

Legislative changes that should be made in order to more properly reflect the pension promise that an employer makes to its employees and to better protect retirement savings (a personal view).

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Introduction

The IRF had hoped that I would be able to address you today on some of the principles of retirement funding reform that would have been debated at the NEDLAC-convened trustee conference. However, as you know, that conference has been delayed and so there is no information in the public domain on which I can report. So what I propose to do today is to share with you some of my personal thoughts on reforms that are required to more properly reflect the deal that an employer makes with its employees in relation to occupational retirement funding and to more properly protect employees' retirement savings so that the promise can be fulfilled. Everything that I say today reflects only my personal views and no one should try to read into it what might be the policy proposals of the Financial Services Board or National Treasury on retirement funding reform.

Background

South African law does not require employers to provide their employees with occupational retirement funding or even access to occupational retirement funding arrangements such as pension and provident funds. Nonetheless, a significant percentage of formal sector employers do. Traditionally this has taken the form of membership of defined benefit pension funds but, since the 1980's, there has been a big shift towards defined contribution funds and few employers offer membership of defined benefit funds anymore. Many of those that do are now considering whether or not they should follow the general trend, particularly in the light of the onerous new provisions of the Pension Funds Act.

However, whereas the transfer to defined contribution funds was largely union-driven in the 1980's and generally welcomed by employees in the 1990's (particularly when generous benefit improvements were granted by agreement between participating employers and trustees in order to induce the employees to accept their transfer), these days the position is very different. Having watched as their members have experienced the negative effects of exposure to the vicissitudes of the market, unions are resisting further transfers of members from defined benefit to defined contribution funds or the conversion of defined benefit funds into defined contribution funds.

Many defined benefit funds do not have the excess assets that they used to have and could use to provide

incentives (in the form of benefit improvements) for transfers by consent. Those that do have such assets cannot use them for this purpose because any benefit improvement granted in advance of the apportionment of actuarial surplus required in terms of recent amendments to the Pension Funds Act¹ may be regarded as constituting an “election to apportion actuarial surplus”² when the apportionment is not in compliance with the provisions of the Act governing such apportionments.

In the circumstances, employers who wish to procure a unilateral change in their employees’ occupational retirement funding arrangements in order to reduce their exposure to market and other risk³ are now required squarely to face the question whether such a change will amount to a change in the terms and conditions of their employees’ employment and, if so, whether and how such a change may be procured.

To answer the first of these questions it is necessary to determine what the terms and conditions of employment say in regard to occupational retirement funding.

Few written contracts of employment make this clear. Some say that employees are required to join retirement funds selected for the purpose by their employers - or even named retirement funds – but even these do not say precisely what are the employer’s obligations in relation to those funds. Seldom are the rules of the fund explicitly incorporated in the contract of employment by reference. If they are, then they also incorporate within the contract the fairly standard rules that allow the trustees of the fund to amend the rules provided that they have the employer’s consent, but not that of the members, and which allow the employer to terminate its contributions to the fund on written notice to the fund. Even if these rules are incorporated in the contract of employment, they do not dispose of the question whether, if an employer lawfully terminates its contributions to the employees’ retirement fund, the employer has any residual retirement funding obligation towards those employees.

If the terms of the employment contract are not explicit on the point, the tacit terms of the contract will have to be determined by inference from the circumstances.

A tacit term is a term of an agreement which has not been expressed but which a court would be satisfied, upon a consideration of the express terms of the contract and the admissible evidence of its surrounding circumstances, that the parties must have intended⁴. The inference must be a necessary one in the sense that it is necessary to ensure the efficacy of the main agreement between the parties⁵. Circumstances which were not or could not have been contemplated by the parties at the time that the contract was concluded cannot be used to determine a tacit term because they could not have informed the consent of either party to

¹ The amendments made in terms of the Pension Funds Second Amendment Act of 2001, generally known as “the surplus legislation”.

² As contemplated in section 15B(1)(b) of the Act.

³ Such as increases in the cost of risk benefits (death and disability benefits) provided by many funds at the direct cost of their participating employers.

⁴ See *Alfred McAlpine & Son (Pty) Ltd v Transvaal Provincial Administration* 1974 (3) SA 506 (A) at 531 to 531, *Delfs v Kuhne & Nagel (Pty) Ltd* 1990 (1) SA 822 (A) at 827.

⁵ *Wilkins NO v Voges* 1994 (3) SA 130 (A) at 136H to 136D.

be bound by the contract⁶.

While the existence of a tacit term will depend upon whether such a term is necessary, the content of the term will be determined in accordance with the criterion of reasonableness⁷.

It is highly unlikely that there are today still employed many employees to whom their employers undertook that, for their benefit, they would contribute to defined benefit pension funds on a “balance of cost” basis and therefore at a fluctuating rate for an indefinite term⁸ and regardless of any significant change in circumstances⁹. A contrary intention is evident in the fairly standard pension fund rules and practice which,

⁶ Christie RH *The Law of Contract in South Africa* Butterworths Durban 2001 4th edition at 35.

⁷ ABL Phang “Implied terms revisited” [1990] *JBL* 394 and Grieg DW and Davis JLR *The Law of Contract* (1987).

⁸ Our courts have frequently cut down apparent open-ended obligations by applying a “reasonableness” test where the language so permits. In the case of *Annamma v Moodley* 1943 AD 531 at 538 to 539 the court stated the following:

“Now the agreement does not say expressly that the defendant is bound for an indefinite time and, that being so, in my view the court should hold that she was bound for a reasonable time...in the present case we have to deal with an agreement imposing mutual obligations, and in my opinion, as the agreement does not state that the defendant is bound for an indefinite period, the correct view of the contract in the circumstances is that it implies that the defendant is only bound for a reasonable time. If the agreement is capable of two meanings it should rather be construed in the sense in which it can have some operation than in that in which it cannot have any. It goes without saying that the task of a court of law in determining what is reasonable time might be difficult, but it is not impossible and the difficulty is, in itself, not insufficient reason for holding that the contract is void on the ground of vagueness.”

See also *Rustenburg Platinum Mines Limited v Breedts* 1997 (2) SA 337 (A) at 348.

⁹ Gordon Hosking, an actuary writing in 1968, indicates that the contrary is more likely. See Hosking, G.A. *Pension Schemes and Retirement Benefits* 3rd ed Sweet & Maxwell London 1968 at 117-118 at which he says the following:

“Some employers take the view that once having instituted a pension scheme they should guarantee to meet any deficiencies and thus ensure that the benefits according to the rules are paid and that contributions from the employees are not increased. The rationale of this attitude is that the employer is desirous that a certain level of pensions should be paid and that, subject to any contribution thereto which he may arrange for his staff to make, he is responsible for their payment. In order to stabilise the position and obtain certain tax advantages, he establishes a fund. This fact, however, does not alter his feeling or moral obligation to see that the pensions are paid at the level agreed, and if for any reason the fund is unable to meet them, then he is responsible for the difference.

Against the argument, it may be said that it is unwise for any employer to take on a liability of unknown amount, especially as it is one against which it is virtually impossible to make advance provisions. A guarantee of solvency can prove an extremely costly matter. This was clearly illustrated in the immediate post-war years because falling interest rates and rising salaries and wages tended to produce deficiencies which, in some cases, reached very considerable amounts where pensions were tied to final salaries.

For this reason, some employers have gone to the other extreme and taken the view that, having paid their contributions, their responsibility in the matter is discharged. If a deficiency emerges, then it may be right that the employer should assist in its correction, but only on condition that the members do their share, through increased contributions, or decreased benefits.

It is generally unwise to give a complete and absolute guarantee of solvency for present and future staff for any benefits which may emerge. Such a guarantee should be given only where there is some quite moderate ceiling to individual benefits, and even then the employer should reserve to himself the right to close the fund to new entrants. The exercise of this right would enable him to put a brake on the liability under his guarantee if, though inflation or falling interest rates or other causes, it was becoming too large, or if, on the other hand, the firm was going through difficulties which necessitated financial retrenchment.

Even with these precautions, however, it is not surprising that some employers hesitate to undertake such an unknown liability. They may well intend to support the scheme in order to maintain its solvency, but they do not wish to be legally bound to do so regardless of the cost. In the author's view this is the correct approach. Fulfilling a guarantee given some years earlier does little to improve the employee-employer relationship but making an *ex gratia* grant to improve benefits does.

Eighteen years later, similar statements were made in Lee, E. M, *An Introduction to Pension Schemes* Institute and Faculty of Actuaries, 1986, reportedly the standard textbook on pensions for student actuaries.

“8.86 . . . The main feature of the ‘balance of cost’ arrangement to which attention needs to be drawn is, of course, that the employer accepts a virtually unlimited (sometimes referred to as an ‘open-ended’) liability. The trust deed and rules of a scheme will almost certainly provide that the employer may terminate the scheme in extreme circumstances, so that the

until recently –

- granted to the contributing employers the right to appoint and to withdraw the appointment of all of the trustees of the fund;
- provided an investment cushion to smoothe the rates of contribution required of employers;
- adopted conservative investment strategies that were designed to ensure limited risk and a relatively smooth rate of employer contribution;
- treated actuarial surplus as an “employer asset”¹⁰ and allowed it to be taken into account in

funding obligation of the employer is not absolute. Nevertheless, many employers are reluctant to have their obligations defined in this way, although there are on the other hand many schemes in which the provision operates. “

Then, in 1995, the authors of *The Guide to the Pensions Act 1995* edited by Ken Dierden and David Pollard, Freshfields, Tolley Publishing Company Ltd. 1995, said the following:

30.4 The position on winding up is central to the underlying pensions ‘promise’ of a scheme. The following are key issues:

- commonly employers reserve the right to discontinue pension arrangements (whether such a decision could be challenged by employees or the trustees as breach of some implied contractual employment term or duty of trust and confidence is one of the big issues still outstanding in pensions law);
- the security of the accrued pension promise will depend upon the level of the scheme’s funding and the priority under the trust deed given to the member’s benefits; and
- even if the employer is clearly solvent, one lever that it will have in negotiations with the trustees will be the possibility of winding up the scheme and starting again with a new arrangement.

30.13 In considering whether or not employers should continue to be allowed to force a wind-up by stopping contributions to the scheme, the Goode Committee’s (The Pensions Law Review Committee under Professor Goode) attention was drawn to two potentially adverse effects of wind-up on scheme members:

- that it defeats their expectations that the scheme will continue up to and beyond their retirement; and
- that members’ rights may not be adequately secured.

The Goode Committee concluded, on the first point, that employees cannot realistically assume a scheme’s continuance after wind-up any more than they can assume the continuance of their employment with the same employer. The second point they considered to be covered by their recommendations for a minimum solvency requirement (now the minimum funding requirement) – a duty on the employer to make up a shortfall in minimum solvency even if neither the employer nor the scheme is in winding-up, improvements in the monitoring of schemes, and a statutory compensation scheme.

The Goode Committee concluded, therefore, in the light of all their recommendations and the voluntary nature of pension schemes, that the employer should continue to be able to reserve their right to stop contributing to the scheme, with or without the consent of the trustees or the members. “

¹⁰ See Milburn-Pyle, P. “Fund Surplus: The Ownership Debate” *Alexander Forbes Quarterly* Vol 1 no. 1 January 1991, Trollip, T “Who owns the surplus ?”, address to conference on “Successfully Managing the Exposure on Conversion of Pension to Provident Fund”, 1992, *Re Imperial Foods Ltd’s Pension Scheme* [1986] 2 *All ER* 802 (ChD) at 813C-D, *Re Courage Group’s Pension Schemes, Ryan & others v Imperial Brewing and Leisure Ltd & others* [1987] 1 *WLR* 495 at 514. See also the testimony of witness Lewis described in the judgment in *Lorentz v Tek Provident Fund & other* 1998 (1) SA 204 (T) as follows:

“Lewis explained that when a pension fund is set up an actuary would meet with an employer and look to see what benefits were intended to be guaranteed. Employer and employee contributions would be computed. Employee contributions are usually determined up to 7,5% of pensionable salary. The actuary would compute employer contributions to guarantee specific benefits. If employer contributions prove higher than what is necessary to meet the pension fund’s defined benefits, the actuary’s assumptions would have been too conservative. The employer would thus have contributed too much to the fund . . . Lewis confirmed that he initially discussed the question of the surplus with Tek rather than with the trustees of the pension fund.

As far as Lewis was aware, this was the first time that the legality of what was considered to be the employer’s prerogative to take a contribution holiday was challenged in Court. He stated, however, that the question was well aired in the matter of *Lintas SA Pension Fund and The Registrar of Pension Funds* (a decision of the Board of Appeal constituted under s 26 of The Financial Services Board Act 97 of 1990, dated 2 June 1994). Lewis accepted that if his understanding of the legal position was incorrect, it would be necessary for him to change his assumptions and the advice he dispensed. Lewis testified that although the pension fund was under the control of the trustees, they have to exercise control in terms of the rules of the pension fund.”

determining the rate of employer contribution – thus granting to employers the benefit of good investment years to reduce the financial impact of the bad;

- granted employers the right to veto pension increases and rule amendments that had the effect of granting benefit improvements to in-service members and thus the liabilities of the fund¹¹;
- permitted employers to terminate further contributions to the fund on notice to it or to procure the termination of the fund altogether when the employers wished to replace it with another.

These rules and practices have effectively limited the exposure of an employer which funded defined benefits on a “balance of cost” basis to market and other risk by allowing the employer effectively to “manage” the risk almost as easily as it could manage any other employment-related costs. They reflect the terms on which employers were prepared to contribute to the retirement funds for the benefit of their employees and thus the terms of their employment contracts with those employees insofar as they related to occupational retirement funding.

Since 1990, many of these powers and limits on the exposure of employers to the investment risk of contributing to a fund on a balance of cost basis have been removed.

- Employers now have the right to appoint only up to 50% of the members of boards of management of funds¹²;
- our courts¹³ and the pension funds adjudicator have warned those trustees that their duties lie with the funds and their members and not with the employers;
- since 7 December 2001 the right of employers to benefit from surplus assets has been severely restricted¹⁴;
- funds are now required by law to phase in certain minimum benefits¹⁵; and
- if a fund which is required to pay minimum benefits is thereafter liquidated, its contributing employers will be liable to fund any shortfall in the assets required to fund those benefits on

¹¹ Both the UK courts (in *Imperial Group Pension Trust Ltd v Imperial Tobacco Ltd* [1991] 2 All ER (Ch) at 608A) and our pension funds adjudicator (in *IBM Pensioners Action Group v IBM South Africa (Pty) Ltd & another* [2000] 3 BPLR 26 (PFA)) have said that an employer is entitled to take its own interests into account when exercising its discretion in terms of the rules of a fund.

¹² Following the insertion of section 7A in the Pensions Act in terms of s2 of Act 22 of 1996. The section required funds by 15 December 1998 to have boards of management “of which members shall have the right to elect 50%”.

¹³ *Tek Corporation Provident Fund & another v Lorentz* 1999 4 SA 884 (SCA) at 894.

¹⁴ Section 15A of the Pension Funds Act.

¹⁵ Section 14A read with section 15B of the Pension Funds Act.

liquidation¹⁶.

Few, if any, of these changes could have been contemplated by employers which agreed with their employees to contribute to occupational retirement funds on a “balance of cost” basis.

In the circumstances it cannot be said that the employers which agreed to contribute to defined benefit funds on a “balance of cost” basis before these changes came into effect are bound in terms of their contracts of employment with their employees to continue to contribute on that basis, notwithstanding these changes. A court seized with a dispute concerning such a matter is likely to find that it is improbable that a prudent employer would have undertaken an obligation of this kind.

What then, are they required to do in terms of those contracts ? What is the pensions promise ?

The answer to the question lies in the historical development of occupational retirement funding arrangements both in the UK and in South Africa.

The earliest forms of occupational pensions were paid by employers to individual employees out of the revenue of the employers. They were funded on a “pay-as-you-go” basis and granted only to long-serving employees who reached retirement age in the employment of the employers which paid the pensions.

Later, in order to ensure greater security and to obtain certain tax advantages, pension schemes were established, generally in the form of trusts. In essence, however, these trusts were merely vehicles through which employers gave effect to their promises to provide pensions. These promises were made to employees as a group, rather than as individuals. The employers established the trusts, determined the terms of the trust deeds – these usually permitted the “refund” to the employers of assets in excess of those required to fund the benefits – and appointed all of the trustees of the fund.

In 1956, by enacting the Pension Funds Act, parliament determined that occupational retirement funds should be legal entities separate from the employers that sponsored them¹⁷ and that their liabilities be pre-funded¹⁸. This meant that employers did not provide the actual pensions but what they did do was

¹⁶ Section 30(3) of the Pension Funds Act which states the following:

If a registered fund which has not been exempted from actuarial valuation in terms of section 2 (3) (a) is liquidated in terms of section 28 or 29 after the date from which minimum individual reserves are payable on cessation of membership, and the fair value of the assets of the fund, less any current liabilities, is less than the sum of the minimum individual reserves payable in respect of the existing members and former members who may participate in the distribution of the assets (with appropriate adjustment for benefits previously paid in the case of former members) and the cost of annuity policies which will provide equivalent pensions for the existing pensioners and deferred pensioners, the shortfall shall represent a debt payable by the employer to the fund: Provided that, where more than one employer participates in the fund, the shortfall shall be distributed amongst such employers in a manner deemed reasonable by the liquidator.

¹⁷ See section 5(1)(b) of the Pension Funds Act which provides that “. . . all the assets, rights, liabilities and obligations pertaining to the business of the fund shall . . . be deemed to be assets, rights, liabilities and obligations of the fund to the exclusion of any other person, and no person shall have any claim on the assets or rights or be responsible for any liabilities or obligations of the fund . . .”. See also *Ex Parte Trans-Africa Pension Fund* 1959 (2) SA 23 at 26G to 27H.

¹⁸ See sections 16 to 18 of the Pension Funds Act.

pay the contributions¹⁹ which, if managed properly, would be sufficient to fund those pensions. This, in essence, became their promise. It was the contributions to the funds, not the benefits paid by the funds, that constituted the pay for which employers tacitly agreed to be liable²⁰. These contributions, particularly to funds which provided any benefits determined without reference to the amount of those contributions, were made in respect of a *group* of employees, not individual employees.

The Employment Appeal Tribunal of the UK described the relationship between employer, employee and fund as follows in *Frankling v BPS Public Sector*²¹ -

“There is a tripartite arrangement under which the employee is entitled under statute to receive the payments from the scheme, which is under a correlative duty to pay them. The employers owe to the scheme an obligation to provide the necessary funds, which is an obligation enforceable under the regulations. There is, plainly, we think, scope for arguing that as between employer and employee the employer is under a contractual obligation to make the payments to the scheme to enable the eligible employee to receive payment of the benefits. But we are not persuaded that there is any scope for implying a term in the collective agreement to the effect that the employer is under an obligation, owed to the employee, to pay the benefits. Such a term is not necessary, because employees have statutory rights to them.”

As most of the funds were defined benefit funds, the rate of contribution fluctuated over time but, for the reasons already described, the scale of the fluctuation was not usually significant. Over time, the contributions were sufficient to fund pension benefits which were reasonable in relation to the pre-retirement income of the members. If for any reason, the defined benefit target could not be reached (if, for example, the employer could not afford the increase in its rate of contribution that would be required to fund them), then the target could be adjusted by rule amendment provided it was done in good faith and for good reason. This, I venture to say, exposes the lie of defined benefit funds and reveals something of the content of the underlying agreement that an employer makes with its employees in relation to occupational retirement funding. It is this: the employer undertakes to its employees to make such contributions to a retirement fund – the identity and nature of which may change during the period of the agreement – which, together with the contributions made by the employee and taking into account reasonable assumptions as to investment returns and the like, would, had such contributions been made over the working lives of all of the employees of the employer subject to the same agreement, procure for the employees retirement benefits which are reasonable in relation to their pre-retirement income.

¹⁹ The rules of most defined benefit funds require their in-service members to contribute to them at a fixed rate usually expressed as a percentage of their monthly pensionable remuneration and that the employers of such members contribute at the rate determined by the fund's valuator to be sufficient to ensure that the fund is able to meet its liabilities in the long term. The employer's obligation, then, is to fund the balance of the cost of the benefits after payment by the employees of their fixed rate contributions. However, as both the employees' contributions, which are deducted from their salaries, and the employers' contributions form part of the employees' remuneration, there is no significance in the distinction between them. See *Parry v Cleaver* [1969] 1 All ER 555, [1970] AC 1 (HL) at p36 and *The Halcyon Skies* [1976] 1 All ER 856 (QBD) at p864.

²⁰ See cases discussed in Hunter, R *Inequities and Illegalities in Occupational Retirement Funding*, an unpublished research report, University of the Witwatersrand, 1993, in chapter 1, and, in particular, *Parry v Cleaver* [1969] 1 All ER 555, [1970] AC 1 (HL), *The Halcyon Skies* [1976] 1 All ER 856 (QBD) at 863 and *Smoker v London Fire Authority* [1991] WLR 422 (QBD) at 431. But cf *Dippenaar v Shield Insurance Ltd* 1979 (2) SA 904 (A).

See also the Transfer of Undertakings (Protection of Employment) Regulations of 1981 which specifically exclude from the rights and obligations which transfer from the former employer to the new one on the transfer of employment contemplated in the regulations pension benefits accruing under an occupational pension scheme.

²¹ [2000] 43 BPLR (10).

Such a term would be necessary to provide efficacy to the pensions promise. A term requiring an employer to pay to a fund whatever contributions were required to fund defined benefits for individuals, regardless of significant changes in circumstances, would not. Its effect would be to impose on the employer an increase in the rate at which it was required to remunerate its employees and our law does not require this²².

The fixing of a “reasonable” rate of remuneration has been held to be appropriate in contracts of service²³.

If the content of the “pension promise” is not the guarantee of a specific pension, then, but the obligation to maintain a fixed or determinable reasonable rate of contribution towards retirement funding, an employer is probably not obliged to make its contributions to a single fund throughout the duration of an employees’ employment. It may exercise the powers given to it in terms of the rules of the retirement fund²⁴ to which it now contributes to terminate contributions towards that fund and make future contributions to another fund instead.

This change in retirement funding vehicle will not entail a change to the terms and conditions of the employment of the employees.

The only limitation on the exercise by an employer of its right to terminate contributions to a fund lies in its duty of good faith towards its employees and former employees who are members of the fund. It is generally accepted that it is a term implied in every contract of employment that an employer will not exercise its right in such a way as to destroy or seriously damage the relationship of trust and confidence between the employer and the employees and former employees²⁵. This does not mean that an employer may not withdraw from a fund. As the pension funds adjudicator said in *I H Bailes & others v Richards Bay Minerals Pension Fund & others*²⁶ -

²² *Mans v Mondi Kraft Ltd* (2000) 21 ILJ 213 (LC) in which it was held that, unless it is specifically agreed between the parties, an employer is not obliged to grant a salary increase to its employee.

²³ *Elite Electrical Contractors v The Covered Wagon Restaurant* 1973 (1) SA 195 (RA), *Inkin v Borehole Drillers* 1949 (2) SA 366 (A), *Middleton v Carr* 1949 (2) SA 374 (A) and *Angath v Muckunlal's Estate* 1954 (4) SA 283 (N).

²⁴ Which reflect the terms on which the employer is prepared to do business with the fund, not its members.

²⁵ See *Imperial Group Pension Trust Ltd v Imperial Tobacco Ltd* [1991] 2 All ER (Ch) at 606 at which the court said –

“It must be open to the company to look after its own interests, financially or otherwise, in the future of operations of the scheme in deciding whether or not to give its consent. However, in my judgment the obligation of good faith does require that the company should exercise its rights (a) with a view to the efficient running of the scheme established by the fund and (b) not for the collateral purpose of forcing members to give up their accrued rights in the existing fund subject to the scheme. In every contract of employment there is an implied term – ‘that the employers will not, without reasonable and just cause, conduct themselves in a manner calculated or likely to destroy or seriously damage the relationship of confidence and trust between employer and employee. . . . The duty of good faith requires the employer to preserve its employee’s rights in the pension fund, not to destroy them.”

This statement was endorsed by the South Africa Pension Funds Adjudicator in *IBM Pensioners Action Group v IBM South Africa (Pty) Ltd & another* [2000] 3 BPLR 26 (PFA) at 278-9.

²⁶ PFA/KZN/276/03/NJ.

“[W]hilst I have sympathy for the remaining members of the fund, the employer’ decision to withdraw from the fund on the grounds of potential escalating costs is not an exercise of bad faith or an irrational decision. Thus, there are no grounds permitting me to interfere with the decisions of the employers . . . “.

What this suggests is that, provided that it does so for good reason and after properly consulting with its employees likely to be affected by the decision, an employer may withdraw from a fund. However, the duty of good faith is not fulfilled by compliance with these requirements alone. The duty extends, in my view, to the duty to provide a reasonable replacement retirement funding vehicle and to contribute to that vehicle at the rate required to produce reasonable retirement benefits for its employees as a group, taking into account their retirement savings accumulated to date in their former fund.

It does not require that the employer establish for the benefit of the employees a retirement funding vehicle which would provide benefits which are identical in all respects to the benefits provided by the old fund.²⁷

If I am right, then I believe that this formulation of the pensions promise should assist employers and employees in working out what the rights and obligations of both are in, for example, the context of an employer’s restructuring of its retirement funding arrangements such as that in which the SA Local Government Association is engaged on behalf of its members.

The 284 local authorities in South Africa contribute to some 79 different retirement funds, of which approximately 21 are defined benefit funds. Each has its own rules, benefit and contribution structure and board of management (trustees). Rates of employer contribution to these funds range from 15% to 26% with the average rate at about 18,6% whereas the average rate of employer contribution to retirement funds in the private sector is now approximately 10,2% of pensionable remuneration. The rate of employer contribution to the Government Employees Pension Fund is now 15%. A number of local authority retirement funds have benefit levels and special forms of benefit which are far superior to those in central government and corporate sector funds and have rules requiring the municipal employer to make additional contributions to fund these benefits. These payments can potentially have a debilitating effect on the finances of the municipality.

There are also at least 15 700 local authority employees who do not belong to any occupational retirement funds.

SALGA wishes to assist local authorities to restructure all occupational retirement funding arrangements in the local authority sector to ensure that they are equitable, affordable and sustainable

²⁷ In its judgment in *Frankling v BPS Public Sector (supra)* the EAT also made the following interesting statement at paragraph 18:

“Mr. Millar for the applicants also invited us to the view that it would be unfair to deprive the applicants of their [redundancy] benefits which they had earned from their past membership of the scheme. We have some sympathy for that submission, but it should be kept well in mind that they did not have accrued rights to the redundancy scheme in the same way as they enjoyed accrued rights to their pension. The employers were required to fund the redundancy exercise as and when it occurred. There was no right to a benefit unless and until redundancy occurred. Having ceased to be employees of the health service, they carried with them their accrued pension rights which they had earned, but, having ceased to be in the service, their membership of the scheme came to an end in respect of rights

in the long-term. Current arrangements do not meet these criteria because –

- they are inequitable in that they provide for different benefits for employees in comparable employment, often as a consequence of historical discriminatory practices;
- they are not affordable in that they require that employers contribute to them at rates which are excessive when compared to the rates at which Government and private sector employers are required to contribute to retirement funds; and
- they are not sustainable in that they are unpredictable²⁸ and expose employers to liabilities to funds which they are not able to control.

Empirical evidence shows that, if employers and employees contribute to a retirement fund at a fixed rate of 22.5% (15% by the employer) over the working life of the employee, and retirement savings are preserved until retirement, the employee should enjoy a retirement benefit equivalent to some 70% of his or her final salary. This is high when compared to “replacement rates” now achieved in the country.²⁹ Accordingly defined contribution funds are capable of providing for reasonable retirement benefits for local authority employees.

To achieve their transformation objectives, local authorities need to withdraw from participation in all funds which expose them to any liability in excess of a fixed rate of contribution equivalent to 15% of a member’s monthly pensionable remuneration. This means that local authorities should not contribute to any defined benefit funds and any other funds which provide for benefits which cannot be purchased by the combined fixed rate contributions by employers and employees, including death and disability benefits. Instead they should contribute to one or more defined contribution funds operating in the sector which will provide the benefits of scale, ensure proper governance and management control and which will encourage the responsible investment of retirement fund assets including investments in socially desirable investments such as local authority infrastructure development and projects that will promote job creation and long term economic stability in the country.

SALGA has been engaged in lengthy negotiations with trade unions representing local authority employees with a view to reaching agreement with them on the transformation of retirement fund arrangements. Clearly, an agreed solution is desirable, provided that it does not undermine the

which had not, at that date, accrued due to them.”

²⁸ The rates at which employers are required to contribute to defined benefit funds may vary with changes to the market value of the assets of the funds and with losses incurred by the funds as a consequence of their mismanagement or of misconduct by their trustees and/or service providers. Furthermore, the rules of some funds require employers to contribute additional amounts to the funds in respect of –

- “bonus years of service”;
- the matching of additional service “purchased” by members;
- shortfalls in investment returns “guaranteed” by employers in terms of the rules of the funds;
- 13th cheques for pensioners;
- benefits payable on the retrenchment of members or the reorganisation of their employment.

²⁹ Which, according to evidence supplied by the Financial Services Board, are thought to be about 10 % at present. This is largely due to “leakage”, that is, the spending, rather than preservation, of retirement savings on changes of employment.

principle objectives of equity, affordability and sustainability. Unfortunately, to date these negotiations have not resulted in agreement and at least one major local authority has taken steps, with the support of SALGA, to implement its transformation programme. Others may well follow suit.

If my analysis of the content of the pensions promise is correct, employers should be able to terminate their contributions to existing retirement fund arrangements that do not meet the aforementioned criteria and require their employees to belong to arrangements that do, and this should not entail a unilateral change to the terms and conditions of employment of the affected employees. The old retirement funds should then either be liquidated or remain open on a paid-up basis. Either way, accrued retirement savings should be preserved and used to supplement the retirement benefits payable by the new funds in order to ensure that the retirement savings of members are used for their proper purpose.

My proposed formulation of the pension promise should also help the parties involved in the transfer of employment obligations in the context of section 197 of the Labour Relations Act as it reflects a sensible interpretation of section 197(4) of that Act and section 14 of the Pension Funds Act. This provides that no transfer of assets and/or liabilities from one fund to another will be of any force or effect unless the Registrar is satisfied that the transfer scheme is reasonable and equitable and “accords full recognition to the rights and reasonable benefit expectations of the persons concerned in terms of the rules of a fund where such rights and reasonable benefit expectations relate to service prior to the date of transfer.”

It would be helpful if such a formulation were captured in the Labour Relations Act so that we could avoid the kind of litigation which is bound to arise in the future as employees become more assertive in relation to the enforcement of their rights in relation to occupational retirement funding arrangements.

But this is not the end of the story.

In the annual lecture to the 1998 conference of the UK Association of Pension Lawyers, Edward Nugee SC reportedly said –

“I have always taken the view that the primary function of a pension fund is to act as a guarantee of the pension promise which the employer has made to the employee in his contract of employment; and if that is right, then the primary duty of the trustees may be said to ensure, for the benefit of the employer as much as the employee that that guarantee is honoured and that the assets of the fund are sufficient to provide the promised benefit”.

In my opinion, this statement correctly reflects the role and duties of trustees of occupational retirement funds.

Employees and employers cannot work together effectively to make appropriate provision for the post-retirement income of employees if the trustees of their retirement fund vehicles do not properly manage

those vehicles and allow the retirement savings of employees to be eroded by excessive costs.

This brings me to the second theme of my paper today.

The issue of cost control is inextricably linked to the issue of the governance of retirement funds because good governance requires diligence, an avoidance of conflicts between personal interests and duties and transparency, particularly in relation to costs. For so long as retirement fund trustees are either unable or unwilling – because of their close and dependant relationship with service and product providers - to properly negotiate fees and costs with those providers, members of the retirement funds are at risk that their retirement savings will be eroded by costs that bear little relation to the value of the services or products provided to the funds for their benefits. Members have no basis on which to challenge decisions made by trustees in relation to the costs that they incur on behalf of the retirement funds unless they have full disclosure of those costs, the identity of the persons and/or organisations to which payments are made and the reasons why the trustees have agreed, actively or by acquiescence, those costs with those persons and/or organisations.

Given the relatively low level of expertise, experience and bargaining power reflected in the composition of many boards of trustees, these boards are heavily dependant on consultants to advise them on a wide range of issues including investment strategies, the choice of products and services that a fund may require and the selection of the providers of those products and services. Unfortunately the market is dominated by multi-service organisations whose consultants usually recommend that products and services be obtained from their employers or organisations related to them or from organisations which reward those consultants for recommending their products and services by means of commissions, rebates and other rewards, the cost of which is built into the purchase price of those products and services.

What many fund advisors appear to fail to appreciate is that, when they advise a fund in regard to, for example, the purchase of products or services, they must give the advice that is in the best interests of the fund without regard to their own personal interests because otherwise they may be in breach of their statutory³⁰ and common law fiduciary duties to the fund.

³⁰ Section 2 of the Financial Institutions (Protection of Funds) Act, No. 28 of 2001 says the following:

“Duties of person dealing with funds of, and with trust property controlled by, financial institutions

- (1) A director...official (or trustee), employee or agent of a financial institution (or retirement fund)...who invests..., controls, administers or alienates any funds of the financial institution or any trust property –
 - (a) must, with regard to such funds, observe the utmost good faith and exercise proper care and diligence;
 - (b) must, with regard to the trust property in the terms of the instrument or agreement (the rules of the fund) by which the trust or agency in question has been created, observe the utmost good faith and exercise the care and diligence required of a trustee in the exercise or discharge of his or her powers and duties; and
 - (c) may not alienate, invest, pledge, hypothecate or otherwise encumber or make use of the funds or trust property or furnish any guarantee in a manner calculated to gain directly or indirectly any improper advantage for himself or herself for any other person to the prejudice of the financial institution (the retirement fund) or principal concerned.

South African common law governs the conduct of persons who owe fiduciary duties to others as a consequence of the nature of their relationship with those others. The category of persons who assume such fiduciary duties is not a fixed one but a fiduciary relationship will be indicated if the person in whom it is thought to be reposed has scope for the exercise of some discretion or power, the power or discretion can be used unilaterally so as to affect the beneficiaries' legal or practical interests and there is a peculiar vulnerability of the beneficiary to the exercise of that discretion or power.³¹ The High Court has said that a legal advisor, an accountant and an investment adviser could be held liable for a breach of their duties of care towards the beneficiaries of a trust in relation to the advice that they gave to the trustee of the trust.³²

As I have mentioned, while a consultant in law is required to give his or her client (the fund) advice in its best interest³³, and may not make a secret profit in relation to the service he or she provides to the client³⁴ many, if not most, consultants in the employee benefits business fail to appreciate that they have this duty. They play the dual roles of consultant and salesperson and seldom, if ever, give advice that is not in their own interests or the interests of their employers. For example, it is a rare consultant who, when advising a fund to purchase insurance to underwrite its liabilities in relation to the payment of pensions, advises the fund to request quotations determined on the basis that no commission will be paid to the consultant if the quotation is accepted. This situation means that there is little to prevent suppliers of goods and services from fleecing the retirement funds which are under their effective control.

In my opinion, we need our new law to say the following:

1. **Retirement fund trustees must make separate appointments of consultants, actuaries, legal advisors, accountants and auditors, investment advisors, investment advisors, insurers and fund administrators.**

Such a provision appears in both the UK Pensions Act, 1995³⁵, and the Superannuation Industry (Supervision) Act, 1994.³⁶ The advantage of such a provision in our law would be that it would prevent

³¹ *Phillips v Fieldstone Africa* 2004 1 All SA 150 (SCA).

³² *Jowell v Bramwell Jones* 1999 (1) SA 836 (W). But see (2000) 2 All SA 161 (SCA) in which the court held that the beneficiary's claim against the advisors had been brought prematurely.

³³ *Robinson v Randfontein Estates Goldmining Co Ltd* 1021 AD 168 at 177, *Jowell v Bramwell Jones* 1999 (1) SA 836 (W) and (2000) 2 AllSA 161 (SCA).

³⁴ *Regal (Hastings) Ltd v Gulliver* 1967 2 AC 134 at 153. In *Transvaal Cold Storage v Palmer* 1904 TS 4 at 21 Innes CJ said: "The doctrine of an agent's liability to account for profits does not rest upon the fact that he has prevented the principal from earning profits; but is based upon his duty in good faith to hand over to his employer every advantage directly or indirectly connected with the agency, save and excepting the remuneration agreed upon."

³⁵ The UK Pensions Act, 1995, requires that the trustees of a fund specifically appoint the following advisors to the fund; the fund's auditor, actuary, (in most cases) fund administrator, asset custodian and (in most cases) legal advisor. See section 47(3)(b).

³⁶ Section 58 of the Australian Superannuation Industry (Supervision) Act, 1994, says that the governing rules of a fund may not permit its trustees to be subject, in the exercise of any of the trustees' powers under those rules, to direction by any other person.

funds from being required in terms of their rules to use “tied” services, that is, only those advisory and other professional services provided by, for example, the fund’s administrator or “tied” products, such as the insurance or investment products provided by them or related entities. This means that the trustees can (and should) place these products and services out to tender and select their suppliers with reference only to the quality of the services and their cost.

2. **All persons who give advice to retirement funds, including investment advice, who exercise any discretionary powers in relation to the management or administration of the fund or the control and investment of its assets and the disposition of its benefits are fund fiduciaries and must discharge their duties with the care, skill, prudence and diligence that can be expected of a person who is responsible for the affairs of someone dependant on him or her. Fund fiduciaries, including fund trustees and consultants should be required to give the advice and take the decisions that they believe to be in the best interests of the fund without regard to their own interests other than in their interest in their remuneration as consultants.**

Similar provisions appear in the US Employee Retirement Income Security Act (ERISA)³⁷ and the Canadian Pensions Benefits Act, 1985³⁸. It would be useful to have them in our statute so that everyone knows and understands the rules of the game. They should improve the kinds of advice that is given to retirement funds and reduce the likelihood that advice will be given in the interests of the persons giving the advice when that interest conflicts with the best interests of the funds and their stakeholders, both members and contributing employers.

3. **Advisors should be prohibited from simultaneously acting as fund consultant and salesperson and should not be permitted to receive any direct or indirect remuneration from any person or body other than the fund in respect of the advice that they give to the fund.**

The US ERISA prohibits fund fiduciaries from receiving any consideration for his or her personal account from any party dealing with the fund in connection with a transaction involving the assets of the

³⁷ The Employee Retirement Income Security Act (ERISA) of the USA requires that a fund fiduciary “discharge his duties with respect to a plan with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” See section 404(a)(1)(B). A fiduciary is a person who –

1. exercises any discretionary authority or discretionary control in regard to the management of a fund or the management and disposition of its assets;
2. provides investment advice for a fee or other compensation (whether direct or indirect) in respect of the assets of the fund or has the responsibility to do so;
3. has any discretionary authority or discretionary authority in regard to the administration of a fund.

See section 3(21). A person who simply calculates benefits is not a fiduciary because he or she has no discretionary authority. Neither is an employer which designs, amends or terminates a fund. *Lockheed* 517 US at 891; *Hughes* 525 US at 443. Attorneys, accountants and actuaries who perform their usual professional functions in relation to a fund ordinarily will not be considered fiduciaries. See cases cited in footnote 25 on page 244 of Zanglein, *Pension Investments and Fiduciary Duties under ERISA*, National Labor College, 2002. They may become fiduciaries if they assume additional functions. An investment manager and an investment consultant will always be fiduciaries to the extent of their authority.

³⁸ Section 8(4) obliges a fund administrator to exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another.

fund³⁹. I think that a similar provision would be useful here. If fund advisors – or their employers - were to be remunerated only by their clients, then that remuneration could be properly controlled and advisors should not be subject to the undue influence that the prospect of indirect remuneration in the form of commissions is likely to have on their advice.

4. Funds should be prohibited from engaging in transactions with fund fiduciaries and other related parties such as employers .

The UK Pensions Act confirms that, in exercising any discretion in terms of the rules of the fund, the trustees must not participate in any decision relating to the fund in which he or she has a personal interest although this duty is not breached if the exercise of the discretion may benefit the trustee in his or her capacity as a member of the fund.⁴⁰ By implication, then, trustees are prohibited from exercising a discretionary power in the appointment of a service or product provider if they have an interest in that appointment in their capacities as employees (that interest being in the form of remuneration, including bonuses, which depends upon business generated for the employer) and/or shareholders in any organisation which provides the products or services.

The US ERISA prohibits any transactions between a fund and a “party in interest”, that is, a fund fiduciary, counsel or employee, service provider, participating employer, union, a shareholder with a controlling interest in a participating employer, employer, and relative of or corporation or trust owned by any of the aforementioned or in which any of the aforementioned has a beneficial interest.

A similar provision in South African law could be useful in minimising cross-selling within a multi-service organisation (that is, an organisation which provides administration, consultancy and actuarial services to a fund and which is also linked to organisations which provide risk cover and/or investment services to that fund) and thus improve competition. Product and service providers will then be compelled to compete with one another on the basis of merit and price, rather than on shareholding relationships and the reward of intermediaries.

5. Retirement fund trustees must set out in annual reports to the members the identities of their service providers, why they have selected those particular service providers and what payments have been made by the funds to them.

Similar provisions appear in ERISA⁴¹ and the Canadian Pension Benefits Standards Act, 1985⁴². The

³⁹ Section 406(b).

⁴⁰ Section 39.

⁴¹ ERISA requires the administrator of each retirement fund to prepare an annual report – to be supplied to the regulator and made available to all members - in which is set out, amongst other things – the name of each person or organisation who or which rendered a service to the fund in the year under review and received compensation directly or indirectly from the fund during the year and the amount of such compensation. Section 1023(c). An actuarial statement is required to be included in the annual report of a fund other than an individual fund which report must disclose information on the fund's normal costs, accrued liabilities and the actuarial assumptions which have been made in determining the costs.

disclosure of information in relation to decisions that the trustees of a fund make, and the reasons for those decisions, should promote rationality in decision-making and a culture of accountability.⁴³ Members will be able to challenge decisions that have not been made for the proper reasons because it should be easier to determine why the decisions were made.⁴⁴

6. Fund actuaries and auditors should be given whistleblower responsibilities and protections

The UK Pensions Act obliges a fund's actuary and auditor immediately to report in writing to the regulator if he or she "has reasonable cause to believe" there has been a breach of any duty relevant to the administration of the fund in terms of its rules or any law imposed on the fund's trustees, administrator, adviser or any prescribed person acting in connection with the fund and the employer of the fund's members and the breach is likely to significantly affect the exercise by the regulator of any of its functions.⁴⁵ Breaches of these obligations are subject to sanction. I think that a similar provision in our law would assist in the better supervision of funds by the regulator and ensure better governance.

Conclusion

While we all need greater certainty as the rights and obligations of all people involved in occupational retirement funding, we also need a law that is adaptable to changing circumstances. This means that we should not try to define in too fine detail the precise obligations of employers towards their employees. We should also not try to closely control the prices at which products and services are sold to funds. What we need instead is measures that –

⁴² This Act requires each fund's administrator to file with the regulator (the superintendent of financial institutions) and provide to the members of the fund prescribed information including –

1. the operating expenses paid by the fund and the identities of the persons to whom such payments were made (section 15(j)); and
2. records and documents evidencing all direct and indirect compensation that any person received or became entitled to in relation to any service provided by that person to the fund (section 15(k)).

⁴³ Section 31, read with section 34, of the Australian Superannuation Industry (Supervision) Act, 1994, provides that regulations may be promulgated setting standards with which funds are required to comply, including standards relating to the disclosure of information to beneficiaries and the Insurance and Superannuation Commission. These regulations appear in the Corporations Regulations, 2001. They, require, in general, that a fund make available to its members, information that its "responsible person" reasonably believes the members would reasonably need for the purposes of understanding the management and the fund and the relevant sub-fund, if any, and understanding the condition of investment performance of the fund, or sub-fund, whichever is the more relevant. Regulation 7.9.35, Corporations Regulations, 2001. They do not specifically require a breakdown of the costs incurred by the fund save that they require the costs of investments in pooled superannuation trusts to be disclosed.

⁴⁴ In PF 96 the Registrar states that –

"The board should pay due regard to the information needs of the members concerned and communicate relevant, meaningful information in a timely and comprehensive manner to enable the members to make balanced and informed decisions."

The FSB has recently issued draft new formats for financial statements to be issued by large and small privately administered funds and large and small underwritten funds. They require that the identity of various service providers be disclosed and that, in relation to large self-administered funds, the administration of the costs of the fund be broken down into actuarial fees, audit fees, consultancy fees, administration fees, depreciation (at cost and revaluation), levies, office expenses, operating lease payments, staff costs, secretarial fees, trustee and principal officer remuneration, penalties and other unspecified expenses.

⁴⁵ Section 48(1).

- 6.1. will assist employers and employees in clarifying what their rights and obligations are towards each other, and what are their rights and obligations are in relation to the retirement funding vehicles through which they make provision for the employees' retirement; and
 - 6.2. will promote -
 - 6.2.1. competition between service and product providers;
 - 6.2.2. better processes of, and better criteria for, the selection by trustees of product and service providers;
 - 6.2.3. a reduction in costs which may be regarded as excessive when regard is had to the nature and value of the product or service to which they relate;
 - 6.2.4. a culture of justification which is consistent with the administrative law standards applicable to organs of state and other persons in positions of power.
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