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STATE OF THE PENSION FUND INDUSTRY

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Pensioners – Orphans Of Their Own Industry?

GANDY GANDIDZANWA & ITAI MUKADIRA

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Gandy Gandidzanwa



Itai Mukadira

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Forty years on, following those mass conversions from DBs to DCs of the early 1980s, we can now studiously scrutinise the cogs and gears that is the engine room of the DC system for a clinical diagnosis of its faulty lines. What becomes immediately apparent from such an investigation is that the system's problems are more structural than mechanical. We fitted the wrong engine into an engine bay and framework designed to power a totally different engine type altogether. The wiring problems we are grappling with today, trying to fix in isolation, are only but the results of an acute engineering problem whose roots are deeply engrained in the conceptualisation of the system.

Let us explain.

Design Issue

The Defined Contribution system is one of a few systems that “spits out” its products half-way through the production line. If providing a financially independent life in retirement is the end goal, then abandoning members at the point of retirement is tantamount to churning out of semi-finished products mid-way through the production line. On a journey to one's end of life, the Defined Contribution system offloads its passengers at the connecting station, from accumulation phase to decumulation phase, and leaves them, with a few sign posts here and there, to wander around and figure out the route and the transport mode for the rest of the journey.

Fundamentally, any retirement fund system should put pensioners, and not members, at the front and centre of its object of existence. For too long now the industry has consistently failed to comfortably meet workers' reasonable expectations of a financially secure life in retirement after long

careers of loyalty and dutifully contributing to their retirement savings schemes.

“It is all because of the hyper-inflationary environment”, alternative voices would want to quickly remind us. We are never oblivious of the impact of that – but the DC system flaws transcend economic environments, political boundaries, geographical locations, and regulatory jurisdictions. Show us one country that is not struggling with its retirement fund issues today, and we will show you ten that are. This is a global industry challenge of our generation that cannot be just downplayed by blaming it all on macro-economics. It is an industry design issue.

Focussed on Input, Not Output

That in structuring the industry we seem to have missed the forest for the trees should not surprise many. Take a look at any set of retirement fund rules from any jurisdiction with a dominant DC system, and you will find reference to “member” overly dominating any reference to “pensioner”. That alone should confirm for you with who in mind were the rules crafted. At the centre of all such trust deeds is a “member” who, effectively, at the point of retirement, becomes less visible and less of a focal point to the eyes of their radars.

Some would argue, and perhaps correctly so, that by giving more referral dominance to members, as opposed to pensioners, the system is forward-looking. Members are on a journey to becoming pensioners and by focusing more on them the system is “financially moulding” them into becoming the pensioners that it wants them to be, the argument would go. By getting it right with the product design the system should be able to get it right with the end product, they would probably argue furthermore. We hear all that, and it probably does make sense – but the counter-argument is simply that we seem to have overly focused on the input, and not the output, in the value chain.

Preoccupation with “Accumulation at Retirement”, Not “Income in Retirement”

Boards of trustees are by far dominated by active members. Probably for purposes of reinforcing the same principle for the need of a forward-looking fund management body. Such an approach though misses one fundamental human flaw – a behavioural bias that places little value, time, and attention to something that will happen in the far distant future. Independence of thought challenges us to re-imagine how differently, and probably more effectively, a fund whose board is dominated by pensioners could be run. Maybe, the ideal structure is found at the point of equal representation between member trustees and pensioner trustees. It could be any other split between the two key constituencies for that matter, but certainly not one informed by the current system that seems to only incorporate pensioner trustees as an afterthought. On the other hand, as for the real and unique value that employer trustees bring to the table on a pure DC fund, let's just say it's a topic for another day, suffice to say though that those that fully understand it please kindly appraise us also. What we need are more informed and intellectually empowered trustees, representative of the key beneficiaries of the system – active members as beneficiaries-in-waiting, and pensioners as incumbent beneficiaries.

The system's ultra-focus on “accumulation at retirement”, as opposed to “income in retirement”, has been well-documented as one of the key causes of its conceptual flaws. Operationally, the result of this is that at retirement, members who once shared a common space, identity, and a sense of belonging, go their separate ways as pensioners. They are, one by one, converted from being “beneficiaries” of their fund as a collective, to being clients of insurers as individuals. Their strength, voice, and bargaining power as a collective is immediately lost – that all happening at the point they, for the very first time, are starting to consume the product that have been in the making all their entire working lives.

From “Paternalism” to “Parental Absenteeism”

What makes what is already a bad situation ugly is that, not only does the

system harshly deserts its core constituency at a point of its most need, it does so to a people that are no longer economically active. They neither have much strength nor will to fight for fair treatment. Financially, resources would also be quite limiting, and a lack of a common identity means they cannot congregate together to express, in one voice, disapproval of their mistreatment. That they are now scattered across the country, with little to no means of communication, means any attempts to self-organise are near impossible.

For members still in active employment, the industry firmly believes in a duty of “paternalism” towards them. Seems that disappears the moment the members reach retirement – and is replaced with what, in the same analogy, would appear like an “absentee parent”. Years of paternalism means they are left behind ill-prepared to stand on their own to deal with matters that confront them. That the system has been blamed for nurturing members who, during their active membership, are either totally disengaged, or overly engaged for the wrong reasons, is well known. It is these same members that the system churns out into retirement – poorly prepared to engage with and navigate the retirement savings landscape. An otherwise overly protective system structurally takes the shield off members when they need it the most – that is, just as they step into retirement.

Pensioners’ Reasonable Benefit Expectations Not Met

The system “offloads” members into the hands of insurers and financial planners, who all by design are self-interested economic agents. The annuity rates used to convert members’ lumpsums into an income stream in retirement, correctly so, are a function of the economic and investment outlook at the point of retirement. So, after many years of contributing, a member arrives at the point of retirement with no knowledge of how much income they will get in retirement. That can only be determined right at the actual time of converting the lumpsum into a pension. Trying to explain this, even to the more sophisticated members, is not easy, let alone trying to do it with the less sophisticated members, who are by far in the majority. While

we are generally quite literate, we are not as financially literate as a society, and our pension fund design does not seem to help us that much.

The issue of neglect of pensioners by the system, while it dates back to the birth of the system itself, is made topical today due to the shift in socio-economic tectonic plates that are all moving at the same time, albeit in different directions. Traditionally, society had assumed the role of taking care of its loved ones in old age. This is no longer the case.

At the current high levels of unemployment, low real salaries, and a generation of pensioners that seems to be living longer, the burden on the economically active is forever compounding. Effectively, that notion of reliance on the family safety net is slowly fading away into the distant horizon.

The loss of trust that the industry today suffers from can be traced back to its consistent failure to meet its pensioners' reasonable benefit expectations. The two bouts of hyper-inflationary environments we have suffered have further compounded that loss of trust. With no doubt, a DB system, with its focus on income in retirement would have better handled the inflationary environments – further reinforcing our assertion that, while a hyper-inflationary environment is an enemy of long-term savings, the DC system does a very poor job in responding to that.

We are aware that there is a directive from the regulatory authorities to review, re-design, and re-develop post-retirement products. One cannot help but place a lot of trust onto that process to save the day for the industry. While, of course, on its own the initiative does not bring about a complete overhaul to the system, if well thought through, it should address some of the shortcomings raised in this humble contribution.

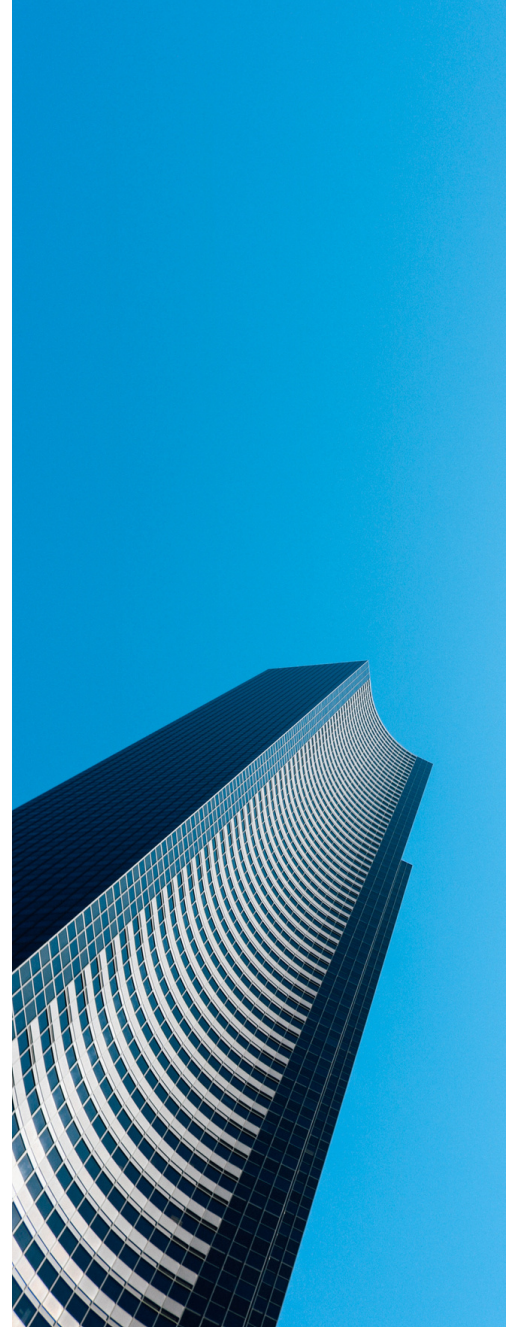
Much in line with our commitment to the industry, to not only highlight issues without proposing solutions – we will be sharing our thoughts in some of our upcoming industry contributions on this matter.

Conclusion

Forty years on, a new industry order requires that we bring back pensioners as the centre of focus of industry practices and regulatory frameworks. It is probably our only hope of regaining the lost trust.



Our monthly publication is aimed at inviting conversations from like-minded individuals with a view to engaging in forward-thinking-led discussions on how we can collectively improve the state of our industry.



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Contact Us:

gandy@rimcasolutions.com

itaim@rimcasolutions.com

www.rimcasolutions.com