

their old age.

The truth of the matter is that we do not live in Utopia and no-one believes that the average person can do this.² Most people have a limited capacity, if any, to make sensible investment decisions; certainly those of the long term consistent nature that ensure a secure retirement. When charged with that responsibility the majority by and large miss the upward ladders of investment and plod along square by square sliding down most of the snakes. They take short term decisions on long term issues and when they finally retreat to the security of interest-bearing investments the Masterbonds, Owen Wiggins Trust, Tromp & De Wet, Supreme Holdings and Krion pyramid schemes are there to fleece them, something which they do with lamentable frequency. I choose South African examples because they are readily to hand but the problem is international as anyone will testify, who has taken even a cursory interest in the latest mis-selling saga in England, involving the sale of billions of pounds of precipice bonds to old age pensioners. What aggravates the problem in South Africa is the fact that the bulk of our workforce is under-educated and relatively unsophisticated and therefore both less qualified to look after its interests and more vulnerable to the incompetent and the unscrupulous.

²There are of course exceptions and no doubt there are people who are capable of doing their own investing and would prefer to have more money rather than a company pension but they seem to be few and far between. Even those whose working lives are taken up in looking after other people's investments usually belong to the company pension fund and the top executives are usually the biggest contributors.

Protection of members of pension schemes is necessary in this area but it is by and large misleading to talk of the protection of rights of pension scheme members. The shift from defined benefit to defined contribution funds has brought about a seismic shift in the rights of fund members. Before they were entitled to a pension fixed at a defined level and linked to salary and years of service not contribution. The vagaries of stock markets left them by and large unaffected and their employer's role as underwriter of the scheme protected them from harm. Now that protection is withdrawn and they are entirely exposed because at the end of the day all they are entitled to is their actuarially assessed share of the fund at the time of their withdrawal. This introduces the element of lottery into many pension schemes. Take three friends who worked for the same company for thirty years and progressed along the corporate ladder at much the same rate. They plan their retirement together - the holidays they will take and the games of golf they will play. Because of the accident of their different dates of birth one year spans their retirement and they retire at intervals of six months. The first leaves in May 1997; the second in October 1997 and the third in May 1998. The first and the last enjoy their holidays and the games of golf. The middle one turned 65 in the middle of the Asian financial market crisis, which plunged world stock markets into a decline, and now has to find a job in order to make ends meet. The story has been repeated since on several occasions.

I use this example to illustrate that our principal concern is not protecting members' rights but protecting their interests. Rights are matters of entitlement arising from the rules of a pension scheme and the provisions of the Act. They are policed by boards representing both members and the employer and by a principal officer; an auditor; and a valuator who is ordinarily an actuary. Over all this is the umbrella of the Financial Services

Board (FSB) and any person dissatisfied with all of this can resort to the Pension Funds Adjudicator or the courts.

If all this does not suffice to provide adequate supervision of the exercise of powers and the observance of rights then as Justice Kriegler said the other day in regard to defects in the justice system, that is due to human failure. Superimposing further layers of supervision, reporting and control will not solve that problem. A Rolls Royce system of regulation and control is of little use if it is operated like a battered Volkswagen Beetle.

What we need to be concerned with is protecting the interests of members. This has two aspects which operate at opposite ends of the scale. The first is safeguarding them against catastrophic loss. The second is securing reasonable returns on their savings. It is the former problem that grabs the headlines, but the latter one is the more widespread and the more difficult to resolve. Let me start with the easier one although the two will tend to merge as I go on.

There is a tendency whenever something goes catastrophically wrong with a pension scheme to blame the regulator but the regulator should be the last resort in safeguarding against catastrophic loss. The regulator's function is not to operate the system but to oversee its operations. It needs to be concerned with the structural framework within which pension schemes operate. It needs to establish the safety net of precautions that must be taken and minimum standards that must be observed in the operation of pension schemes. Then it must police those standards effectively so that it is alerted to signs of danger. And it must be ready to

step in, as it did last year with the SACCAWU fund, to remove those who have failed in the discharge of their duties, whether because of incompetence or untrustworthiness. Above all it needs to be alert to changes in the market place and the prospect that schemes that seem innovative and plausible will turn out to have fatal weaknesses and pitfalls that may lead to disaster. Financial markets have become increasingly flexible in the last twenty years and there is little sign that this will change. Regulators in the pension industry must keep themselves abreast of such changes and constantly examine them to see where they can adversely affect the viability of pension schemes.

Having said all that I come back to the point that it is not the role of the FSB to run pension funds although it may sometimes have to rescue them. It is not its province to dictate investment policies or the types of supplementary benefits that a fund may offer its members. If we were looking for that kind of decision making we would scrap private pension funds altogether and consolidate them into one giant national fund or perhaps a few huge industry funds. Then one would need a national fund administrator rather than a national regulator. However, that is not a direction one would recommend. We need only look at the history of deficient performance in relation to pensions in the public sector and the sorry state into which the Associated Institutions Pension Fund got itself at a time when virtually every private pension fund in South Africa was generating surpluses, to be wary of following that route.

I think that we need to clarify the proper role of the regulator in this field. Broadly speaking it is two-fold. Firstly there is its role in setting the standards. Secondly it is its role in enforcing them. At present my sense of matters is that the FSB is struggling more with the latter

than the former. There have been massive changes in the pension fund industry in the last few years, particularly with the passage of the surplus legislation, but also with the restructuring of the FSB itself. All of this has happened at the same time as the tidal wave of changes from defined benefit to defined contribution funds, with funds being restructured, wound-up or closed to new members, new funds being constituted and transfers between funds. This has imposed huge administrative burdens. One knows that substantial delays are experienced in dealing with section 14 applications which form a critical part of the supervisory function. As we know from the *Mostert* case³ schemes become impatient and implement changes before the requisite authority has been forthcoming. There is no reason to think that this was an isolated instance. In my experience it has been a pattern for some considerable time and in that case it was contended that this practice justified a departure from the strict legal position⁴. It is an issue that needs to be resolved. Clearly that requires the FSB to deal more expeditiously with section 14 applications but it must also police the industry better to make it clear to the participants that rule changes may not be implemented until they have been approved. Equally there needs to be a change in attitude by the boards of pension schemes and the administrators of pension schemes. Experience shows that once changes are implemented overwhelming difficulties can be experienced in unravelling them. It is vital that we establish a culture of playing by the rules. In other words rule changes must not be implemented until they have been brought into effect.

³*Mostert N O v Old Mutual Life Assurance Co (SA) Ltd* 2001 (4) SA 159 (SCA).

That brings me to the boards of pension schemes. Formerly these were the private fiefdoms of management. In their favour it should be said that they tended to operate with caution because they knew that if something went wrong with the fund it would be the employer who would have to underwrite the deficit. Admittedly the caution was reflected in low rates of return for those who left the fund early and benefit increments that lagged the inflation rate. On the other hand funds remained solvent and South African experienced no Robert Maxwell or Jimmy Hoffa.

The change in composition of the boards of funds has had the beneficial effect of forcing funds to concentrate more on the needs of their members. In principle that is desirable, although I have encountered some peculiarly parochial and self-interested attitudes on behalf of existing members when it comes to surplus distribution. However, in addressing the real issues of risk that I identified earlier I have difficulty in seeing how this has been advantageous, either in preventing catastrophe or in providing reasonable and secured rates of return on behalf of members.

My concern follows quite simply by reasoning from the general to the specific. As I said earlier the average person has no particular qualifications or ability to manage their own investments and their own pension. Why is it thought that the elevation of an individual, who lacks that capability, to a board of trustees somehow invests him or her with the capacity to do on behalf of all the other members of the fund, that which they are incapable of doing on their own behalf? The answer is that it does not and in the end result it leaves such board members at the mercy of more articulate colleagues or more often the professional advisers of the scheme.

Many if not most of us in this room are, of course, professional advisers and it is

not my purpose to bite the hand that feeds. It is, however, pertinent to ask whether the existence and availability of professional advisers is a sufficient safeguard of the interests of members of pension schemes against the risks to which they are now exposed. Does the employment of professional advisers in the form of financial consultants and pension fund administrators safeguard the ordinary member of a pension fund against the risk of catastrophic loss, due to ignorance, incompetence or dishonesty and does it secure to the ordinary member a regular and reasonable return on the investment constituted by their pension fund contributions?

Happily the answer to the first of these questions is by and large that the existence of reputable professional advisers generally provides a safeguard against the kind of disastrous losses that occurred in the pension funds in Robert Maxwell's companies or the pension schemes in place at Enron or WorldCom. However, even in this field it is not enough, as was unfortunately demonstrated by the litigation brought by Mr. Mostert, as curator of the CAF pension fund, against Old Mutual.⁵ If even Homer can nod it is hardly surprising that from time

⁵*Mostert N.O. v Old Mutual Life Assurance Co (SA) Limited* 2001 (4) SA 159 (SCA). The portion of the judgment which deals with Old Mutual's approach (paras. 66 - 72) does not reflect well on Old Mutual. In the subsequent judgments on costs (*Mostert N.O. v Old Mutual Life Assurance Co. (SA) Limited* 2002 (1) SA 82 (SCA) at 89G the court remarked that : "There have been times in the course of this litigation, from trial onwards, when it has been difficult to avoid the impression that the respondent has pursued points with a persistence quite unwarranted given their lack of merit." I stress that I speak only of the reputable. I am mindful that in *Durr v ABSA Bank Ltd* 1997 (3) SA 448 (SCA) at 461I investment brokers were described

to time members of the boards of pension schemes, who may have no particular expertise in financial markets and very few criteria for judging the respectability of the persons who jostle for appointment as professional advisers, fund managers and the like, should sometimes pick badly. Even an obligation on pension schemes to have independent professional board members does not resolve this problem. It merely shifts responsibility elsewhere. As Juvenal wrote the problem is always: “*Sed quis custodiet ipsos Custodes.*” (“But who is to guard the guards themselves?”).⁶

The problem is aggravated when the focus turns from the first element of risk to the second. Here the problem becomes how to select professional advisers and in particular fund administrators whose investment of the funds entrusted to them will produce reasonable and consistent rates of return. If business giants such as Unilever can end up feeling that they were mistaken in choosing Mercury Asset Management⁷ to manage its pension fund and wound up suing them for £130 million⁸, what hope has the ordinary fund of ensuring that its investments are properly looked after?

as “a motley lot”.

⁶ Juvenal, *Satires*,iii,347.

⁷Subsequently Merrill Lynch Investment.

⁸The case was settled during the cross-examination of the Mercury Asset Management witnesses. Although the terms of the settlement were confidential the suggestion in the media is that the settlement figure was £70 million. It is also believed that Merrill Lynch settled a similar action brought against them by the supermarket, Sainsbury’s.

It seems to me that in this brave new world the only way in which we can hope to provide members of pension schemes with some protection is by introducing structures that create a different apportionment of the risks inherent in such schemes. At present the risk lies exclusively with the members who are the people least capable of bearing it. The only thing that can be said is that they are probably better off even with a poorly managed pension scheme than most of them would be if left to their own devices. That is cold comfort and surely not an acceptable response. South Africa has far too many social needs that make demands on a limited public purse for it to accept a situation where the pension fund industry is not pulling its full weight. What then can be done about the situation?

I do not think that we can simply turn the clock back to the days of defined benefit pension funds. I looked at some statistics from the United States of America in preparing this paper and discovered that in 1980 some 80% of pension arrangements in the USA were defined benefit arrangements, either exclusively or in part, and in 1998 the figure was below 45%. Pure defined benefit funds now make up less than 15% of all pension arrangements. In those circumstances to suggest that one should return to a situation where employers underwrite the guaranteed pension benefits of their employees seems impractical. One must bear in mind the risk of the employer simply saying that it is not prepared to provide any pension on those terms.

What struck me as interesting in those statistics and gives rise to my first suggestion for consideration and debate was that the one category of funds that has remained relatively consistent - indeed has even grown slightly - during the twenty years of that study has been funds which were both defined benefit and defined contribution funds. At the beginning of the period they represented roughly 20% of pension arrangements and that has now risen to some

30%. There seem to me to be potential significant benefits that could arise from the establishment of pension schemes in South Africa that combine the elements of defined benefit and defined contribution funds. It is unlikely that they could guarantee benefits to members at the same level as defined benefits funds historically did. If we are considering a blend of risk, however, a fund that guarantees some reasonable level of benefits, whilst leaving the final ultimate return to depend upon the success of the scheme's investment policies would do something to lessen the risk that at present attaches to membership of pure defined contribution funds. That could be combined with a situation where the employer assumed some of the investment risk in return for a corresponding advantage if things went well, by permitting the employer's contributions to fluctuate within a defined range. In other words the employer would be obliged to make a minimum contribution of say 5% but could be required to contribute up to 10% if the level of contributions was insufficient to enable the scheme to achieve certain defined benchmarks.

As I have said my goal is a situation where there is a more balanced distribution of the risk among the various parties involved in a pension scheme and its administration. At present the risk is entirely with the member. My previous suggestion was directed at apportioning risk to some extent between the member and the employer. However, that leaves out of the equation the party who has most to do with the actual performance of the scheme, namely the administrator of the scheme who manages its assets and makes the investments on its behalf. There is I think a growing trend, particularly in relation to the largest schemes, for the board of the pension scheme to set benchmarks against which the administrator's performance is

to be measured.⁹ This is welcome but may not be sufficient. In the interests of apportioning responsibility equally, and remembering that Jonathan Mort in explaining this topic asked me to express views on how members' rights can be protected by trustees, service providers and the regulator, my less radical suggestion is one for the FSB. It is that it should consider whether it should make it compulsory for schemes, when they appoint fund administrators to manage their investments, to agree formal benchmarks against which to measure that performance. This could be supplemented by a set of guidelines indicating the benchmarks that the FSB as the regulator regards as the minimum level of acceptable performance by an administrator. My reason for suggesting that the FSB should at least provide some basic guidelines in this regard is the experience one has seen in practice of benchmarks being set in a commercial context that are wholly one-sided in favour of the service provider. I have had a case where the set of benchmarks, which also determined the fees to be paid to the service provider, were set in such a fashion that it made no difference whether the service provider made money or lost money on behalf of its client. I seem to recall that long before Mr. Jack Milne's PSCGG collapsed a series of articles were written either by Bruce Cameron or at least in Personal Finance pointing out that in soliciting investments in PSCGG Mr. Milne had established the benchmarks in such a fashion that it was well nigh impossible for him not to meet them even if he lost everyone's money, which he appears to have done.

⁹The Unilever litigation turned to some extent around the failure to adhere to agreed benchmarks and the measurement of the manger's performance against that of other managers.

That brings me to the last suggestion which I suspect may be regarded in some circles as heretical. It is that it is insufficient simply to have benchmarks to measure the performance of service providers with only the threat that their services will be terminated if they fail to reach those benchmarks. After all it is perfectly easy to replace one poor fund administrator with another. Academic research on the inability of fund managers generally to outperform such basic benchmarks as the Dow Jones index or the FTSE 100 does not inspire confidence in this regard. My suggestion is that the time has come for consideration to be given to requiring fund administrators to provide guarantees that particular levels of performance will be achieved. This should not be unduly difficult as there are already financial products in the market place that do offer guaranteed returns on investment. In this context the structuring of the scheme of administration will no doubt be rendered more difficult by the obligation to provide a guarantee. It would, however, have a salutary effect on those who hold themselves out as being experts in the field of the administration of pension schemes and the investment of funds. If that is how they choose to describe themselves then perhaps the time has come when they should be obliged to put their money where their mouths are.

Thank you very much