

## SOUTH AFRICAN PENSION FUND CONVERSIONS: DEALING WITH ENVIRONMENTAL CHANGE

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**Purpose:** The purpose of this paper is to analyse South African pension fund conversions from defined benefit to defined contribution structures and to develop a model for dealing with environmental change.

**Design/Methodology/Approach:** Qualitative research methodology was used. Industry experts were interviewed to obtain a macro view of the phenomenon and specific manifestations of the phenomenon were also considered in case studies. Feedback from semi-structured interviews was categorised into several emergent themes. Within-case and cross-case analyses were conducted.

**Findings:** Results indicated 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 relative power of the 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.

**Implications:** This paper provides insight into organisational behaviour during periods of environmental shock. 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.

**Originality/Value:** Analysis of pension fund conversions revealed organisational behaviour during periods of environmental shock and the emerging model can be applied in other instances of environmental shock, such as broad-based black economic empowerment (B-B BEE), land redistribution, sanctions and constitutional development.

**Key words and phrases:** Environmental shock; organisational evolution; pension fund conversion; pension fund surplus; unintended consequences; vacuum circumstances.

### INTRODUCTION

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 and other risks.

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.

## **PURPOSE**

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 and other risks.

In the early 1980s, trade unions agitated for the establishment of defined contribution retirement funds. 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 phenomenon 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” in the form of “sweeteners”.

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

## **LITERATURE REVIEW**

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 percent 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.

### 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 one third cash payment on retirement; the balance must purchase an annuity for life. A provident fund is a pension fund that allows 100 percent cash payment on retirement.

Joubert (1999) suggests that 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 further 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.

According to Ponting (2000), 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.

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.

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) explains 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.

### **Current Affairs in the South African Pension Fund Industry**

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.

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.

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.

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 percent 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.

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 percent. 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.

### **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 percent of final salary for each year and completes 40 year's service, the member will receive a pension of 80 percent 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.

### **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.

### **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-going 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 percent dividend yield.

### **Investment Reserves**

Stock market values constantly fluctuate. To compensate, actuaries usually place a lower value on shares than the market value. This ensures that, should the stock market 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.



### **The “Surplus Issue”**

Wellsted (2000:22) 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 stock market, 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.

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.

### **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 Trustees 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 protect.

### **Existing Theory**

Existing theory does, to a certain extent, explain the phenomenon of pension fund conversions.

- **Competitive shocks**

According to Ghemawat and Khanna (1998:43), 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. It appears that, under environmental shock, several competitive shocks may occur.

- **High turbulence**

Cameron and Kim (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.

- **Organisational evolution**

Hayden, Ruvinsky, Gilgoff and Sobel (2002:2) 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 (2002:10) 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 “trusted advisors” in the process of their own sense-making. Subsequent events would show that these “trusted advisors” were not trustworthy.

- **Decision-making speed**

Eisenhardt (1990:39) 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 councilors; 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 up 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 conversion process outpaced the thought process.



- **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), particularly the members.

- **Ethical considerations**

Johansson (1991) proposes 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.

- **Theory of the firm**

Penrose (1959) saw the organisation 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. An organisation 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 organisations 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.

Organisations utilised pension fund assets as if they were the organisation'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.

### **What the Literature Does Not Explain**

The literature does not explain how organisations respond to fundamental environmental change<sup>1</sup>.

### **PROBLEM INVESTIGATED**

The phenomenon of 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

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<sup>1</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."

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.

Propositions were that, during an 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.

## **METHODOLOGY**

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 (1994:8) list three approaches to qualitative research: interpretivist, social anthropology and collaborative social research. The interpretivist approach was used: it suggests that 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. Various instruments were implemented for this purpose.

Miles and Huberman (1994) suggest that one 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.

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. To investigate particular manifestations of the phenomenon, eight cases were studied. Cases, drawn from various industry sectors, were studied in Johannesburg, Cape Town and Durban.

The analytical process was qualitative. Cross-case and within-case analyses were conducted. Responses of industry experts were analysed and various themes emerged. Data collected from the case studies served to enrich findings from the industry experts.

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.

## **FINDINGS**

Research results indicate that pension fund conversions occurred under conditions of environmental change that revealed various organisational behaviours.

- **Environmental change**

Conversions occurred under conditions of political, economic and social change. In the 1980s, black trade unions were acting as proxies for the government-in-exile and the liberation struggle was waged on the shop floor. Control over pension fund assets served as a flashpoint. In the 1990s, South Africa's economy was opening after sanctions were lifted. Business was exposed to the force of globalisation and experienced increasing pressure to manage the risks associated with the potentially rising cost of sponsoring defined benefit funds. Concern over cost increases associated with the growing prevalence of HIV/Aids emerged, with the possibility that orphans would collect pensions for many years until they reached maturity. With amendments to the Pension Funds Act leading to the establishment of boards of management and the member election of at least 50 per cent of its members, employers were concerned about the uncertainty that would arise from sharing decision-making with members and, under defined benefit arrangements, the financial implications.

- **Evolutionary driving forces**

Trade unions were seeking political power; employers were seeking certainty and consultants were seeking profit and new markets.

- **Pace of change and uncertainty**

The pace of change was too fast and was not thought through. Despite the steep learning curve, there was no effective legislative framework; no actuarial guidelines; no strategy; and no collective thought. Respondents from the employer category reported feeling a "pressing need" to convert the funds.

- **Consequences**

Under defined benefit pension funds, a pension was usually provided by the fund, at no cost to the member. After the conversions, members who retired were required to purchase an annuity from a life office, and pay the applicable fees. This leakage eroded capital available for investment. Employers no longer provided the social benefit of underwriting the risk and, thus, eroded a social benefit.

After serving as consultants to encourage conversions, service providers began to offer a full range of services – ranging from annuities to administration – and became dominant players in the industry.

Training needs were underestimated prior to the conversions. Extensive education for trustees and members is required. In some instances, not all, members were informed of investment risk. Members were not informed of interest rate risk. The annuity amount that members would purchase on retirement is dependant on interest rates prevailing at the time of retirement. The current low interest rate environment means that members are able to purchase a smaller pension than they would have received under defined benefit arrangements.

The "intergenerational cross-subsidisation" that operated under defined benefit arrangements has fallen away and it now matters to members how the economy performs during their working lifetime. Previously, returns under market conditions in one generation would be "smoothed" by returns under market conditions in another.

- **Redress**

“Surplus legislation” was compromise legislation and, pressured by the trade unions, government set out to refund members whose transfer benefits were understated – especially during the first wave. For this reason, legislation included former members as far back as 1980 in a surplus apportionment exercise. Indications are that this legislation is failing to achieve its objectives.

- **Relative stakeholder power**

In the 1980s the trade unions were at their most influential, and drove the conversion process. By the mid-1990s, employers, encouraged by consultants, were driving the conversion process and the Financial Services Board was starting to exercise its influence. Service provider influence increased as the employer abdicated. Now service provider influence appears equal to that of the combined influence of the union/FSB/trustee group. This is manifested in the split of the Institute of Retirement Funds (IRF) into the IRF, to serve the needs of trustees, and the Institute of Retirement Industry, to serve the needs of other who operate in the industry.

- **Ethics**

Members were worse off and needed protection during the conversion process, which they did not receive. Members received poor transfer benefits – never their full entitlement to the investment reserve that was held to ensure they would receive their promised benefit at retirement. Surplus valuations were manipulated to inflate the surplus and consultants advised employers that they would be entitled to the monies “left over” after the conversions. There was some deliberate unethical, and illegal, behaviour.

## **IMPLICATIONS**

Research results provided insight into the various propositions that were subject to investigation.

### **Proposition One: Factors Combine to Drive Evolution (i.e. adaptation to the environment)**

An environmental shock occurred, within which 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 themselves and their members – this was a political and social factor – and the employer acted to reduce uncertainty<sup>2</sup> – an economic factor.

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<sup>2</sup> Employers were uncertain about rising benefit costs and the impact of shared decision-making with member elected trustees.

### **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>3</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.

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.

### **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 not properly monitored 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. In some instances, actuaries manipulated assumptions to the detriment of fund members.

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

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<sup>3</sup> Although business/employers suggested that there was a “pressing need”.

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”. When some stakeholders are better off and none are worse off, the consequences are “good”.

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.

#### **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.

#### **Proposition Five: An Imbalance in Stakeholder Interests<sup>4</sup> Arises and Ethical Considerations become more Consequential<sup>5</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. The question is whether stakeholders adhered to a particular, acceptable, code of behaviour.

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<sup>4</sup> An imbalance occurs where one or more stakeholders are exerting a disproportionate influence.

<sup>5</sup> Consequentialism is the doctrine that the morality of an action is to be judged solely on its consequences.



If stakeholders are to be judged on the consequences of their actions, it is clear that several stakeholders will be judged harshly. One brokerage in particular grew its business on the back of pension fund conversions and attained a dominant position thereafter by providing services required post-conversion. 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>6</sup> occurred where stakeholders set out to access monies held in surplus to the detriment of members.

### **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 employers 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.

## **CONTRIBUTIONS TO THEORY**

Research on the pension fund conversion phenomenon suggests various contributions to theory:

- **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.

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. In an environmental shock, as evidenced in the research on pension fund conversions, various dynamics occur, as set out in the research propositions above, that eventually result in a modified or new set of rules.

- **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. A third wave to encourage remaining members of defined benefit funds who did not previously convert to convert now, is being driven by the uncertainty of rising costs to the employer.

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<sup>6</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.

Cameron and Kim (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.

- **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.

#### **A MODEL FOR DEALING WITH ENVIRONMENTAL CHANGE**

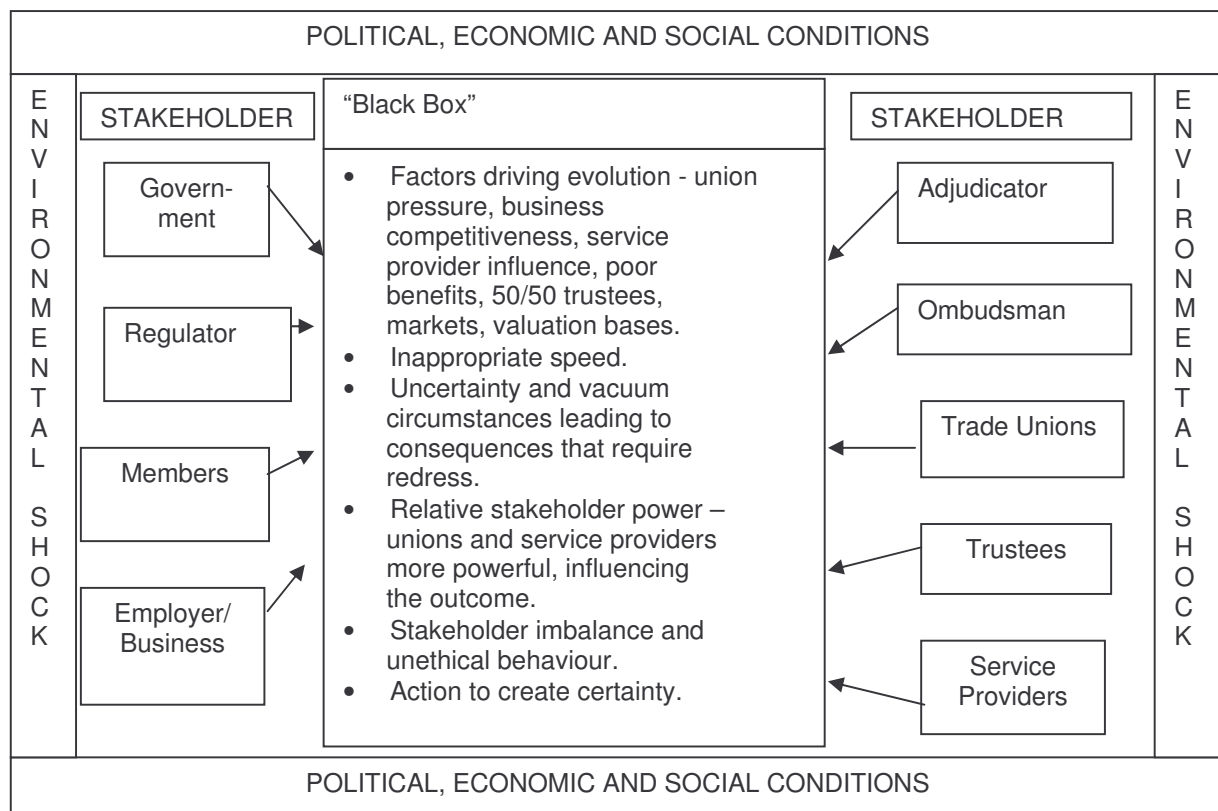
Managers can deal with fundamental environmental change by taking the following actions:

- 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.

A model emerged from the analysis of pension fund conversions between 1980–2006. The dynamics occurring in the “black box” became evident.

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.

Figure 1: Graphical representation of the model for dealing with environmental change



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.

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 well 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 short-changed, 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.

## **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 arrangements. 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 re-structuring, 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>7</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 can be applied to pension fund reform and to the pension fund perspective on B-B BEE. It remains to be seen as to whether or not the pension funds industry will take another evolutionary leap, this time driven by activities aimed at aligning pension fund reform with 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.

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<sup>7</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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