

THOUGHT PIECE 1

In recent decades there has been a global shift away from defined benefit pension funds to defined contribution (or provident) funds. South Africa experienced a similar movement. As a result, the Rhodes University Pension Fund (now closed to new entrants) was one of only two open funds still in existence at South African Higher Education Institutions.

This shift towards defined contribution funds was driven by a number of factors. For employees, the trend towards greater employment flexibility (it is today increasingly rare for employees to work for the same employer for their whole life) encouraged the shift to defined contribution funds. This is because defined benefits are not transferable from one employer to another. Employees moving to a new employer would have to start accruing benefits from scratch. Historically, they often did not receive the full actuarial value of their past contributions either. This was because employers used pension benefits as a “golden handcuff” to encourage continued employment. Some employers withheld employer contributions entirely unless employees had worked for 5 or even 10 years. This penalized younger employees in particular, as employees tend to change jobs more often in the early stages of their career.

The shift to defined contribution funds was driven also by changes to accounting regulations. These now require employers to reveal any actuarial shortfall on a defined benefit fund in their annual financial statements. They must do this even if they believe the current shortfall is due to unusual stock market volatility and is likely to be short-lived.

Defined benefit fund regulations today require that when statutory actuarial valuations reveal insufficient assets to meet estimated future liabilities, funds must draft a plan for addressing the shortfall. The plan must achieve either more rapid than projected asset growth or reduced liabilities to eliminate the shortfall. In practice, reducing liabilities requires either reducing members’ future pension benefits (by reducing the accrual rate) or reducing future pension increases. Increasing assets requires either a lump sum injection of funds by the employer, or for employers or employees (or both) to increase their monthly contributions to the fund. Where employers have staff on both defined benefit and defined contribution schemes, increased injections by the employer may be problematic, as one group of employees is seen to be treated differently from the other. It is also problematic when employees are employed on a “cost-to-company” basis.

So, the trend to defined contribution funds has advantages for both employers and younger employees for whom it brings greater certainty and flexibility. But it introduces greater uncertainty for older employees, who are now planning for actual retirement. Whereas members of a defined benefit fund could look to receiving a certain percentage (depending on how many years they worked for their final employer) of their final salary, members of a defined contribution fund must rely on estimates of the final value of their savings and the size of the pension they are able to procure with that sum. This they can add to their savings accumulated during previous employment, or as a top-up to current contributions. This allows the development of an investment strategy for their overall savings appropriate to their age and retirement needs.