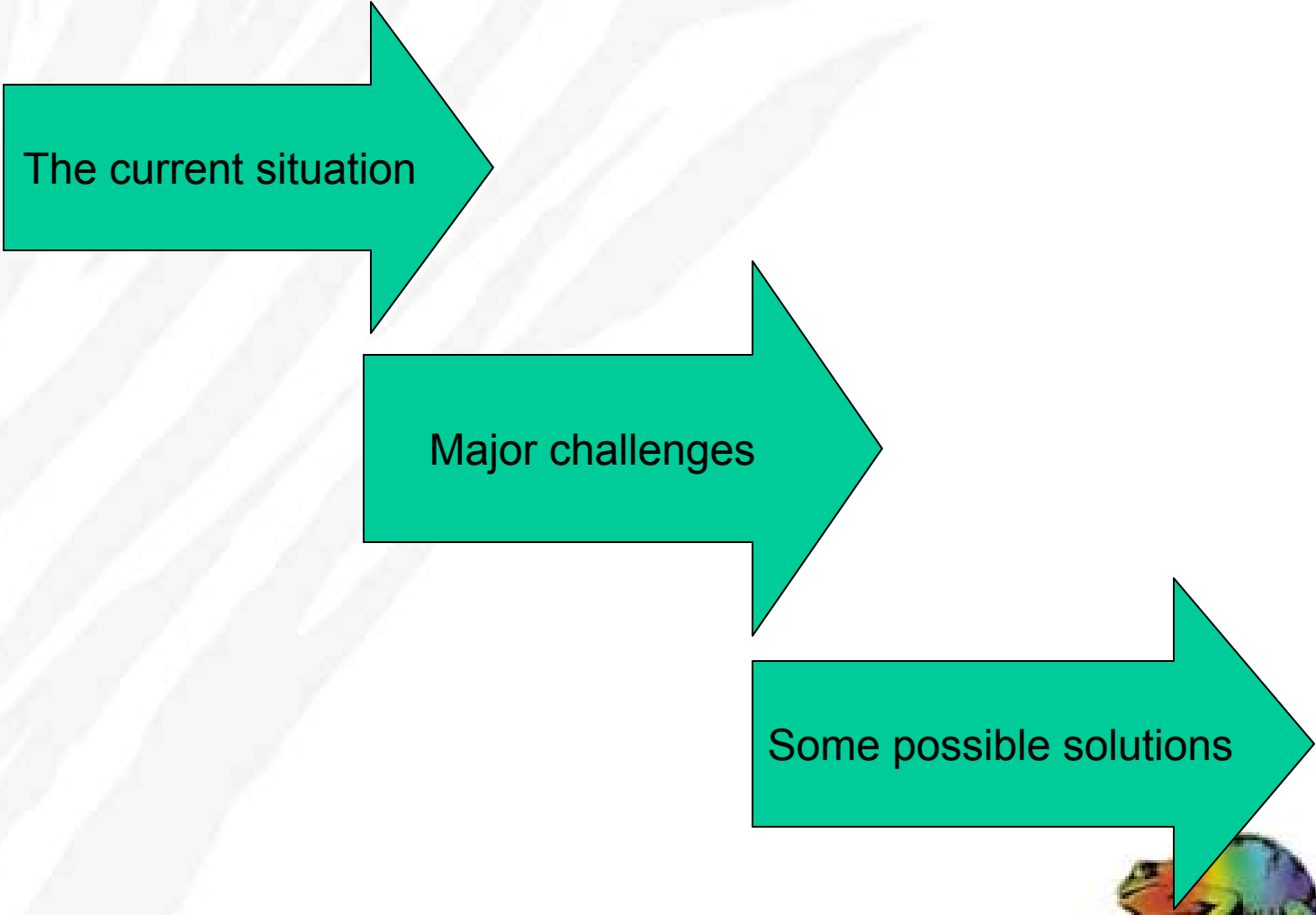


**Major challenges in
rewriting the
Retirement Funds Act
in South Africa –
A personal view**

Jeremy Andrew





Successes

- **Young country**
 - **Census 2001: 78 people aged 65 and over per 1000 people aged between 15 and 64**
 - **The number under the age of 14 are significantly larger than the number aged 45 to 64**



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- **Private retirement fund industry covering in excess of 60% of the formal sector**
- **Contribution rates, on average, are as high as mandatory levels in many other countries**



Areas for development

- High unemployment
- Burgeoning informal sector



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Areas for development

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- Burgeoning informal sector
- Limited social security
 - Unemployment Insurance Fund
 - Social old age pension small in relation to earnings in commerce and industry
- Strong need for investment in infrastructure, job creation and transformation
- **Extreme disparities in income**
- **Two economies:**
 - **“First world” economy for employees in commerce and industry**
 - **“Third world” economy for others**



Existing Retirement Fund Structure

- **Pillar 1: means-tested social old age pension aimed at poverty relief, funded from general taxation**



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- **Pillar 2: private occupational retirement funds and individual retirement annuity funds**
 - compulsory for new employees after establishment
 - mainly defined contribution in private sector; defined benefit in the public sector
 - growing use of multi-employer funds sponsored by trade unions or service providers
 - taxed on an ETT basis



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- **Pillar 1: means-tested social old age pension aimed at poverty relief, funded from general taxation**
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 - compulsory for new employees after establishment
 - mainly defined contribution in private sector; defined benefit in the public sector
 - growing use of multi-employer funds sponsored by trade unions or service providers
 - taxed on an ETT basis
- **Pillar 3: sophisticated range of alternative savings instruments**
 - taxed on an TTE basis or EtT basis



Major challenges

- **Access for the poor**
- **Achieve higher replacement ratio**
- **Governance failures**
- **Investment in infrastructure development**
- **Unclaimed benefits**

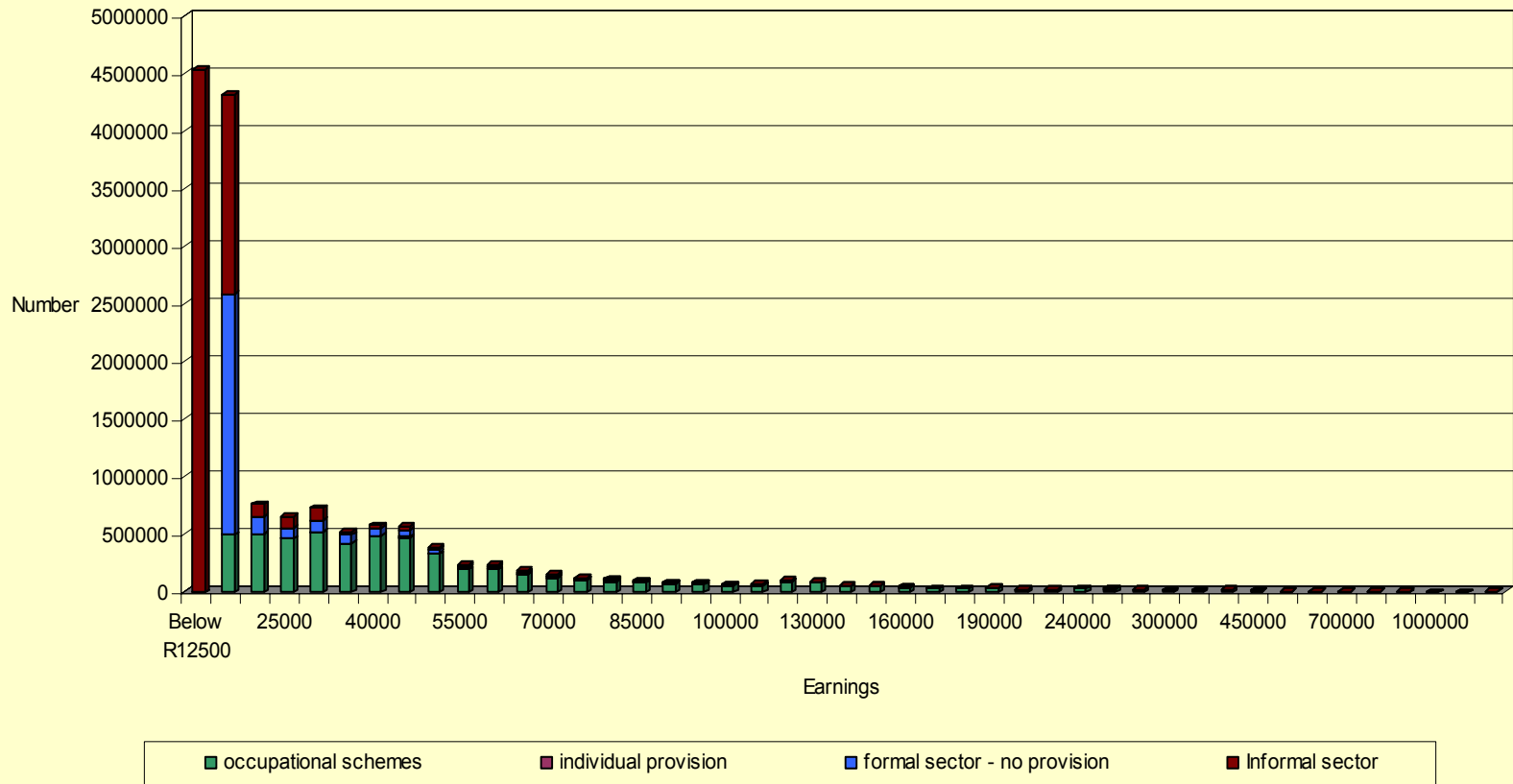


**Challenge 1:
Access for those with low and
irregular incomes**



System excludes the unemployed and low-income workers

Participation in retirement funding by earnings level
(2001 Labour Force Survey adjusted by retirement fund administrator data)



Which is no surprise!

- **Savings vehicles**
 - exclude irregular small contributions
 - lock up savings, when there is a need to access in times of life crisis
- **Administration costs per member are high = poor value for contribution saved**
- **Tax system (ETT) penalises saving through a retirement fund**
- **Tax incentives are irrelevant to those below the tax threshold**



National Savings Fund

- **Competitive returns**
- **Remove current tax penalties:**
 - **Exempt benefits from means test**
 - **Exempt investment accumulation from Retirement Fund Tax**
- **Cheap administration (economies of scale / government subsidy / simple uniform structure)**
- **Allow**
 - **Irregular contributions**
 - **Withdrawal to meet life crisis needs**
- **Incentivise retention in the Fund**
 - **Retirement bonus**
 - **Prizes**



**Problem 2:
Improve replacement ratio**

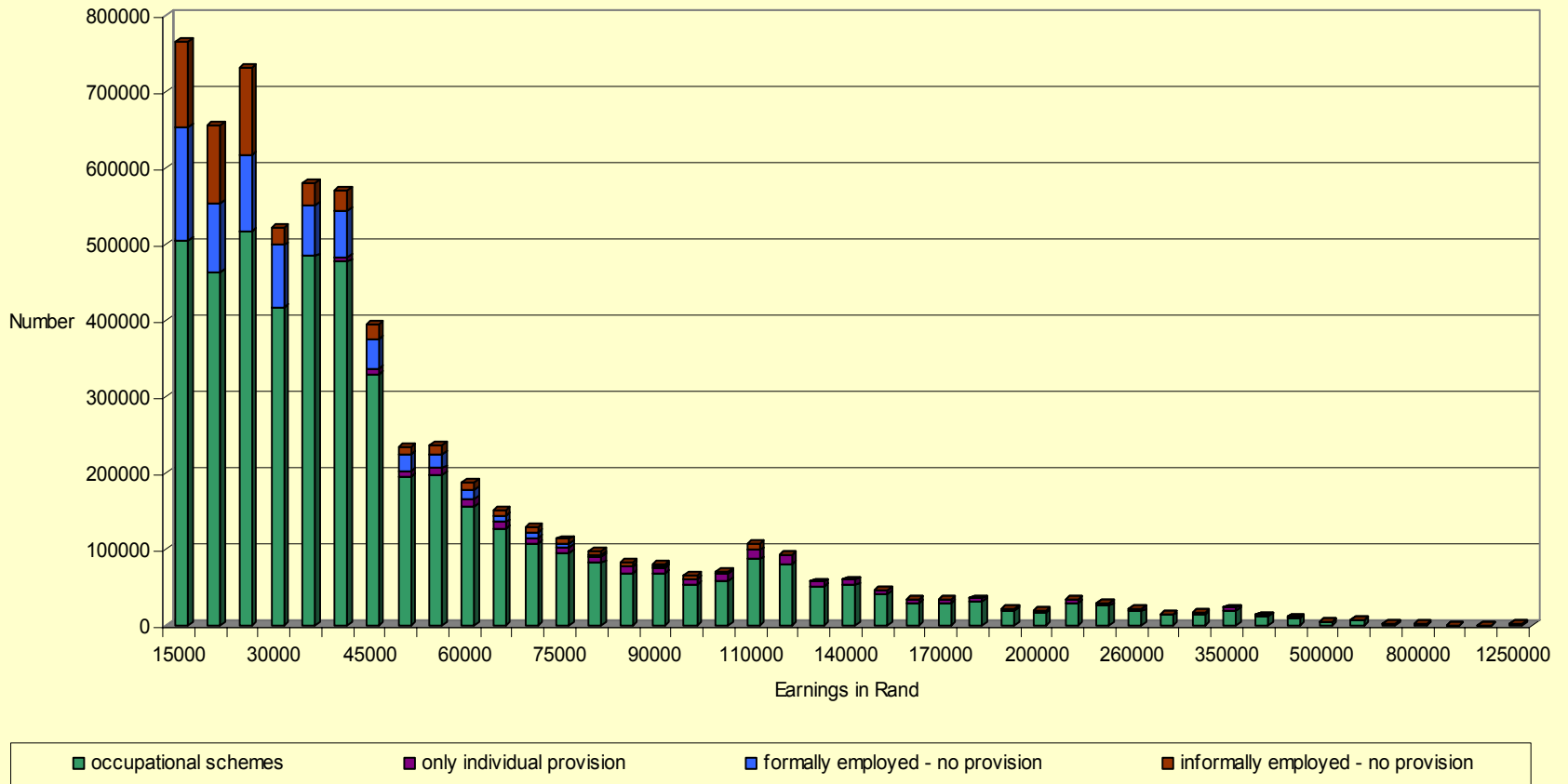


Is there a problem?



High coverage of those in permanent employment

Participation in retirement funding by earnings level
(excluding 4,3 million in employment earning less than R12500 per annum and 4,3 million unemployed)
(2001 Labour Force Survey adjusted by information from retirement fund administrators)

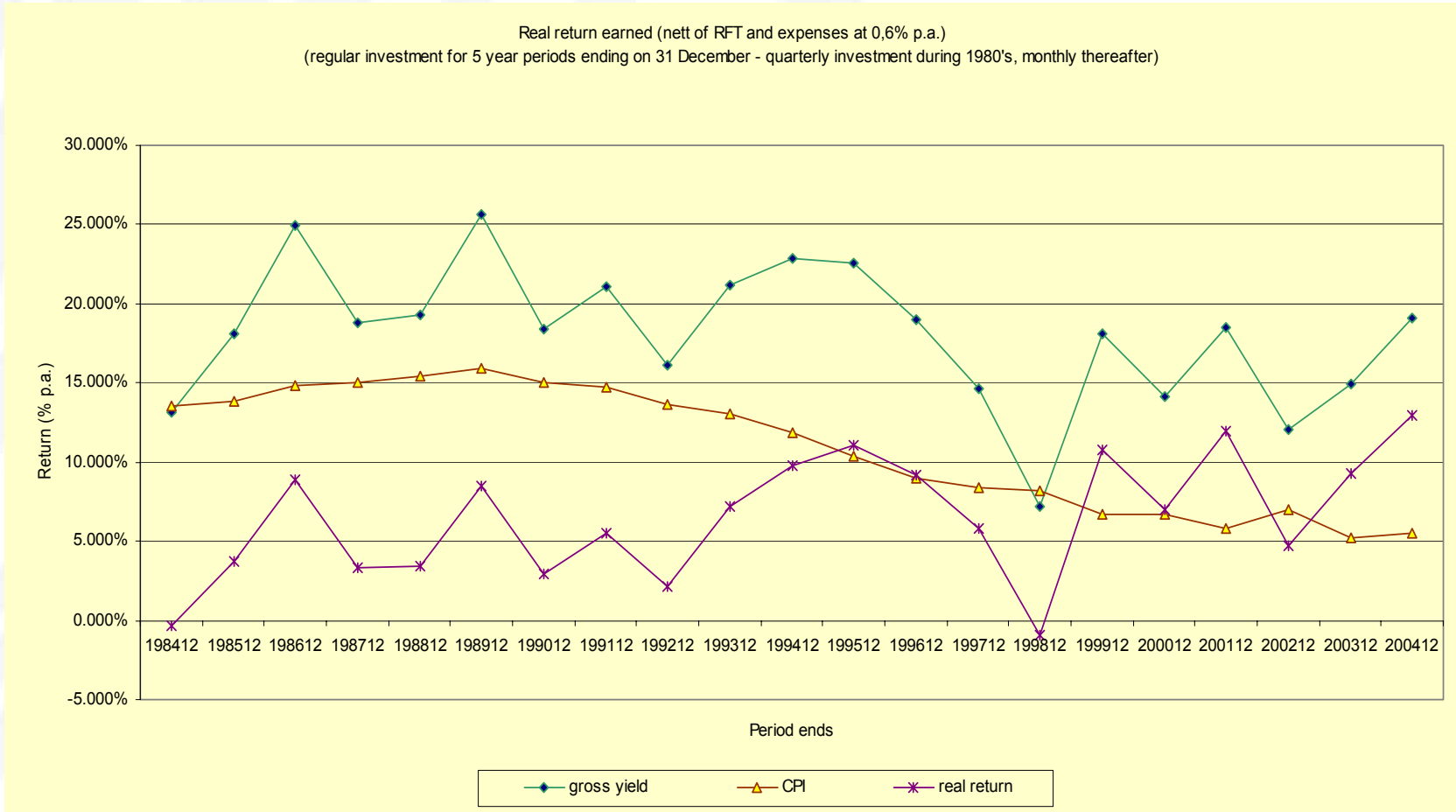


“Average” contributions suggest little scope for an increase

	2004 survey	2002 survey
• Member	6,3%	6,2%
• Employer	<u>10,2%</u>	<u>10,6%</u>
	16,5%	16,8%
• Premiums		
– Death	2,5%	1,9%
– Disability	1,8%	1,5%
• Administration	<u>1,4%</u>	<u>1,0%</u>
Saved	10,8%	12,4%

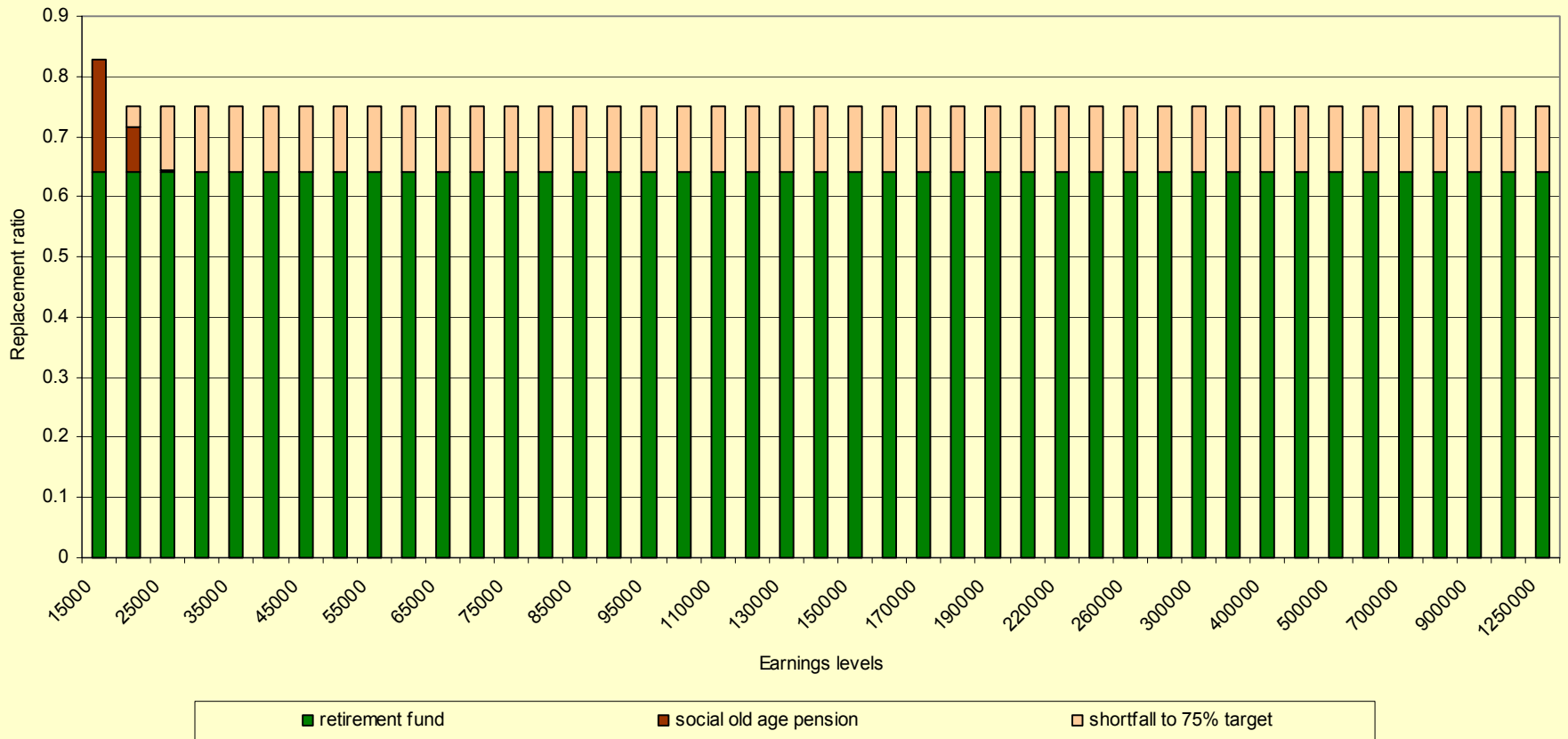


Real returns are good, on average, but volatile



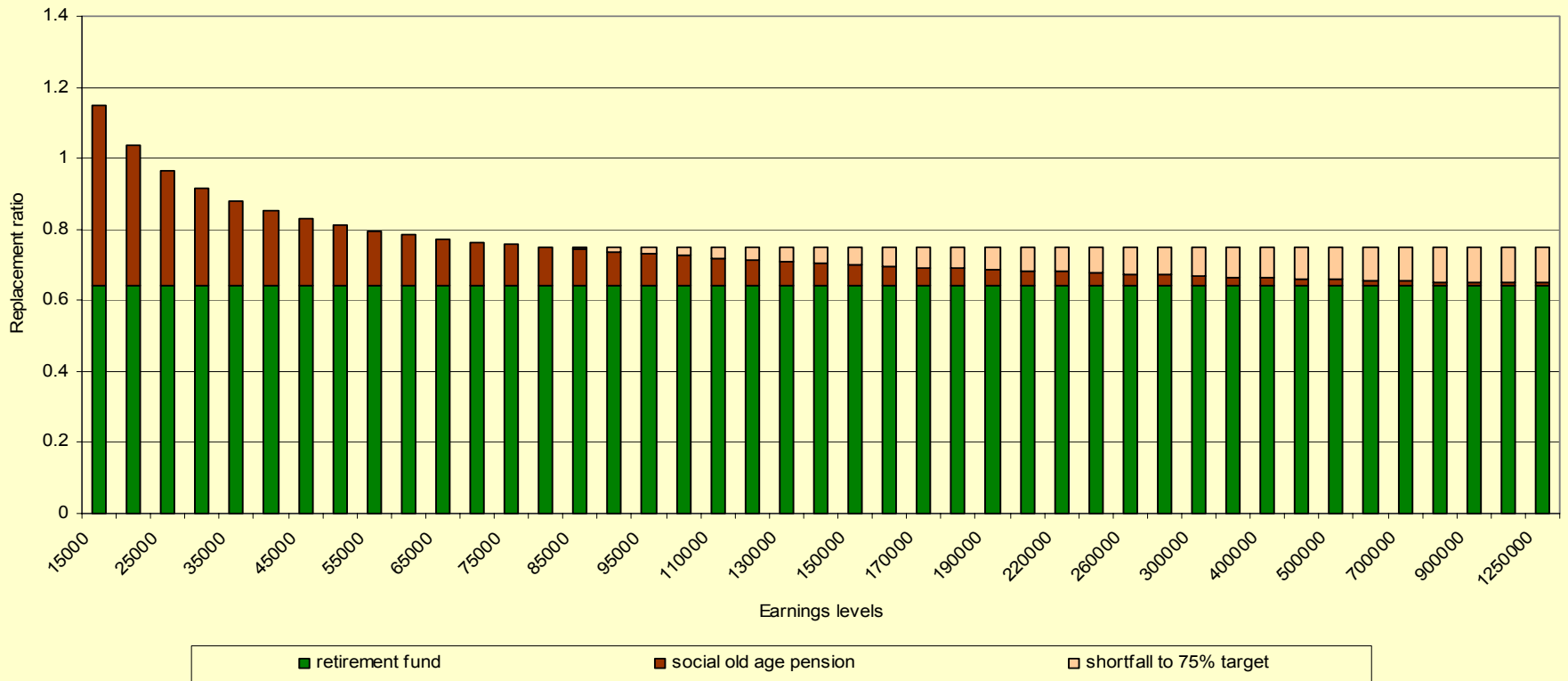
If people save during their full career, they should be OK at 5% real

Replacement ratio:
 accumulation of 10% of payroll, after expenses, at a 5% real return, for 35 years,
 converted to pension at a rate of R13,8 for R1 of pension, means test from R1



Relaxing the means test means that we can achieve a 75% replacement ratio for the poor

Replacement ratio:
accumulation of 10% of payroll, after expenses, at a 5% real return, for 35 years,
converted to pension at a rate of R13,8 for R1 of pension, no means test



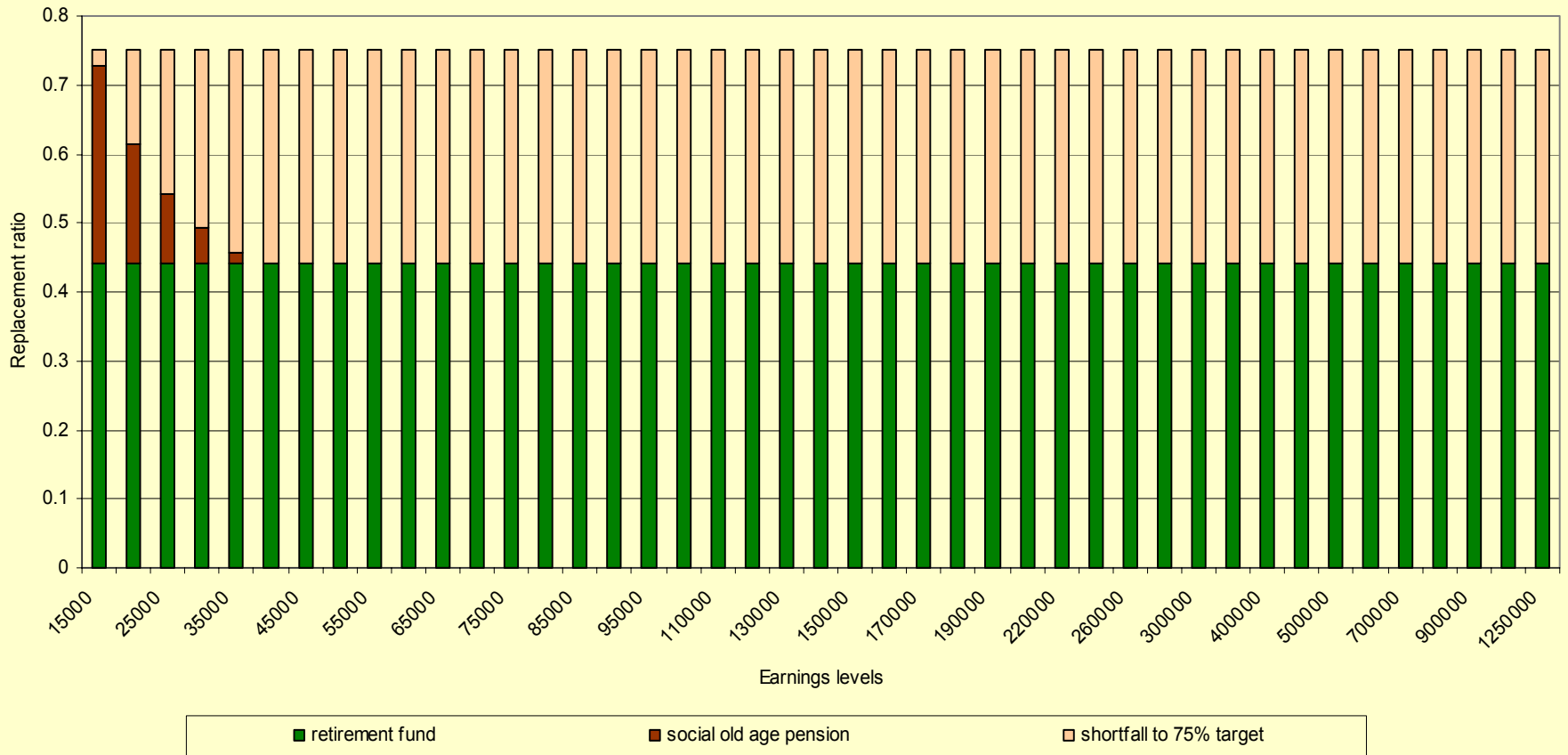
BUT: we have leakage

- **Resignation benefits available in cash**
- **High costs and increasing risk premiums erode contribution saved**
- **Tax on the investment buildup**



There is bad news, if the real return drops

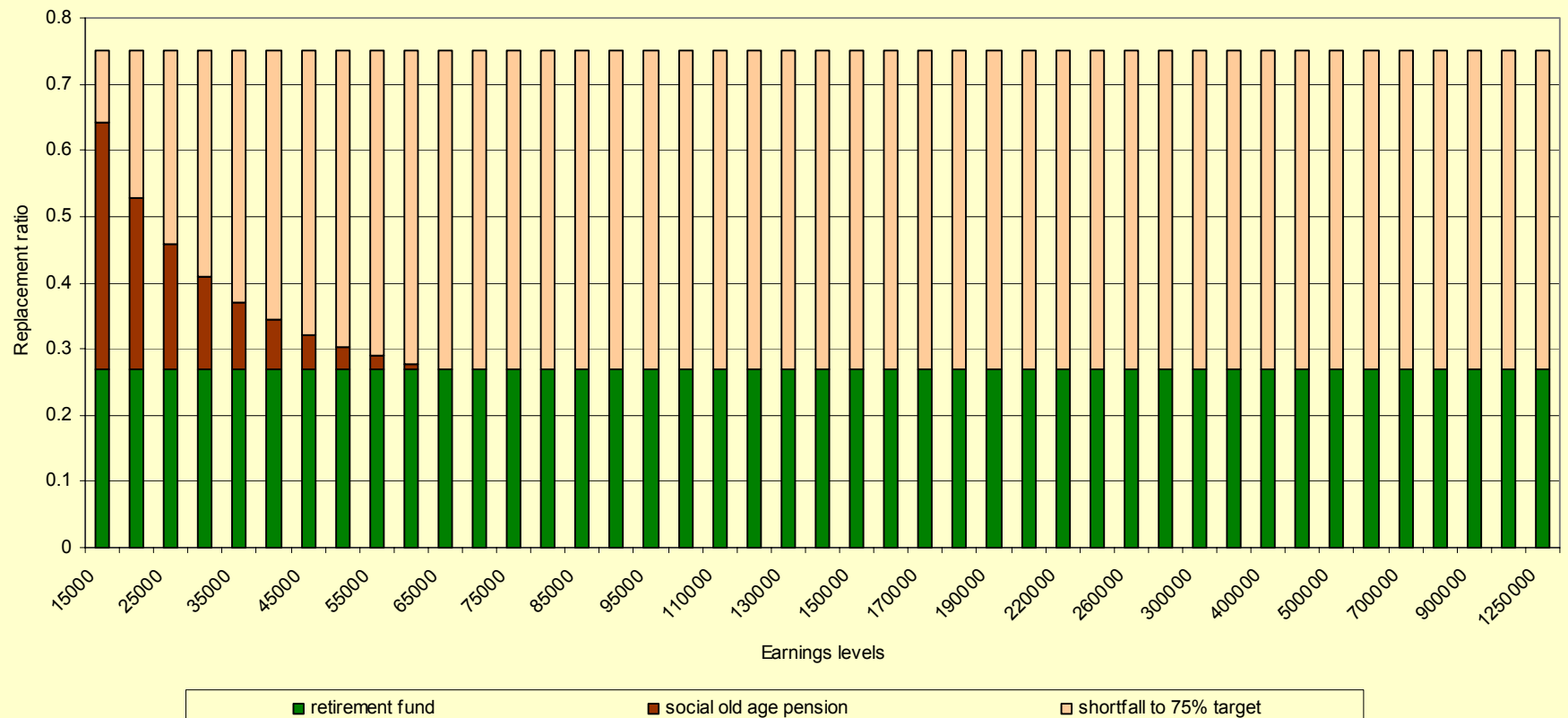
Replacement ratio:
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converted to pension at a rate of R13,8 for R1 of pension, means test from R1



And even worse, if you contribute for only a shorter period

Replacement ratio:

accumulation of 10% of payroll, after expenses, at a 5% real return, for 25 years,
converted to pension at a rate of R13,8 for R1 of pension, means test from R1



Possible solutions

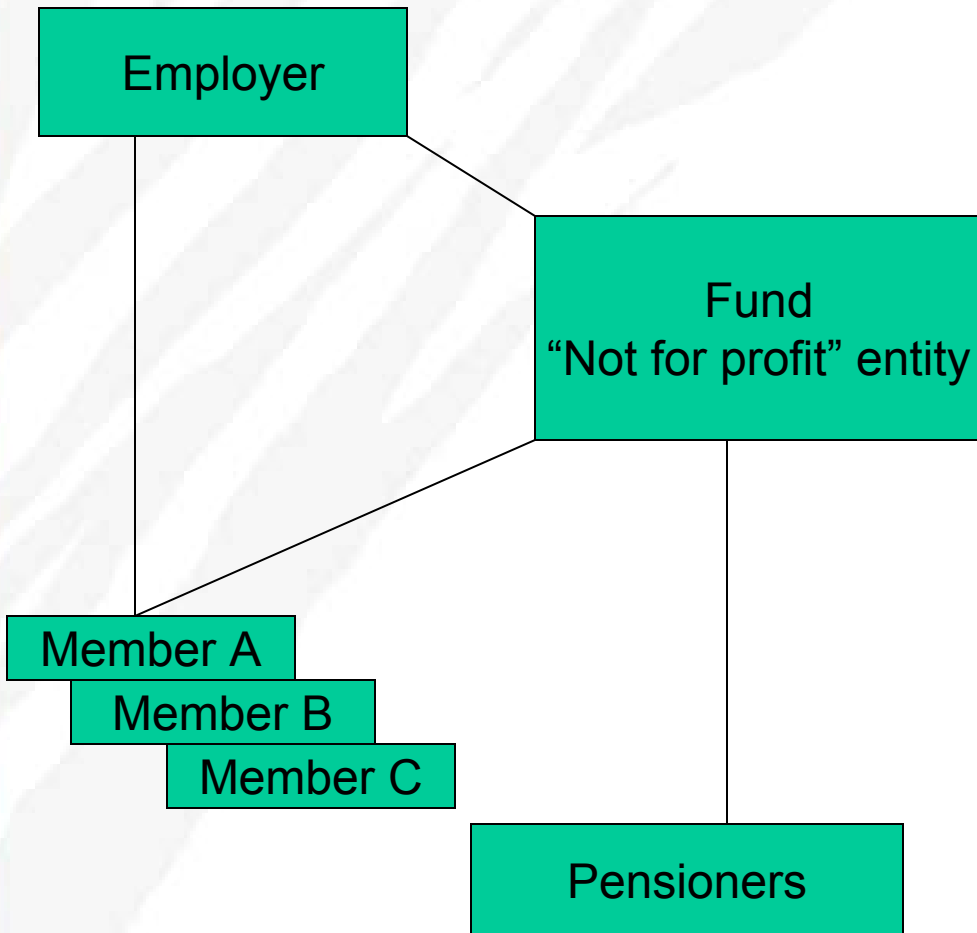
- **Limited preservation**
 - Transfer to new fund or individual fund on a change of job
 - Only draw once unemployment benefit is exhausted
- **Cost disclosure in simple terms**
- **Cap risk premiums and administration costs or make “exclusive”**
- **Review tax structure**



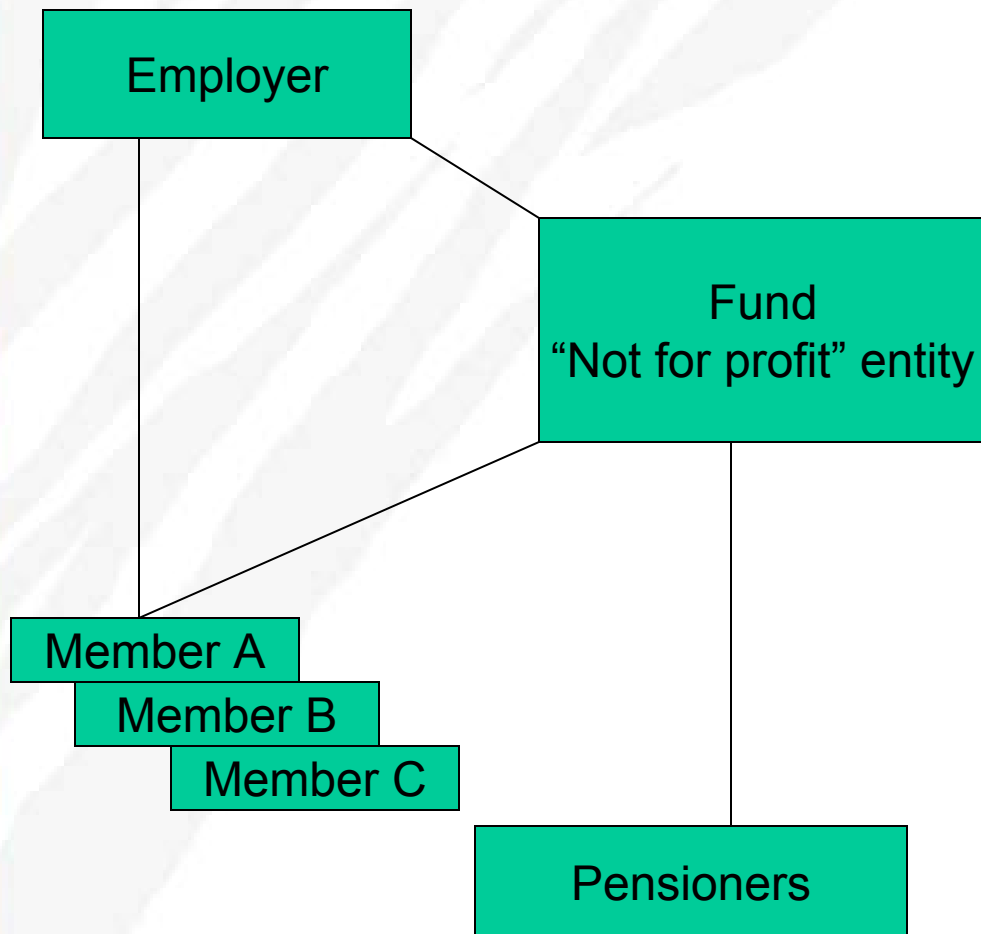
Challenge 3: Improve governance



“COLLECTIVE MODEL”



“COLLECTIVE MODEL”



CHEAP

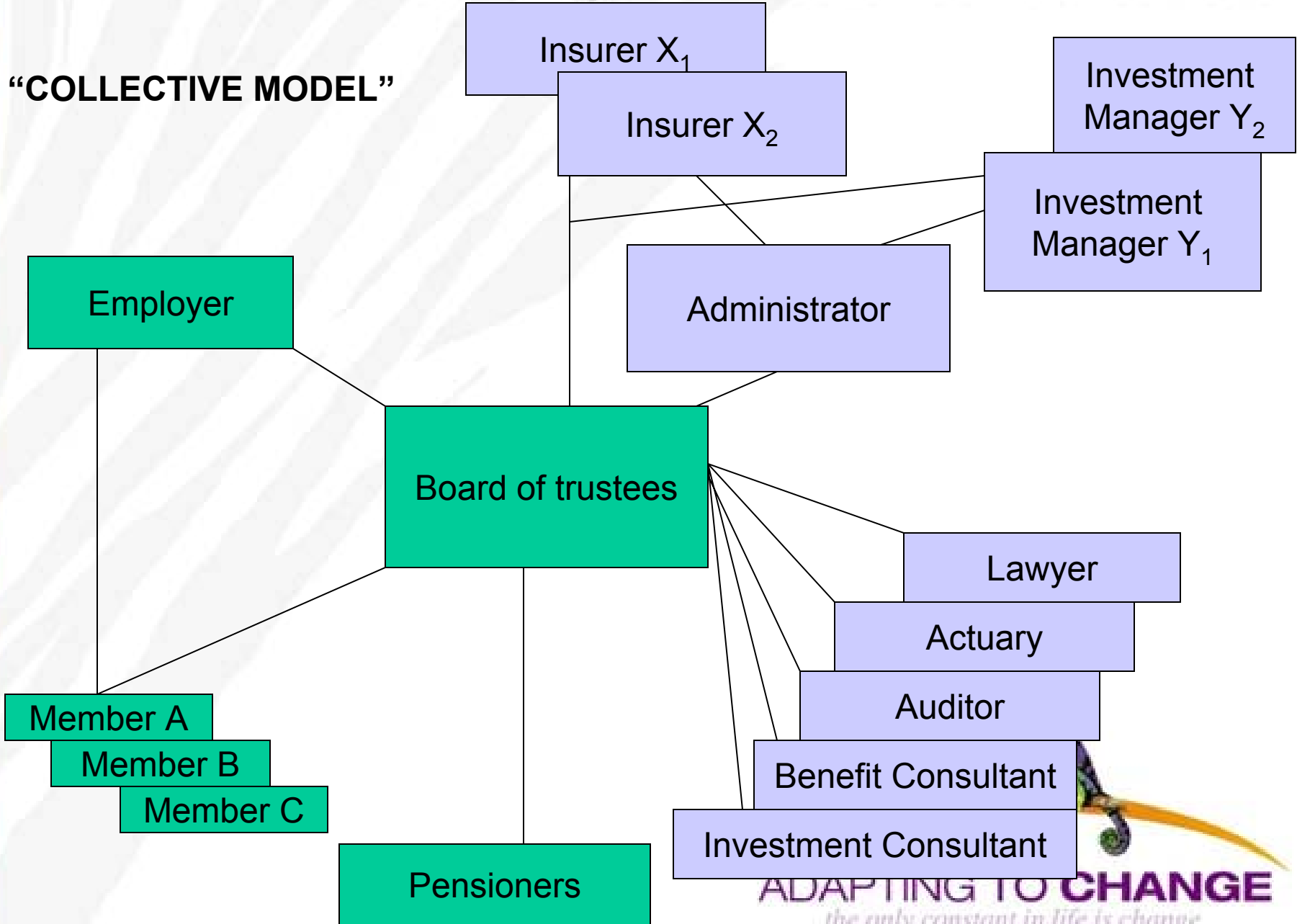
- employer payroll facilities = ease of contribution collection
- easy communication through employer
- bulk purchasing power for services required
- group underwriting of risk and medical free limits
- spread overheads across all members
- cross subsidies:
 - * healthy to sick
 - * rich to poor

BUT

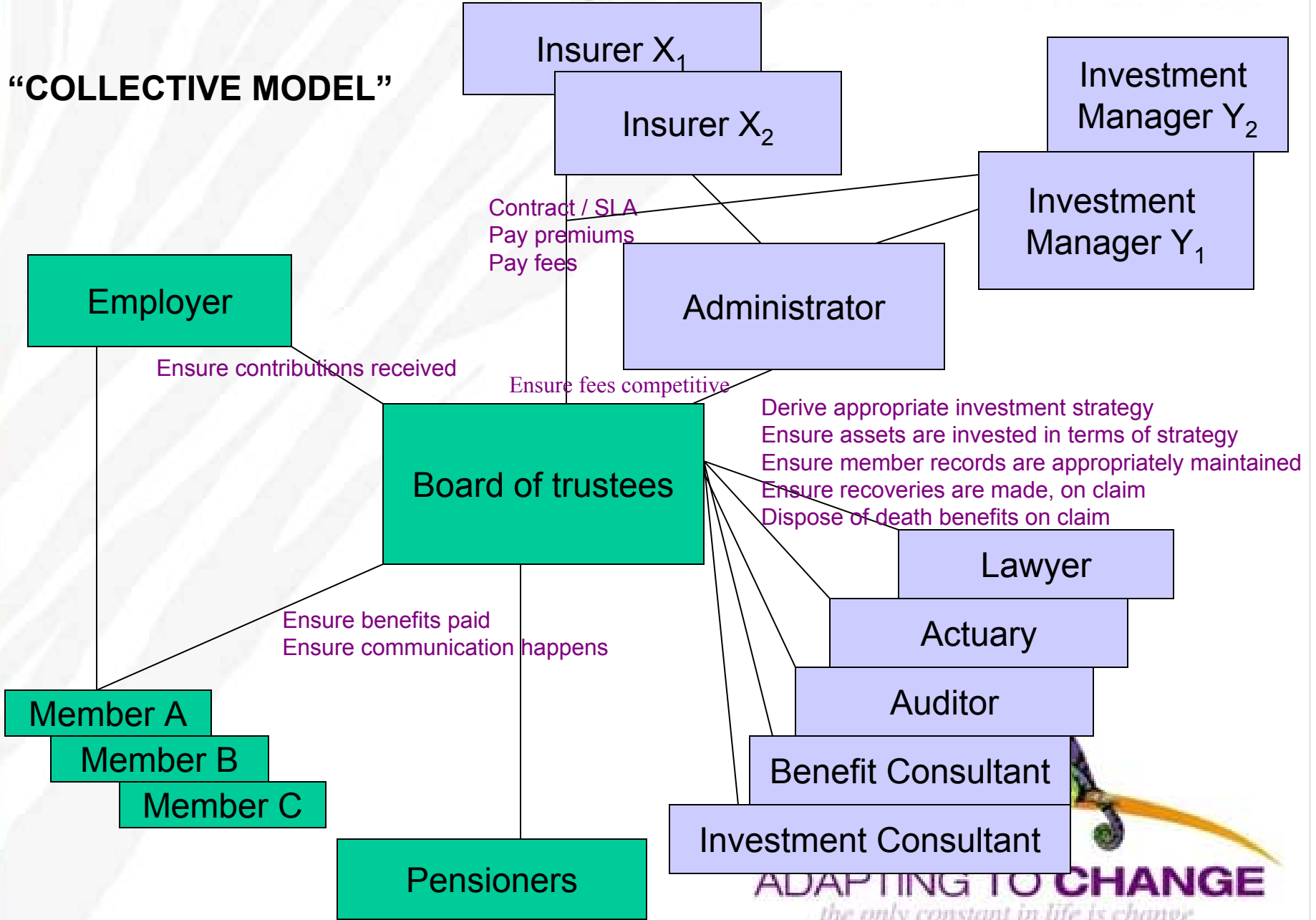
all members treated the same



“COLLECTIVE MODEL”

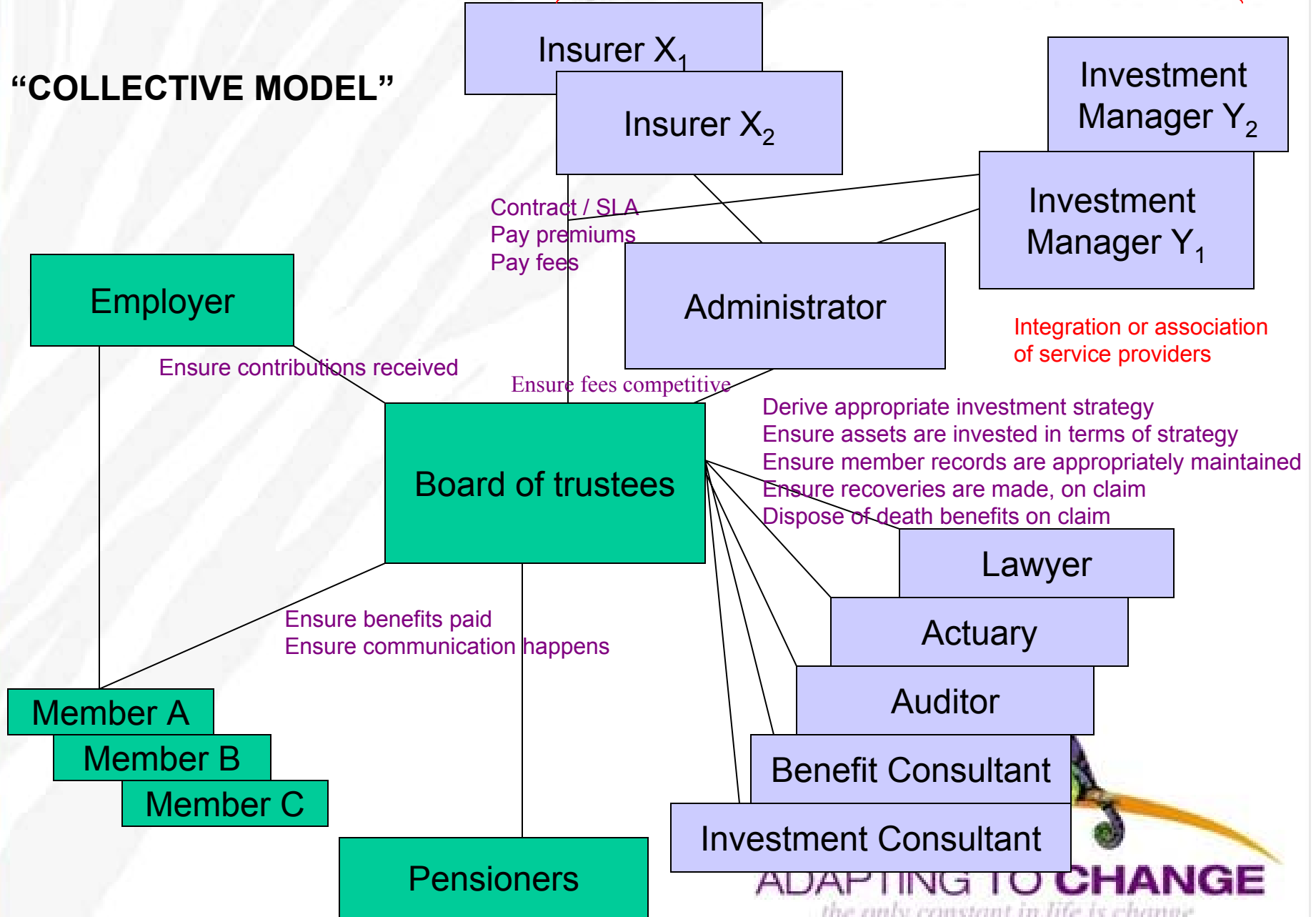


“COLLECTIVE MODEL”



“For profit” entities

“COLLECTIVE MODEL”



Governance failures

- **Insufficient skills = “I relied on the professional advisor”**
- **Conflict of interest**
 - **Integration of services within a single provider group**
 - **Financial interests of sponsor or firm conflict with fiduciary duties to the fund**
- **Failure to develop and implement an appropriate investment strategy**
- **Services not obtained in a cost effective manner**
- **(DB funds only) Funds run as “subsidiary” of employer**



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**Aggravated by limited powers of intervention
and enforcement by regulator**

Particularly acute for multi-employer funds



Improve governance (1)

- **Member elected representatives to form a majority of trustees in DC funds /
Employer appointed representatives to form a majority of trustees in a DB fund**



Improve governance (1)

- Member elected representatives to form a majority of trustees in DC funds / Employer appointed representatives to form a majority of trustees in a DB fund
- **Code of conduct for trustees**
 - Independence from sponsor, employer, constituency
 - Any conflict of interest to be declared
 - Cost effective management
 - Regular tender process for services
 - Appropriate appointment process
 - Service level agreements
 - Regular performance review



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 - Service level agreements
 - Regular performance review
- **Encourage trustee education**
 - Regulator to license education programmes
 - Education independent of service providers
 - Evaluate trustee performance on a “reasonable trained trustee” standard after initial learning period



Improve governance (2)

- **Require disclosure of all fees or rewards to a service provider or firm employing consultant**
- **Forbid any kickbacks or rebates**



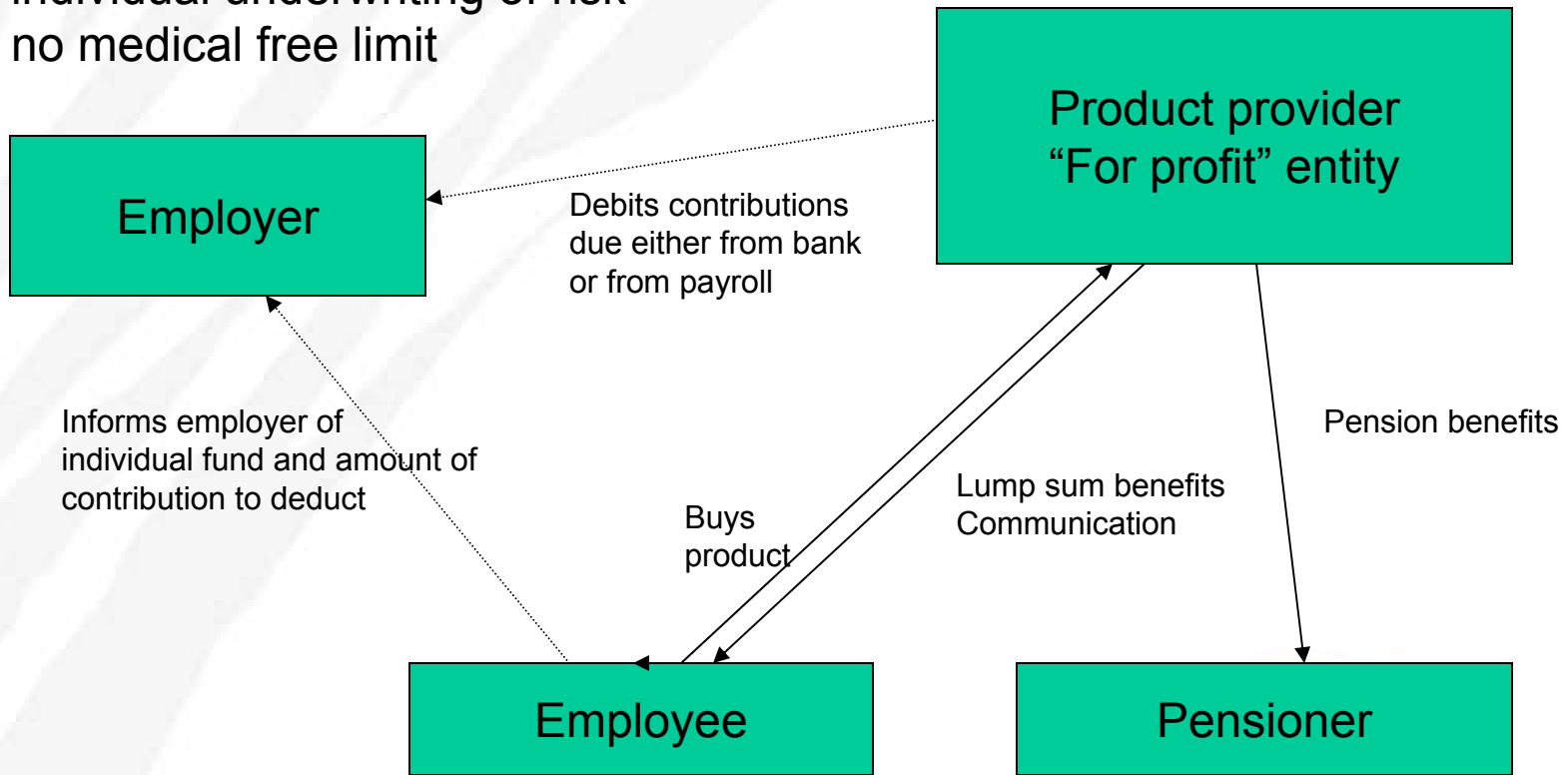
Improve governance (2)

- Require disclosure of all fees or rewards to a service provider or firm employing consultant
- Forbid any kickbacks or rebates
- **Allow delegation with transfer of accountability provided persons to whom tasks are delegated are “fit and proper”**
 - Regulator to license service providers to do certain work
 - Provided properly appointed, service provider assumes fiduciary duty of trustees
- Use independent professional trustees where costs permit



“INDIVIDUAL MODEL”

- simple
- individual choice
- individual underwriting of risk
- no medical free limit

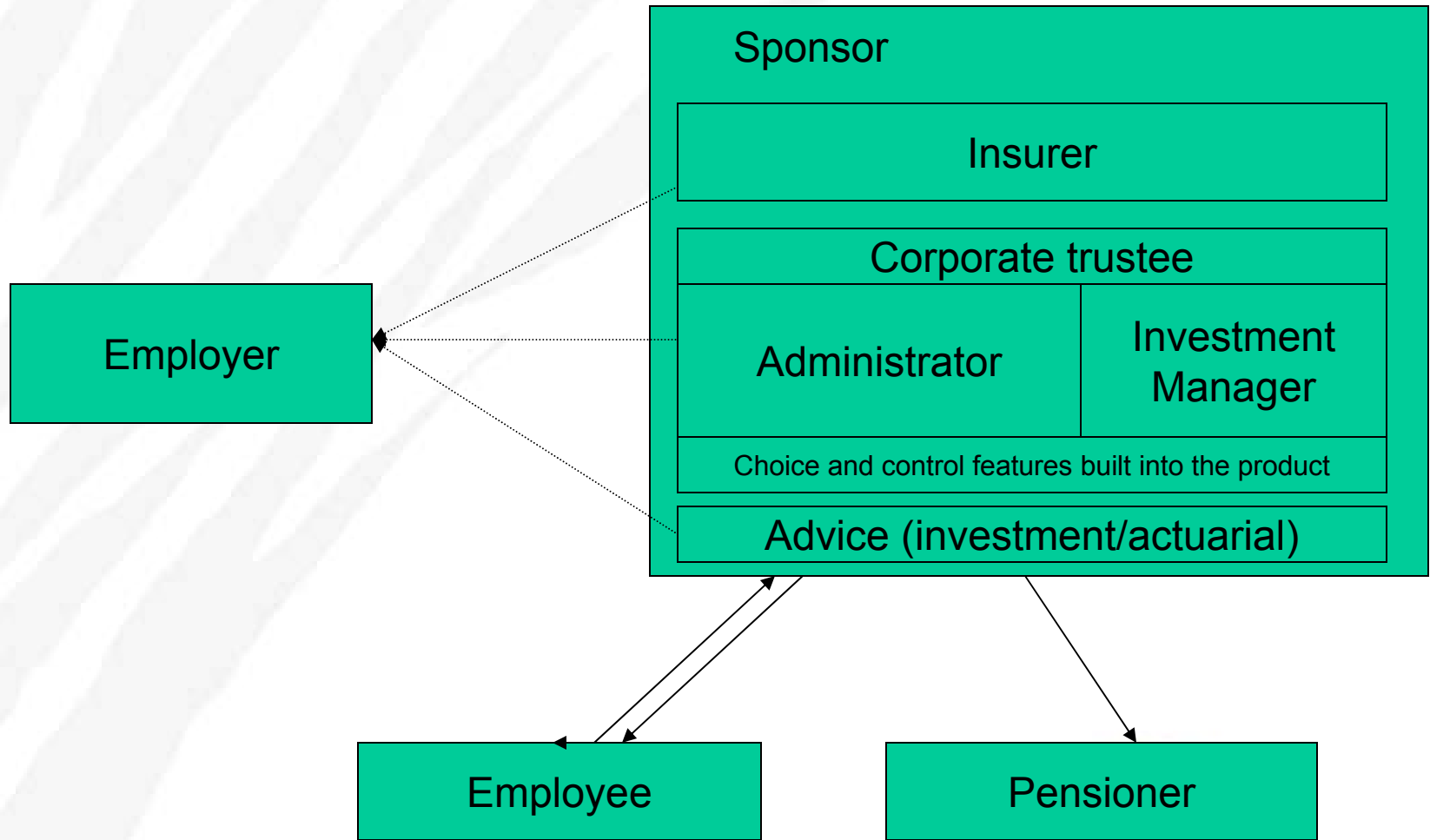


Apparent failures of individual approach

- **Significantly more expensive**
 - Individual choice / communication
 - Payment for advice at individual level
- **No evidence of superior delivery compared to collective approach**
- **Service providers bar transfer or impose punitive penalties**
- **No independent professional monitoring of performance**

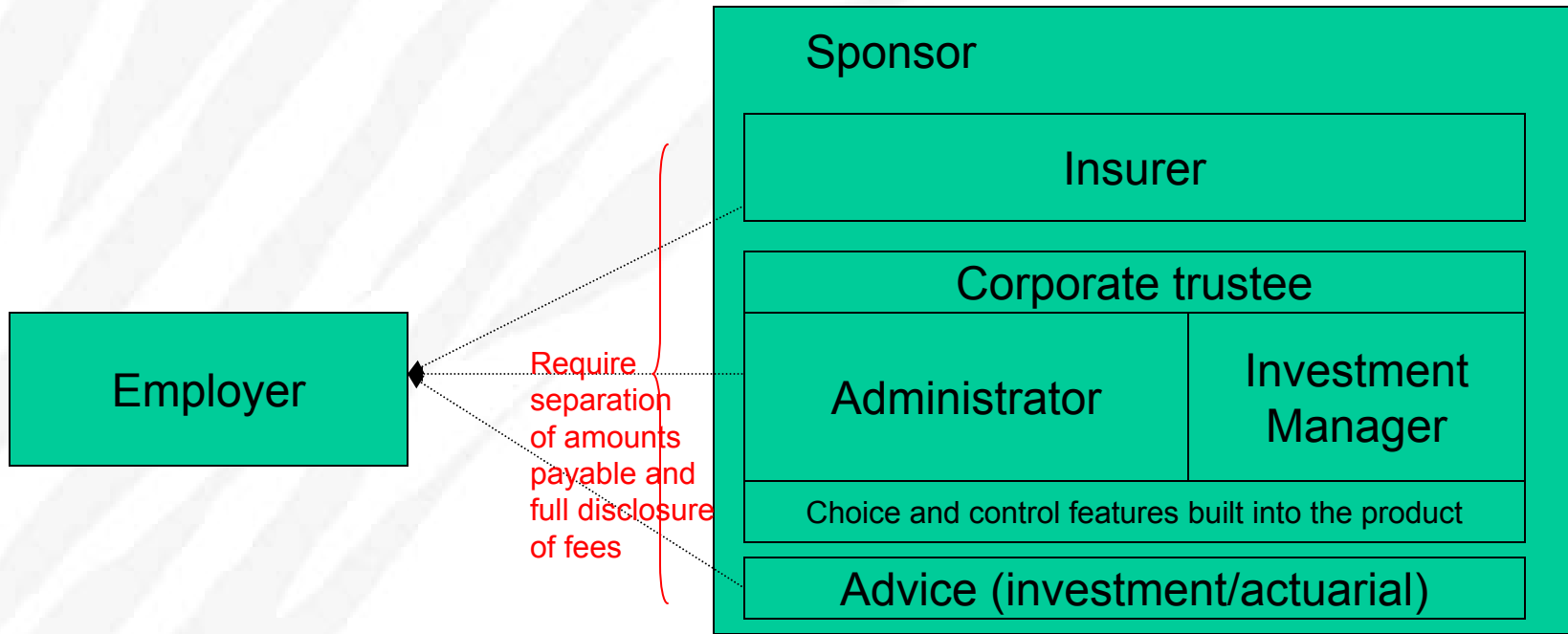


“INDIVIDUAL MODEL”



“INDIVIDUAL MODEL”

Require product to invest as though it was under the “collective model”



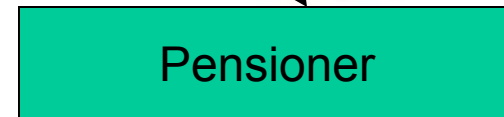
Adequate consumer protection at the advice / sale stage
No inducement payable on transfer

Regulator to publish league tables



Has right to transfer to another individual fund at any time without penalty

Require disclosure of performance



Challenge of multi-employer funds

- **Member involvement in management**
- **Improve disclosure of fees, performance, sub-fund accounts**
- **Independent trustees**
 - **Services may not be tied to sponsor**
 - **Sponsor's right to be considered in placement of services**



Strengthen regulator

- **Ensure that the regulator gets adequate information about a fund**
 - **Compliance report**
 - **Obligation to whistle-blow (independent trustees, compliance officer, service providers)**
- **Enforcement of adequate governance / exercise of fiduciary duties: independent tribunal may suspend, fine or disqualify the trustee/ board / service provider**



**Challenge 4:
targeted investment and
shareholder activism**



Investment regulation

- **Implement an investment strategy suited to the fund**
 - **Establish strategy with expert assistance**
 - **Actuary to confirm suitability**
 - **Report compliance to regulator**
 - **Monitor performance**
 - **Regularly review strategy**



Investment regulation

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- **Exempt small funds on condition that they are subject to quantitative limits**



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 - Actuary to confirm suitability
 - Report compliance to regulator
 - Monitor performance
 - Regularly review strategy
- Exempt small funds on condition that they are subject to quantitative limits
- **Encourage shareholder activism by enabling trustees to exercise voting power on a “look through” approach**



How to achieve infrastructure investment?

- **Set limits by regulation**
- **Give trustees the responsibility to find suitable investments (private equity funds, infrastructure bonds)**
- **Measure and report performance in terms of yields and social dividend (determined using a scorecard approach)**
- **Allow regulator to take action if persistent breach**



Unclaimed benefits

- **Create central registry**
- **Allow access from rural areas, hospitals, government departments**
- **Transfer moneys out of funds after they have been unclaimed for 2 years into a central fund**
- **Give the central fund a responsibility to trace beneficiaries and pay any that emerge**
- **Release surplus from the central fund to meet the costs of the social old age pension**



Process being followed

- **National Trustee Conference - November 2004**
- **Discussion document released - December 2004**
- **Comments to be submitted by 31 March 2005**
- **National Treasury prepare draft proposals**
- **2nd round of consultation**
- **Bill to Parliament**



Pension Lawyers Association Conference 2005

Thank you!

