

MAINTAINING VIABILITY OF PENSION FUNDS IN A HYPERINFLATIONARY ENVIRONMENT *

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Introduction

As Insurers, Reinsurers, Brokers, Employers, Managers, Trustees and Decision makers of one form or another I wish to remind you from the onset that one day you will retire and require a pension and therefore maintaining viability of Pensions through decisions that we make today in our different capacities and spheres of influence is in our interest. As is often said "self interest is the best motivator" and I am hoping to motivate you through my presentation to want to take measures or steps to maintain viability of Pensions despite the hyperinflationary environment as opposed to the common talk nowadays that, 'Pensions are a waste of time; it is better to discontinue the fund and give people their money to invest elsewhere'".

I also wish to bring to your attention the fact that as Pension practitioners, Insurance companies and Employers we are now dealing with a populace that is more sophisticated and litigious in nature. Hyperinflation or otherwise there is an expectation of value delivery from Pensions when they retire and if this does not happen I predict that we will observe Pension Funds, The Trustees and employers

being taken to courts for not delivering the promise.

Purpose of Pensions

Pensions have two main purposes which I will touch on:

Firstly as you know, the primary purpose of a pension is to provide income to us during the years of our lives when we are no longer able to work and earn. We save during our productive years so as to be able to receive what I term deferred pay or salary when we retire. In other words pensions are supposed to provide financial security in future in the form of a standard of living almost equal to that enjoyed prior to retirement. Therefore pensions are important to workers and business entrepreneurs alike, as there is no guarantee that your business can exist into perpetuity.

Secondly from a National perspective, pensions are important as a tool for domestic savings mobilization and I would like to dwell on this aspect for a while. Worldwide, economic development is generally underpinned by the capacity of the citizens to save and accumulate sufficient resources that are utilized to venture into various economic endeavors including

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business and infrastructural development. The national savings are generally split into two, voluntary and involuntary savings. Voluntary savings are generally managed by the short-term savings institutions such as Commercial and Merchant Banks, whilst involuntary savings are Long-term and are through pension funds and life assurance companies. The involuntary or long-term savings are invested in long term instruments such as the Stock Exchange, Government stock issues, Property such as Commercial, Industrial and Residential buildings, Debenture arrangements for companies and supporting Bankers Acceptances (BAs) issued by Commercial Banks. The importance of these investments to an economy cannot be overemphasised ladies and gentlemen.

Where, such long-term savings arrangements do not exist in developing countries, they have been forced to borrow externally without complimentary local finance leading to exchange rate risks and certain degeneration into the debt trap. A strong and vibrant involuntary savings movement in which contributing members and employers have faith in is therefore a strong catalyst for both domestic investment activity and a good pointer to foreign investment attraction. There is strong evidence of this in countries such as Kenya, Botswana, Mauritius, Zimbabwe and more clearly South Africa. Countries where, either these long-term saving institutions did not exist or were poorly managed into bankruptcy can be observed by the very poor domestic

financial institutional base as exemplified by Nigeria, Tanzania, Zambia, Uganda and DRC to mention but a few although some remarkable recoveries have been registered now in some of these economies when compared to Zimbabwe where the propensity to save have declined remarkably due to the hyperinflation.

Strictly speaking, it goes without saying that both voluntary and involuntary savings rates should be high to ensure the best results. There has to be capacity to generate both short and long-term savings allowing for long-term investment projects and longer dated issues of government paper to be supported.

In Zimbabwe, the privatization of some quasi-government institutions was achieved with massive support from pension funds and assurance companies; the likes of Dairiboard and Cottco come to mind.

In addition, these savings were chiefly responsible for providing self capital for the majority of what were and in some instances what continues to be successful business institutions owned locally such as:

First National Building Society, Century Holdings, NMB Bank, Global Insurance, Kingdom Financial Holdings, to name but a few.

The tragedy for Africa and Zimbabwe in particular however, is that the high inflationary environment we have experienced since 1998, has resulted in the erosion of purchasing power for individuals. This has been compounded by the shrinking economy, company closures resulting

in rising unemployment (said to be around 70% plus) and the cost on individual families both human and financial imposed by the advent of the HIV/Aids pandemic, resulting in the collapse of voluntary savings.

We find ourselves against the background of non-existent voluntary savings amongst families, but fortunately we still have the involuntary savings unit as mainly the only pillar for mobilizing domestic investible resources for this economy and at the same time it is the chief source of financial security for both members and the dependants on retirement and death, and I am referring here to pension funds in the main.

From the foregoing Mr. Chairman, Ladies and Gentlemen, the importance of Pensions to us as individuals and collectively as a nation is therefore unquestionable.

The Trustees appointed to manage these Funds are therefore charged with a legal fiduciary responsibility to ensure that benefits derivable by all claimants are not only secured but demonstrate value for money and hence the need to maintain viability and the challenge is how do you do it in a hyperinflationary environment.

The Challenge

What is the challenge ladies and gentlemen, as the theme for the Seminar states, "Winning Strategies for Life Insurers in the Emerging Markets, Now and in The Future". Like I said earlier with God willing we shall all become pensioners at one stage or another or alternatively we shall be

held accountable by pensioners and beneficiaries and it is therefore in our interest to come up with ways and means of reversing the unviable state in which Pensions are in due to hyperinflation.

As Insurance companies and as Brokers we also have an interest from a business product point of view.

The levels of pensions paid to pensioners have deteriorated significantly over the recent past especially since 1998 when we started in earnest on our hyper-inflationary journey. As a result the majority of pensioners are more or less destitute having either fully commuted for cash lump-sums the miserable monthly payments they were receiving whilst others continue to receive amounts not adequate to pay transport to the nearest collection point or the minimum required to keep the bank book open. Unfortunately once on retirement, pensioners and dependants lose the bargaining power that actives possess to argue for increases in salary. They are off-site and cannot withhold labour to press their point.

These concerns are shared by the pensions industry, the regulators and the country at large and the sooner we find solutions the better for us all.

Developments

In Zimbabwe's recent past of about 10 years or so, most Pension funds were funded on the Defined Benefit basis which in short defines the normal retirement pension as the final average salary multiplied by the number of years in employment multiplied by an accrual rate. These funds require

valuation every 3 years or some shorter period as might be decided upon. Unfortunately, due in the main to salary increases trying to mirror inflation and the investment returns on contributions towards the Pension falling short of inflation targets, valuations started reflecting huge shortfalls which by the very nature of Defined benefits had to be made good by the employer. It became imperative to weigh between the funding of ongoing operations and keeping jobs on one hand, and funding for pensions on the other. As the deficits grew companies were left with no option but to change the funding basis of their pension funds to Defined Contribution, which works basically like a savings account. The employer and member have predetermined contribution rates into the fund to form individual pots for members that grow with investment income and at retirement your pension is based on what that pot can buy. The investment risk in this instance transfers from the employer to the member.

This trend has seen more than 90% of pension funds now being funded on this basis and this is not only unique to Zimbabwe. Worldwide there is also a trend of schemes converting from Defined Benefit to Defined Contribution. The reasons for conversion though vary from country to country, for example in UK schemes were running away from too many regulations which were put in place for defined benefit schemes and in South Africa Trade Unions pushed for conversion because they wanted their constituency to have a share of the

actuarial surpluses. For employers in general though, there is a common underlying desire to run away from the open ended liability associated with Defined Benefit pension funds.

In our scenario, the plight of members was made worse by that on conversion, not all employers were able to pay the valuation shortfalls and hence some members were given amounts lower than their actuarial reserve as the opening balances under the new defined contribution schemes, and to compound the problem negative real returns continued to be earned.

The challenge for us goes further; besides failing to obtain real returns in the open market you are also required to invest 45 % in prescribed assets where returns historically have not been market related and hence putting a further dampener on the returns. Before I incur the wrath of the Registrar let me hasten to say, there have been efforts of late to issue prescribed assets at returns that are inflation linked.

Further to that, the moment you start receiving a pension the value starts depreciating due to inflation and the salvation lies in Pension increases which derive from returns on the invested pension capital, but unfortunately, as indicated earlier this is normally below the rate of inflation and before you know it, you can hardly fill a tank of fuel with the pension payment. The same scenario applies to salaries for the actives, which now have to be reviewed quarterly, monthly, and you never know some might be doing it weekly to maintain

purchasing power. The same environment is affecting pensions and viability requires measures along the same lines.

How Can We Maintain Viability

Many times it has been suggested that pension funds should be discontinued and the money invested elsewhere. These sentiments are an advocacy for substituting the involuntary savings mode for a voluntary one, which as I indicated earlier has collapsed due to the economic conditions obtaining. Unfortunately the market where pension funds are invested is that same market that any other forms of savings will have to invest in, with the exception of prescribed assets aspect. The solution therefore lies in coming up with ways and means of maintaining viability of Pension Funds.

Solutions

Minimum Pension at Retirement

As earlier stated the main objective of pension provision is to provide a certain standard of living after retirement. A pre-retirement standard of living can still be maintained with a lower post retirement pension due to change in spending patterns such as:

- The individual's mortgage is normally fully repaid prior to retirement.
- There is a need to save whilst working, and on retirement the level of saving can be expected to fall.
- There are also lower costs after retirement such as travel costs, school fees (small houses),

contributions to pension arrangements, etc.

These aspects might however be offset by requirements for more leisure activities like going on holidays, golf and health care costs etc.

For the lower paid employees they may need 100% replacement income due to their inability to have any other meaningful form of saving and normally have little in the form of capital assets. Defined benefit schemes based on accrual rates of 2% of final salary are designed to ensure that post-retirement income keeps pace with pre-retirement income as after 40 years of service a pension that is 80% of the final salary is targeted and the target reduces proportionately with the years of service.

A typical Defined Contribution scheme does not target any pension at retirement. Members will be given whatever their pot of money can buy. Given the hyperinflationary environment that we are operating in, the retirement pension of such a member is likely to be less than that of a member on a Defined Benefit scheme with a similar salary at retirement and service.

This is so because members in a Defined Contribution scheme bear the investment risk whilst in a Defined Benefit scheme, it is the employer who bears the investment risk. The investment risk is very significant in this hyperinflationary environment.

To counteract the Defined Contribution hyperinflation effect Hybrid pension schemes can be instituted which

combine Defined Benefit and Defined Contribution provision:

- A scheme could provide for the greater of a Defined Benefit formula and the benefit from the accumulation of a defined level of contribution. The advantage to the employer is funding for an individual at point of exit as opposed to funding for the whole group on an ongoing basis when the majority will not retire on the fund anyway.
- Alternatively a minimum pension of say 40% of final salary for those that have 30 years service and the percentage is cascaded downwards based on years of service.

NSSA for instance has targeted a pension of 40% of salary at retirement after 30 years of service within the salary cap they set from time to time. This can be used as a guide. Hence the regulators can aim to give a minimum pension of 40% of salary at retirement as anything lower than the NSSA target may be perceived as an inferior pension by the generality of stakeholders.

This would convert all Defined Contribution schemes to Hybrid schemes. Hybrid schemes would give a reasonable minimum pension at retirement without exposing the employer to the full risk of a Defined Benefit scheme. Hence the employer and the employee will now share in the investment risk. A fully-fledged Defined Benefit scheme whilst it will try and address the employees concerns at point of retirement will not be afforded by the employer given the current

viability problems, which companies are facing.

Whilst a minimum pension should be set in relation to service with the employer, the regulators can also require members to transfer all their pot of money from previous employers in order to be eligible for the minimum pension related to their full working lifetime. Currently members of pension schemes are given the option to transfer benefits from previous employers into the pension scheme of the current employer to enable the members to have a reasonable replacement ratio. The regulators have assisted in increasing the net replacement ratio by requiring that at withdrawal the employer's withdrawal portion should be preserved for the member, only to be accessed at retirement. However, due to lower withdrawal benefits that were in Defined Benefit schemes a member who has moved jobs will not get the maximum pension commensurate with the working lifetime.

In addition to this suggestion, in the 2006 National Budget statement delivered by Finance Minister, Dr Herbert Murerwa on Thursday 1 December 2005 an effort was made by the Minister to maintain viability of Pension funds in addition to encouraging savings through:

- Having pensions payable to pensioners of 55 years and above being tax-free which improved the age from the previous 59 years.
- Tax free pension contributions increased from 1 440 000 per annum to 72 million per annum

which is 50 times more than the previous limit. The ultimate solution though lies in pegging the contribution rate to a percentage of pensionable salary bill, such as 7% for members and 12% for Employers.

- The regulators also need to seriously consider permitting offshore investments. There are a few funds with offshore investments made before independence and these assets represent the lion's share of the value of these funds.
- There is need for continued provision of prescribed assets at market related or CPI linked returns.

Minimum Pension Increase

After determining the pension at retirement there is need to determine the minimum pension increase that can be awarded annually to pensions in payment in order to preserve value.

The minimum pension at retirement could be indexed against the grade the pensioner was in at retirement and increases are targeted at maintaining the index level.

Increases could be based on the rate of inflation although other schools of thought could argue that the pensioners inflation is lower than the general inflation (Although the medical costs could negate this) and therefore necessitating lower increases like 75% of inflation or a percentage of the return earned by assets backing the pensioners assets.

Alternatively managed pensions or annuities others refer to them as

flexible pensions where the pension capital plus returns minus costs belong to the Pensioner and is able to draw down based on need with the guidance of Pension practitioners. If returns keep up with inflation or better, the pension in payment will maintain its value.

Funding

The minimum pension linked to salary at retirement will need to be funded over and above the defined contributions, which are being paid on behalf of members. This underpin can be funded on an ongoing basis as a percentage of salary as determined by the actuary of the scheme. Alternatively, the employer will meet the cost of the underpin when a member retires which is referred to as terminal funding.

The employer can fund pension increase, if the returns earned on the funds backing pensioner liability is not sufficient to meet the minimum pension increases.

From the foregoing proposals the employer has to come to the 'Party' if viability is to be maintained and as such there are factors that will need to be considered as:

- Ability of the employer to pay for the additional benefit i.e. the defined benefit underpin or the cost of the guarantee and minimum pension increases.
- How to treat the current pensioners who are earning pensions below the set minimum. A starting point could be to do away with level pensions and a gradual conversion of

pensions in payment to managed or flexible annuities or pensions. A huge cost may arise if the current pensions are to be aligned with the new arrangement and the funding mechanism of this liability may need to be agreed with the employers.

- The need to separate pensioner assets from the active members pool and match pensioners' liability with assets as well as coming up with appropriate investment strategy.

Conclusion

In conclusion Mr. Chairman I will summarize what needs to be done for viability of Pension funds to be maintained: -

- (i) Introduce Hybrid Pensions to provide minimum pension at retirement based on service.
- (ii) Minimum Pension increases to match or better inflation deriving from Investments or Employer participation.

- (iii) Government /Regulators to continue providing conducive incentives such larger tax relief and prescribed assets at market related or CPI linked returns.
- (iv) There is need to consolidate pension savings throughout the working lifetime of a member to be eligible for the minimum pension related to the full working lifetime.
- (v) There is also the need to look at how to deal with the current pensions in payment and how to fund any cost that may arise in raising those pensions to a certain minimum.
- (vi) There is need to consult all stakeholders, employers, employees, trade unions, trustees, administrators, etc in order to come up with an agreed position that will meet expectations of everybody.

Failure to take this radical change in mind set will result in the viability of Pension funds not being realized in this environment.■