

Widespread conversion to DC: An opportunity for members

Last week we described the enormous swing from South African Defined Benefit (DB) to Defined Contribution (DC) retirement arrangements in the 1990s and early 2000s as a travesty for members. The key reason put forward for this position is that the widespread change in the retirement model represented a transfer of risk from employer to workers. Now we take the other side of the debate, arguing that this shift represents a remarkable opportunity for retirement fund members to take control of their saving for old age.

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We start with a few notes of explanation, by way of reprise. DB retirement funds pay pensions based on a formula. The pension is usually a percentage of salary at retirement for each year of service. This provides predictability and security of income—conditional on fund solvency—at the cost of significant risk to the employer, normally responsible for ensuring such solvency.

Under DC arrangements, the pension available at retirement is based on the accumulation of member and employer contributions at retirement, plus investment returns less expenses. This accumulation may look very impressive at 60 or 65 but making it last for the rest of the uncertain life of this retiree is not easy. He or she can use it to purchase an annuity that is guaranteed for life but must do so on financial terms that are based on market conditions at the time. If interest rates are low, for example, then the corresponding income is likely also to be low. This and the possibility of early death are two reasons that retirees in numbers choose an income draw-down, a living annuity. They can manage their assets as they wish, but risk running out of money. We address post-retirement strategies in a future article.

The key point in support of the position that the shift to DC was not in member interests is that they are not well equipped to manage the risk transferred to them.

In favour of DC

Contentions could be made against this position in several respects. First, in many cases, members received a bonus. How was this determined? The question of a member's share of a DB fund is complex, but the point is that the fair value of such a share was augmented by an additional amount reflecting the financial position of the DB fund. The basis for such a bonus was even clarified in legislation.

Did this relate to all conversions? It applied to all instances in which the DB fund had a surplus, even where the employer may have argued that they had the right to

such surplus because they had borne the risk up until that point. So, members might have been handed the risk of managing their pensions, but they were rewarded for doing so, where such reward was available.

Second, members or their representatives largely asked for access to their accumulated saving. Such access was not always in the form of a DC fund. In many cases, the new vehicle was a provident fund, which pays a lump sum at retirement, immediately available to the member. We could argue that such a lump sum is even worse than a pension because it could be spent immediately. Suspending paternalism, let us acknowledge for a member the attractiveness of such access. It is surely foolish to ignore the sense of financial enfranchisement that resulted from knowing what his or her saving was worth.

Was this pension saving withdrawn and used to rescue members from dire straits, even at the cost of resignation from work? It probably was in many cases, but it would be unwise and insensitive to judge this as poor strategy under the circumstances.

It belongs to them anyway

Third, this is their money. Members should be encouraged to take responsibility for their finances. Granting them access to information and a degree of flexibility regarding their old age savings is a good thing. Such freedom is constrained in several ways. Funds and their members may not allocate a large proportion of their savings to risky asset types. Trustees must establish sound default strategies, nudging members appropriately towards these defaults. The trustees also retain the responsibility to ensure cost-effective administration and sound governance.

Is such paternalism defensible? These safeguards are justified on the basis that the state (1) supports retirement fund saving with tax incentives, and (2) would suffer the burden of increased old age grants if the private system failed. This is nevertheless another debate.

How might we conclude? The argument is academic, it could be said: we should make the best of what we have. Yes, we are unlikely to revert to DB-dominated funds, but we must continue to consider the retirement system as part of wider national policy. We have no mandatory state-run system. Private retirement funds must work effectively for their members, and we should continue to ask whether we are serving these members effectively. **Rob Rusconi**