

Widespread conversion to DC: A travesty for members

A large proportion of South Africa's private retirement funds switched from defined benefit (DB) to defined contribution (DC) in the 1990s and early 2000s. Unlike the corresponding transition in other countries, like the United Kingdom (UK), this switch was almost complete as member past pension rights were also converted to DC rather than being retained as DB. This article is the first of a debating pair, standing for the motion: *extensive conversion of South African defined benefit retirement funds to defined contribution represented a travesty to members.*

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The argument needs to start with a few notes of explanation. Defined benefit retirement funds pay pensions based on a formula, typically a multiple of salary just prior to retirement for each year of membership. A worker with 30 years of service and with a monthly salary of R20,000 at retirement, for example, might be granted a pension of R12,000 a month.

A pension below the corresponding earnings at retirement may appear unfair. This is common around the world. Expenses after retirement are typically lower than before: no daily work commute, for example. The pension income usually increased at something around inflation and was payable for life, often reduced by half if the member passed away and the spouse lived on. In summary, income was secure and protected against inflation, subject to ongoing fund solvency. It was known in advance of retirement and payable for life.

Defined contribution arrangements make no such guarantee. The combined contributions of the member and employer, plus investment returns, are converted to a pension at retirement. This pension may be for life, but the terms of conversion depend on market conditions at the time, particularly interest rates. Alternatively, the retiree may choose to take an income drawdown, usually known in South Africa as a *living annuity*. In this case, the pension may invest the retirement proceeds as they wish, but they run the risk of running out of money.

Why the massive shift?

Why did South African retirement funds switch comprehensively from DB to DC. In many ways, this was a case of an irresistible force. Workers demanded better access to intangible benefits—the value of a member's accumulated savings is known in a DC plan—and employers were happy to shed themselves of the risk. But what was this risk? A DB fund is making a very long-term promise. The employer is on the hook for any additional contributions required should the value of this promise prove larger than the corresponding assets of

the fund. Employers were understandably willing to wash their hands of this risk. In the UK, most members retained their existing DB benefits, so on retirement they received a mix of the two. In contrast, South African fund members generally had their accrued benefits converted to DC, sometimes with a top up to their DC fund above the equivalent value of the DB accrual.

The risk of adverse outcomes in DC funds is borne by their members. If fund assets perform badly, financial markets offer poor terms at retirement or the fees charged by service providers are unduly high, members lose out. If they are given the freedom to allocate their savings to different investment classes and do so unwisely, the consequences could be severe and permanent. The risk has been shifted from a company—not its core competency perhaps—to the member. And most members are in no position to manage this risk.

What are the consequences for these members? No need to repeat the oft-quoted urban legend that only six (or is that nine?) percent of South Africans retire comfortably. There is no doubt that the correct figure is low. Members of DC funds, without the skills to manage this risk, make mistakes of various kinds. They withdraw their money when they leave employment. When granted flexibility to choose, they elect to pay low contributions, allocate their funds to the wrong portfolios or make poor timing decisions, paying unnecessary fees in the process. And most retirees choose the living annuity over the guaranteed lifetime alternative, accepting the risk of long life, also not one they can manage effectively.

Risk management options

Regulation protects DC members in various ways. It puts limits on allocations to risky asset classes. It insists that trustees design sound default investment- and retirement-strategies for members. But these would not be necessary were it not for the massive transfer of risk that occurred in the rush for access to fund assets.

What is the key evidence that the wholesale move to transfer DB obligations to DC was not really in member interests? Public servants did not participate in it. By far South Africa's largest fund, the Government Employees Pension Fund, is firmly DB in its benefit structure, risky to the ultimate sponsor, of course, in this case the taxpayer. The remainder of South Africa's workers are widely exposed to risks largely beyond their knowledge and skills. **Rob Rusconi**