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Retirement Reform Project

SOUTH AFRICA'S MANDATORY DEFINED CONTRIBUTION RETIREMENT SAVING SYSTEM

PROVIDER ACCREDITATION

Rob Rusconi
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GLOSSARY OF TERMS

ARI	**Accredited Retirement Institution**, the name given to the entities licensed to provide retirement savings services, perhaps also death and disability insurance, to the individuals who choose to redirect their mandatory contributions from the default public-sector entity to a private-sector alternative. The Accredited Retirement Institution is contracted by a Mutual Pension Fund owned by its members.
DB	**Defined Benefit**, a pension fund arrangement under which the benefits received by fund members are pre-determines by reference to other variables such as salary prior to retirement, and contributions vary to meet the requirements of this obligation.
DC	**Defined Contribution**, a pension fund arrangement under which the contributions into the system are defined in advance and benefits are based on the accumulation of these contributions, less expenses, plus investment return, usually without any guarantees or sharing of risks between members.[1]
FSB	**Financial Services Board**, the entity currently responsible for regulating non-banking financial services entities, such as insurers, retirement funds and collective investment providers.
GSRF	**Government Sponsored Retirement Fund**, the working name for the entity responsible for collecting contributions and providing benefits under the pay-as-you-go system proposed by the Department of Social Development.
LOA	**Life Offices Association**, an industry body representing the interests of South African insurers.
MPF	**Mutual Pension Fund**, the legal entity housing the assets of participants. The Mutual Pension Fund contracts an accredited retirement institution to provide administration and asset management services and, if applicable, the provision of death and disability insurance.
OECD	**Organisation for Economic Co-operation and Development**, a 30-country entity with a unit responsible for researching and co-ordinating best practice policy in the design and regulation of private pension systems. South Africa was recently awarded observer status of this unit.

[1] *Hybrid forms, mixing the best of DB and DC systems, exist both at national and company level. Examples include the unfunded Notional Defined Contribution, used in a number of countries, and the Dutch Collective Defined Contribution. This paper limits its attention to the individual member DC environment, referred to in many countries as Individual Account systems*

PAYG	**Pay-as-you-go**, a retirement system under which the cost of benefits is met from other sources of income, like general tax revenue, rather than by building a fund in advance.
PFA	**Pension Funds Adjudicator**, the statutory authority responsible for hearing the complaints of pension fund members and issuing rulings in response to these complaints.
SARS	**South African Revenue Services**, the tax collection authority in South Africa.
SOAG	**Social Old Age Grants**, the system currently in place to provide retirement benefits to elderly South Africans, recently increased to a level of R870 monthly and means-tested to focus on the needy. This is a pay-as-you-go system as annual outgo is funded from general tax revenue.

Summary of Recommendations

South African policymakers are considering the introduction of a system of mandatory saving for retirement in individual accounts. Under the proposals, contributions are to default to a public sector entity, but participants may opt out of the default provider, redirecting contributions to an accredited private sector alternative. This paper considers the conditions that ought to be placed on firms applying for registration as accredited retirement institutions for the right to provide savings vehicles or risk products to these savers.

This research has been commissioned by the Department of Social Development, and has its recommended framework in mind, which includes a comprehensive contributory social security system. The concepts and recommendations of this paper nevertheless apply to any mandatory individual account scenario with some form of private sector management.

This is a discussion document. It puts forward a number of proposals but the wide range of subjects impacted by the retirement savings market is not covered in sufficient depth for detailed recommendations to be ventured. The most significant suggestions are set out below for further consideration.

Overall ethos

This is expected to be a substantial financial system backed by mandatory contributions. It is imperative that the marketplace promotes appropriate competition between providers and low cost to participants, establishing confidence among South Africans that their interests are properly safeguarded. Two key features of the market run through all aspects of system design and regulation:

- **Simplicity and standardisation**. Products are simply designed, providing benefits that are clearly understood by participants, and they are easy to compare.
- **Consistency across providers**. Accredited retirement institutions (ARIs) compete with one another on an equal footing. The conditions for provider participation are applied with consistency across all private-sector entities and their public-sector competitor.

Legal framework

The proposed broad legal framework is analogous to today's collective investments environment.

- Participants selecting a provider become members of a **Mutual Pension Fund (MPF)**, each of which contracts an ARI to supply standardised services.
- **Governance principles** underlying the structure of ARIs are designed to maximize participant protection but do not limit inappropriately the types of organisations that may consider registering as ARIs. The trust-based framework is regarded as the most appropriate foundation to governance structures. Both non-profit and profit-seeking entities should be encouraged to apply.

- **Governance in practice**. ARIs are encouraged to treat governance standards as establishing merely a minimum, finding ways to compete on the basis of the soundness of their practical implementation of good governance structures.

Regulatory framework

The approach proposed for regulation and supervision of this market differs considerably from the corresponding approach used in pension provision today.

- **Proactive supervisory philosophy**. The supervisor proactively and continually monitors the ARIs – which will exist in relatively low numbers – to ensure that they are compliant and financially secure.
- **Comprehensive supervision**. Prudential regulation is supported by thorough regulation of advice and product.
- **Regulatory independence**. The supervisor raises finance from ARIs and is financially and politically independent of government. Structures are established to safeguard members of the executive of the supervisor and its advisory panel from political influence, while retaining the appropriate accountability to the relevant Minister.
- **Existing regulatory structures** continue to work as at present, subject to the review processes provided for under current law. A distinct philosophy requires a distinct operation. The entity responsible for registering and supervising ARIs may form a department of the FSB or a separately established organisation, as appropriate, with structures in place for mutual support and information sharing and the possibility of future merger of operations.
- **Advice** continues to be regulated under the existing framework, but modification to match the needs of participants is considered as part of an ongoing process of assessment.
- **Participant contributions** are collected centrally but the responsibility for managing accounts and processing benefit payments lies with the ARIs. Alternatives to this model must be considered.
- **Communication** to participants and the public at large forms an important part of the responsibility of the supervisor. This communication includes product and price comparison.

Product framework

A major development for the South African financial services environment is the specification of minimum product standards. In the interests of participant security and product simplification, standards are proposed in a number of areas.

- **Contributions and accumulated saving** must be placed with a single ARI.
- **Individuals**, not employers, have the right to exercise the choice of ARI.
- **Death and disability benefits** are partially provided from within the defined contribution (DC) system and participants may seek death and disability cover from ARIs, which must offer both savings and risk cover products. Whether ARIs are permitted to outsource the provision of death and disability benefits requires further consideration.

- **Annuities** are provided by insurance companies, not ARIs. Participants must exercise a choice of annuity provider at retirement to avoid defaulting to the existing ARI, if it also offers annuities. Some state provision of annuities, up to a minimum level, is contemplated, and some standardisation of annuity products is encouraged, to facility product comparison.
- **Administration charges** are reduced through structural interventions such as centralised contribution collection. Furthermore, limits to the available types of charges are considered crucial and limits to the level of charges require strong consideration, in the interests of participants. A long-term target for such a charge limit is an all-inclusive annual management charge of 0.60% of assets, or its equivalent contribution-based charge, approximately 10%.
- **Commission scales** are not regarded necessary under the assumption that administration charges are capped.
- **Disclosure and service standards** are set and monitored by the supervisory authority.

Investment framework

The proliferation of investment alternatives is not in the interest of participants, particularly in a mandatory saving environment, because it increases system costs without necessarily providing concomitant benefit. It is recommended that investment flexibility is limited in a number of ways.

- **Prudential limitation of investment classes** is implemented to safeguard the interests of participants, mainly by reducing the impacts of conflicts of interest and concentration of risk.
- **Minimum investment returns** are not required of ARIs.
- **Investment choice** is mandated, but strictly controlled. ARIs are required to make five portfolios available to participants, each meeting asset allocation requirements to provide reasonably predictable and uniform risk-return characteristics.

Market description

How does this environment differ from what South Africa has at present?

The present range of providers will continue to service customers saving voluntarily, but the market for mandatory contributions, under the recommendations in this paper, would change significantly.

A limited set of providers, each probably developing significant scale would sell straightforward, easily comparable products at low cost and low profit margins. They would compete on the basis of price and investment performance and would demonstrate the value that they bring to participants in unambiguous terms. The financial security of participants would be protected by a strong proactive supervisory process.

Concluding comments

Significant further input is required, from a wide range of stakeholders, in order to understand the consequences of these recommendations and their implications. It is hoped that this paper will give impetus to this process of discussion.

1 INTRODUCTION

This paper forms part of a set of recommendations formulated by the Department of Social Development under the general heading of restructuring South Africa's old age provision environment.

The paper therefore takes it as given that there is to be a

- mandatory pay-as-you-go (PAYG) social security system, incorporating the existing arrangement of Social Old Age Grants (SOAG), supported by compulsory contributions paid by all qualifying South Africans;[2]
- mandatory individual account system, with contributions defined as a percentage of salary, that are channelled into a publicly managed fund, the Government Sponsored Retirement Fund (GSRF), but with the right of participants to opt out of this fund into an accredited private sector fund of their choice; and
- voluntary additional contributions paid into any vehicle selected by the saver.

The paper assumes that

- compulsion will establish a very large flow of contributions into the accredited fund environment; and that
- the standards imposed on the compulsory saving sector will have positive impacts on the equivalent standards in its voluntary counterpart.

At the time of writing there is uncertainty regarding the system of tax incentives applying to retirement contributions. The recommendations of this paper are unaffected by this uncertainty. The scope of its discussion is sufficiently broad to apply to other potential system designs and its recommendations are broad unaffected by the potential existence of the PAYG system and, with small modifications, would apply also to a defined contribution (DC) system without a public-sector default.

Many commentators assume that the conditions for competitive provision of products and services to the compulsory DC system are already in place. The author does not agree with this starting position, pointing simply to the current marketplace for tax-incentivised retirement saving. A number of fundamental concerns with the operation of this marketplace can be identified, particularly in areas of cost effectiveness, conflicts of interest and governance structures, concerns that cannot be addressed through incremental changes.

Even if the existing environment were operating effectively, it is argued that there is a need for higher standards in the contemplated compulsory DC system. As contributions are mandatory, it is a

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[2] *Details such as whether contributors earn above a certain threshold do not impact the content of this paper and are not part of the discussion covered by this paper. Similarly, the influence of a possible wage subsidy is not considered.*

fundamental requirement of that system that it is safe, cost-effective and structured in a way that it meets the needs of the beneficiaries of the system, the South African saver, without being so harsh as to render participation by providers inappropriately challenging.

Four fundamental risks of retirement income social security systems must be addressed in the design and regulation of such systems (Gill *et al*, 2003):

- **Investment risk** arises from fluctuations to account balances and portfolio values. In a defined contribution system, this risk is borne by the individual.
- **Longevity risk** refers to the uncertainty of the period from retirement to death. This risk may be outsourced to an annuity provider, but is often shared by the retiree through product design or through opting out of purchasing an annuity.
- **Policy risk** is the possibility of intervention by policymakers in the operation of the system, for example, through setting constraints on investment rules that are not in the best interests of all participants, or through failing to safeguard the interests of participants against the impact of potential future changes.
- **Agency risk** arises from the involvement of the private sector in the pension system, manifesting in various ways, misappropriation of assets, conflicts of interest and negligence or ignorance by the provider or advising intermediary.

Any system, with its regulatory framework, must be assessed by considering the extent to which it protects its participants against the impacts of these risks.

The objective of this paper is to define the environment within which providers in the mandatory DC system must operate. It draws on local and international research and regulatory material, with specific input from countries as wide-ranging as Sweden, Argentina and India.

The paper, supported by discussion of special topics in the appendices,

- recommends a revised **regulatory framework and governance structure** for this market (sections 2 and 3),
- sets out **proposed standards for the products** and customer service requirements for accredited providers (section 4), and
- discusses options concerning the **investment** of the underlying assets (section 5).

The framework and standards apply just as much to the public sector "default" vehicle as they do to privately-owned "opt out" alternatives.

The author acknowledges with thanks considerable assistance from supervisory authorities and research experts from around the world, not least from members of the policymaking teams in South Africa. This report could not have been completed without that assistance, but the responsibility for any errors is mine, not theirs.

2 REGULATION & SUPERVISION

> An ever-present danger in regulatory systems is that the regulated will "capture" the regulators and prevent them from operating effectively. … Countries should assess their institutional and human capital capacities for regulating effectively before undertaking a decentralized mandatory saving plan. (World Bank, 1994:227)

The regulatory framework under which a financial services system is established has considerable impact on the way in which it operates in practice. South Africa already has a regulatory system for retirement saving products. The Financial Services Board (FSB) supervises all providers of such products, focusing on prudential management, and also regulates the advice that intermediaries give in the process of selling these products. South Africa does not directly regulate the products sold by South Africa's insurers.

Some may suggest that regulation is weak in this country, citing evidence of

- very high charges (Rusconi, 2004), particularly on individual retirement products;
- poor product disclosure on the same products, as evidenced by a raft of rulings against providers of such products by the Pension Funds Adjudicator;
- conflicts of interest and questionable business practices on the part of high-profile pension fund administrators such as Alexander Forbes;
- serious mismanagement of pension fund money, for example by Fidentia, responsible for managing the assets of the Living Hands widows and orphans trust;[3] and,
- the FSB's recent submission to Parliament disclosing efforts to increase its power and effectiveness.[4]

While some of this criticism may be valid, at least to an extent, the purpose of this section is not to criticise the existing regulatory framework, which has been designed for the trust-based system in

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[3] *"The pension fund trustee system in general is hardly foolproof. Trustees of union funds, few of whom are full time and many of whom work for free, may lack the time and training to monitor funds adequately. In a Deloitte and Touche survey on retirement fund governance, two-fifths of the trustees interviewed spent 10% or less of their time on fund-related matters. But where trustees lack knowledge, experts do not necessarily support better decision-making. … As the government gears up for a compulsory pension scheme, there must be better oversight of workers' money. At the moment, our retirement funds seem to be easy pickings." (Tumi Makgetla, Mail & Guardian, 2 March 2007)*

[4] *"… the FSB has been unable to act swiftly against transgressors, hamstrung by a lack of sufficient powers. Currently, the only two legal remedies it has are to refer matters to the National Prosecuting Authority or to take away the licence of a financial institution. It has had no administrative remedies in its arsenal of enforcement powers. The FSB's deputy executive officer for pension funds, Jürgen Boyd, told Parliament's finance committee yesterday that the FSB and National Treasury were discussing legislative amendments that would create an administrative enforcement committee empowered to impose penalties on all financial institutions." (Linda Ensor, Business Day, 7 March 2007)*

existence today. The primary objective of this section is to demonstrate that a different approach is required for regulating the providers of products and services to the mandatory DC sector, which has a number of characteristics distinguishing it from today's trust-based environment:

- **Compulsion**. Since participation is mandatory, the policymaker has a greater responsibility to ensure that the environment is safe and efficient.
- **Standardisation**. Products in this environment will be simpler and easier to compare, but will have to meet certain standards. Ensuring product standards requires a different approach to regulation than the current focus on prudential and advice supervision.
- **Scale**. The supply side of this market will be unlike anything currently in existence in South Africa. Product standards will be tight (see section 4) and the number of providers few. Each of the providers is likely to have the benefit of significant economies of scale, reducing the impacts of regulatory overheads. The regulatory authority, on the other hand, will have the luxury of focusing attention on just a few supply-side entities, making it possible for it to undertake scrutiny of the activities of these providers at a level appropriate to provide the security required of the system. This requires a different approach to regulation, however; one that is more proactive and less reactive.

The regulatory approach proposed by this paper is new for South Africa, but it is not without precedent in a large number of countries around the world. Through research of academic papers and correspondence with the supervisory authorities in a few of these countries, the author aims to demonstrate that there is a better way to supervise a mandatory individual account system than is currently available through existing supervisory structures.

Types of regulation

Three types of regulation may be contemplated for the proposed environment of mandatory contributions.

- **Prudential regulation** focuses on safeguarding the financial strength of the regulated entities. This has been the focal area of the FSB for much of its existence.
- **Regulation of advice** looks to ensure that the information given by providers and intermediaries to product purchasers meets appropriate standards of quality and independence. This has recently been introduced through the promulgation of the Financial Advisory and Intermediary Services (FAIS) Act, 2002.
- **Product regulation** takes these further, putting constraints on the design and possibly pricing of the products in the market.

Comments by South Africa's National Treasury signal concern that the emphasis on prudential regulation has contributed to a sequence of undesirable outcomes, notably providing poor value for money to customers exiting long-term saving products prematurely, without adequately alerting them to the consequences of early termination.

> … these [generally poor] early termination values are to some extent the outcome of the regulatory environment in which retirement annuity funds operate. A Financial Services Board (FSB) study has shown that the values provided on early termination, both in terms of policy surrenders and

> conversion to paid-up, are in line with the prudential requirements of governing statutes. (National Treasury, 2006:13)

While the existence of prudential regulation is not in itself a problem, greater balance across other areas of regulation is required for the accredited environment contemplated in this paper. Poor disclosure, for example, has significantly contributed to the insensitivity of consumers to existing business practice that is not always in their interest.

A summary of what follows

This part of the paper starts with a discussion of the available regulatory models, setting out what the author believes should be regarded as best practice requirements for a regulator. From there, the paper moves into some of the more detailed aspects of the proposed regulatory framework, covering:

- the principles of governance,
- the scope of supervisory responsibilities,
- the process of registering providers and advisory channels,
- the question of premium collection,
- prudential management of providers,
- whether there might be an optimal number of providers, and
- how providers ought to be sanctioned for non-compliance.

The paper distinguishes between regulation and supervision. The former is about setting the rules and the latter about enforcing them.[5] Of course there are overlaps between the two concepts – these are unavoidable – but the section that follows is restricted to principles while later sections consider the framework for their enforcement.

2.1 Regulatory models

> The design and operation of the private pension systems are as varied as the settings and motivations behind them. All share extensive regulatory and supervisory systems that seek to establish and enforce a framework that enables them to function fairly and efficiently, and to provide a high level of security. (Hinz & Mataoanu, 2005:4)

This section starts by proposing a framework for considering issues around the regulatory structure. It discusses some of the thinking on the issue from around the world and itemises a set of standards that could be regarded as forming the minimum requirements of a sound regulatory structure for a mandatory DC saving system.

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[5] Richard Hinz & Anca Mataoatu express this distinction more precisely: "Regulation is defined as the establishment of specific rules and standards, and supervision as the process of implementing the system and enforcing compliance with the rules." (2005:4)

An introduction: three types of regulation

Roberto Rocha and his colleagues (Rocha *et al*, 1999) draw parallels between the regulatory principles of the banking industry and the corresponding measures appropriate to pension saving. The Basle Committee has proposed structuring the supervisory function of the banking industry into three main areas:

- **ex-ante**, covering activities like licensing, approval of corporate activities, and advocating and promoting correct incentives;
- **on-going**, including planning and executing bank examinations, assessing and strengthening audit programs and communicating with bank boards; and
- **problem resolution**, for example, intensive problem bank supervision, formal enforcement orders and removal of directors, managers or auditors.

They suggest that the supervision of pension funds may be categorised as following two basic models, the first of which is associated with systems in which a few providers cover a marketplace, as in most mandatory individual account countries.

> Supervision of these systems emphasizes the first two supervisory "building blocks", by limiting participation in the system to entities that meet strict structural standards, supported by close and direct monitoring of their status and activities through extensive reporting requirements. This approach is closer to the bank supervision model followed in most countries, through its reliance on strict adherence to stringent regulations in order to pre-empt potential problems. These Latin American systems are often characterised as pro-active in regard to their compliance activities… (Rocha *et al*, 1999:24)

The *pro-active* approach, what is referred to in this paper as *prospective*, works in that environment because there are few providers, making it possible for the supervisory agency to exercise stronger control over each of them. Each of the providers has greater scale to respond to supervisory requirements, particularly as these are regular in nature and should form a natural part of the administrative infrastructure of the provider. This is complemented by virtually continuous contact with providers to ensure compliance with strict regulatory and product standards.

The second broad model of pension supervision is referred to by the World Bank as *reactive* and by this paper as *retrospective*. This model…

> … is associated with systems that utilize the Trust/Foundation form of organization. These are systems which are typically voluntary and employment based, with a large number of funds operating as intermediate vehicles for the investment and collection of funds. Investment management is often conducted on a contractual basis through other types of financial service organizations. Supervision and enforcement within this model is labelled as reactive, because the supervisor usually intervenes only when problems are reported, either by trustees, fund members, external auditors, actuaries, or other relevant players (including other supervisors). Pension supervision is more remedial in nature, or more oriented toward the third element of problem resolution. The system essentially relies on other active players monitoring the funds, and also on credible deterrents to violations of the laws. (Rocha *et al*, 1999:25)

A reactive model is currently in place to supervise pension arrangements in South Africa. Perhaps the greatest source of system weakness in this country is indicated by the last sentence in the quotation: *"The system… relies on other active players monitoring the funds and… on credible deterrents to violations of the laws."* South Africa does not appear to have independent monitoring – or if it does, it is not operating effectively – and its deterrents may not have sufficient credibility. Nevertheless, retrospective supervision plays an important part in the regulation of any saving system and it should not be discarded simply on the basis of its weaknesses.

Vittas (1998) uses different terminology to describe the same distinction. He describes the prospective regulatory system in Latin America, in which providers are subject to significant product and investment constraints as *draconian* and the retrospective Anglo-Saxon model, growing rapidly among other OECD countries, as a *prudent person* alternative.[6] His thinking is consistent with that of Rocha and his colleagues.

Hinz & Mataoatu ask *"… whether these represent these represent distinctive modes of supervision or they simply define the ends of a continuum of possible approaches" (2005:4)*. Their analysis appears to support the view of a continuum, in turn allowing countries to modify their approaches as circumstances permit.[7]

A third type of regulation, *the market*, is proposed. Regulatory and competitive structures should be such that market players seek to distinguish themselves from their competitors by virtue of their willingness to go beyond the minimum requirements of the regulation to provide greater protection to their customers.

Disclosure is an example of market-based self-regulation. An industry body may motivate standards of disclosure that are above those required by the regulations themselves. Individual providers may pride themselves in going yet further to set out product details clearly to customers.

Standards of governance provide another example of self-regulation in the market. As discussed further on in this paper, regulation can do no more than provide a framework for governance. The market needs to implement this in practical ways and should seek to do so in a competitive manner. This paper dedicates a separate chapter (section 3) to discussion of the importance of market-based governance.

Gordon Clark's outstanding treatise of governance alternatives (2003) echoes this approach in a three-part methodology of his own, suggesting that fiduciary responsibility must be entrenched by a set of regulations and overlaid further by a market mechanism that encourages efficiency and innovation within appropriate limits.

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[6] If the choice of language appears a little biased, he points out that the Chilean regulations are considerably less restrictive than the corresponding constraints in that country during the 1960s and 1970s, and that they were put into place, in the context of poorly developed capital markets, to protect the interests of system participants. To this we should add the point that these constraints have since been reduced as capital markets have matured and the knowledge of participants improved.

[7] As examples of modification, some Latin American regulators are reducing the intensity of the restrictions placed on pension providers. This is the stated policy of, for example, the Chilean regulatory authority.

> I argue that the golden-rule of fiduciary duty (model 1) and its constituent moral imperatives are insufficient for governing pension fund performance. I show that there is a complementary relationship between fiduciary duty and second-order statutory rules and regulations (model 2). And I show that the apparent limits of both suggest the market (model 3) may have an important role to play in pension fund governance. The asymmetrical distribution of information between pension fund institutions and their beneficiaries and related stakeholders means that no one model of pension fund governance is likely to be successful. (Clark, 2003:1)

All regulatory systems should combine the three types of supervision in a way that best meets the needs of the customers to that market. A concentrated product-regulated individual account system should be supported by a prospective regulatory model and a broad trust-based system may best be supported by a retrospective model, but neither the prospective nor the retrospective approaches should be used in isolation. And in both instances, additional self-regulation must be encouraged through establishing appropriate competitive forces and encouraging consumers to select their provider based on the care taken to safeguard their financial interests.

Scope of regulation

The intention of this paper is not to describe in detail the regulations that ought to apply to providers of service to participants in the compulsory savings environment, but to set out the principles under which these providers might be supervised. It is nevertheless helpful, by reference to World Bank discussion (2005), to set out the likely scope of the regulation covering these entities, with motivations for each recommendation.

It is important to learn from the lessons of other countries but not necessarily to swallow their prescriptions without question, and the author does not agree completely with the sentiment expressed by the World Bank in its recent summary of reform dynamics:

> For a country following the open-end fund concept (as in Chile), the Bank strongly suggests initially applying strict regulations and relaxing them gradually as sound financial markets develop. The strict initial rules include a limited choice for participants, the licensing of specialized providers under the rule of one fund–one account, uniform pricing and limited forms of fees, detailed investment limits, extensive disclosure, minimum return rules and state guarantees, and proactive supervision. The reason for the initial "Draconian rule" is essentially twofold. On the one hand, the new compulsory system starts with a weak capital market, limited traditions, and a lack of familiarity. On the other hand, strict regulations offer safeguards, control moral hazard, overcome opposition to the funded scheme, and are better able to prevent early failures. It is imperative to relax the rules as the market develops and the system matures. (World Bank, 2005:171)

Strict regulations provide safeguards and control moral hazard, and are better able to prevent market failures, but it is not true that South Africa has weak capital markets, limited traditions and a lack of familiarity with this type of arrangement. While strong regulation is a very important part of the recommendations set out in this note, this is aimed primarily at establishing a safe and reliable environment for savers, more so than at present. Many of the elements of the so-called "Draconian rule" are included in the recommendations of this note, but their inclusion is motivated by a desire to improve on existing structures rather than constrain providers so much that innovative offerings in the best interests of customers are no longer possible.

The World Bank (2005) goes on to list two sets of regulations, those which it regards as not controversial and those that it suggests are subject to ongoing controversy. The first group of regulations is listed below. These suggestions are all fully supported and are discussed further in this document:

- appropriate licensing and capital requirements (section 2.4);
- full segregation of assets, sponsors, management firm, and custodian, and the use of external custodian banks (5.1);
- asset diversification and the rules of asset management, including the qualifications and licensing of internal or external investment managers (5.2 and 5.4);
- asset valuation rules (5.1);
- actuarial reviews and financial audits (2.6 and 3.1);
- transparency and information disclosure (4.7 and 4.8); and
- effective supervision (2.3) and consistent application of sanctions (2.8).

The more controversial regulations, on which more discussion is required in this document (again, section references are indicated) are as follows:

- **Controls on market structure and choice**. It is recommended that separately licensed institutions, only, be permitted to provide services to this market (section 2.1), that they must meet stricter capital and licensing conditions than in other parts of the retirement saving market (2.4), that they must report more frequently to the regulator and all other affected parties than is currently the case (3.2). It is recommended also that these institutions would be required to meet a range of product, investment and servicing requirements (sections 4 and 5).
- **Funding, investment and portability rules**. Consistent with the direction currently being taken by National Treasury's pension reform task team (National Treasury, 2007), it is proposed that these vehicles are fully funded and fully portable, at all times, though acceptable charges may be deducted in a fully transparent manner. Investment limitations are a contentious issue and are discussed in more detail in section 5.
- **Legal investment limits versus the prudent person principle**. This bridges both investment issues (section 5) and governance requirements (section 2.2 and 3.1). A combination is envisaged.
- **Limits on commission and switching**. This is part of a much wider discussion of the advantages and disadvantages of explicit limitations to fees, covered in section 4.4. Considerable improvement to disclosure models, together with product standardisation, should improve the level of consumer understanding and hence the effectiveness of price competition mechanisms, but a set of price ceilings is contemplated as well. Switching flexibility is considered in section 4.2 and commission models in section 4.5.
- **Profitability rules and guarantees**. In some mandatory individual account systems, providers must meet certain investment return thresholds and must share with their customers profit earned in excess of a stated level. This issue is discussed in section 5. There are considerable risks to such a system, but consideration must also be given to the risks to system participants of not stipulating minimum investment returns.

Authorised entities

A fundamental question in the mandatory individual account system is who may provide such products.

> There are three types of institutions that may be authorized: corporate pension funds; specially authorized independent pension funds; and ordinary financial institutions (such as banks, insurance companies or mutual funds). (Vittas, 1998:15)

Countries that mandate retirement saving by employers, such as Switzerland, Australia and Hong Kong, set up regulatory frameworks that permit corporate pension funds. They often also establish independent pension funds to take care of the needs of the self-employed and those working for small employees, for which a multi-employer arrangement provides the necessary economies of scale. Kazakhstan, Poland and Hungary are among the many countries that provide for co-existing corporate and independent funds.

In Latin America, on the other hand, where the saving mandate falls onto the individual, pension funds may be operated only by specially authorised institutions, though there is a wide variety in the types of entities that may set up such institutions. This is supported by the existence, in some but not all Latin American countries, of a specialised regulatory entity established to oversee the mandatory saving industry (Queisser, 1998; Srinivas *et al*, 2000):

> In Hungary, Poland and most of the Latin American countries, a new agency was established to supervise the new pension funds. The exceptions are in Colombia and Uruguay, where this responsibility falls on the Central Bank. These agencies ensure compliance with regulations on capital, disclosure and reporting, commissions, transfers between funds, rates of return and investment allocation. In other countries, such as Australia, Switzerland and the United Kingdom, existing financial regulators expanded to cover pension funds. (Srinivas *et al*, 2000:8)

Entities permitted to manage voluntary saving are usually subject to a more limited set of constraints, since the authorities regard the need to protect such saving as lower than for its counterpart in the mandatory environment. This leads to a wider range of entities being permitted to administer and manage this type of saving, banks, insurers and mutual funds not being required to meet the standards of the mandatory saving environment, such as maintaining segregated assets for these accounts.

Demarco *et al* (1998) ask whether separately supervised entities are needed, citing analyst suggestions that they reduce the overall efficiency of the system. The authors defend their position that a separate supervisory agency is required, setting out four reasons for this position.

- Since the system is mandatory, the policymaker has a special obligation to ensure that basic rules are met and supervisory standards adhered to.
- Pension systems lie at the nexus of capital markets, insurance and social security, which means that they have a unique combination of characteristics that require specific supervisory attention.
- Some products in newly-created mandatory pension systems are new, such as life or retirement insurance, because the public pension systems preceding these systems were often unsupervised.

- Citizens may be suspicious of the publicly run systems preceding the individual account system.[8]

What of South Africa? The last three of these reasons, it could be argued, do not apply to this country. South African providers have excellent experience running complex product combinations and citizens should have reasonable confidence in a system that extends the existing voluntary system.

On the other hand, the system does not appear to be working particularly well. The skills of fiduciaries do not appear to be universally high enough, leading to a dependence on professional advisors. The motivations and conflicts of interest of these advisors and the practice of product providers have come under tremendous scrutiny recently with serious and wide-ranging questions being asked of the system as a whole.

This does not appear to be an appropriate environment into which to channel compulsory saving. Costs must come down and governance structures considerably improved, both of which call for considerable simplification of the system. Products would need to come under a separate set of regulations, driving this simplification through a system of standardisation. Regulatory practice would need to be much more proactive, supported by the likelihood of a relatively low number of providers.

Considerable skills vest within existing regulatory structures. However, it would seem clear that, for a mandatory saving system, those entities providing administration and investment services to citizens forced to save for their retirement will have to be regulated under a different system, either inside or outside of the FSB, with a distinct focus.

Public-sector default fund

Readers are reminded of the proposed mechanism by which mandatory contributions are allocated to managers. The default manager is the public sector entity, the Government Sponsored Retirement Fund (GSRF). Private sector administrators are selected by those participants who would prefer to opt out of the default and invest contributions into products provided by accredited private sector managers.[9]

The system of regulation and supervision described in this paper would be ineffective if it failed to cover those individuals who elect not to invest in the private sector. The terms and conditions proposed for managers, and as far as possible the sanctions for non-compliance, apply as much to the GSRF as to the accredited private sector entities. Failure to apply these principles with consistency creates unfair competitive advantage for the public sector entity.[10]

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[8] In the large majority of countries introducing mandatory individual accounts, the system was introduced in response to bankruptcy or mismanagement of its predecessor, an unfunded social security arrangement.

[9] This model is not unprecedented. Sweden, Latvia and Kazakhstan provide examples of countries in which defined contributions default to the public sector provider, with the right for savers to opt out to a private sector alternative. Kazakhstan provides an interesting model of such a system because members initially opted mostly for the state fund but have gradually exercised their right to select from among the 15 private sector alternatives as their confidence in the system has improved (Hinz et al, 2005).

[10] Special consideration may need to be given to an order to close and administrator where the order is directed at the GSRF, quite possible under the regulatory environment contemplated in this document. To avoid this complexity, sanctions are more likely to be implemented against managers of the respective providers rather than the providers themselves. This is much easier to carry out in a manner that is consistent across public and private sector providers.

But special terms may need to be added to those that apply to private sector entities, mainly to safeguard against the possibility of unfair business practices on the part of the state-owned entity, for example, insufficient attention being given to the management of risk. If regulations include the possibility of closing and administering a provider in circumstances of dire need, how might these apply equally to the public-sector entity? Further thought should be given to these issues.

Establishing the regulator

It is important that the authority responsible for regulating this industry has sufficient power and independence to carry out its responsibilities effectively. The author does not have particularly strong views, at this stage, on whether the regulator should fall within or outside of the FSB, but recommends that, if it cannot meet the following requirements within the FSB, serious consideration be given to establishing a separate unit:

- **Reporting**. Since the regulator needs to be accountable to government, it should fall under the responsibility of a government Minister, but the Minister in question should have no power over the regulator, as discussed below.
- **Hiring and firing**. While reporting functions can fall under a government department, a Minister should not have the power to either hire or dismiss members of the executive. It is recommended that the Minister to which the regulator reports can nominate new members of the executive, or recommend the dismissal of existing members, but that this must be approved by another Cabinet Minister and ratified by the Cabinet. This is discussed further in section 2.3, where it is recommended that the regulatory and supervisory authority[11] is headed by an executive and guided by an advisory board, whose members are nominated by the relevant Minister, approved by a specified second Minister and ratified by the Cabinet.
- **Funding**. It is important that the source of funding does not introduce the potential to influence the regulatory process or undermine the independent authority of the regulator. The FSB is currently funded by levies on its regulated entities. This is not a perfect system but it removes some of the potential for gaming that alternative systems might introduce. It is recommended that a similar system be introduced in this case. While a levy system is supported, ultimately, by the members, a mandatory defined contribution system would result in a very large number of members sharing the financial burden of the regulator.
- **Compensation of staff**. Some countries write parameters that establish the remuneration of office bearers and professionals in the regulatory authority to ensure that they remain competitive.[12]
- **Complaint authorities**. It is not clear whether the Pension Funds Adjudicator (PFA) should have authority to rule on complaints in this system. Whether the PFA is appointed the complaint authority or another entity is established, such an authority must have administrative and financial

[11] For the avoidance of doubt, this is expected to be the same entity. Though a number of government departments may have input to policy and thus be said to be participating in regulation, the intention is that regulation and supervision vests in a single authority.

[12] The law in Argentina states that the average wage in the supervisory agency must exceed the average wage paid by the top 50% of providers (Demarco et al, 1998), presumably with some allowance for adjustment for differences in job types.

independence from the minister to which it reports and the regulatory authority that it works alongside.

At the same time, it is important to avoid establishing a separate regulator unnecessarily. All regulatory modifications must be subject to proper appraisal of the costs and benefits, as referred to by the State President in his State of the Nation Address, 9 February 2007.[13]

Policyholder protection

> Life is not fair. But there can be few crueller fates than that suffered by those who spend their entire career contributing to a company pension scheme only to find their retirement plans ruined by the business's financial difficulties. (Financial Times, October 2005)[14]

The risk of failure in the current regulatory system falls on households. There is no underwriting mechanism to provide protection against or financial compensation for provider failure. An argument exists that, no matter how strong the regulatory environment, reliance cannot be placed exclusively on preventing failures because of the financial impact on individuals of the possibility of such failures.

Consideration should thus be given to the possibility of some overarching financial protection for participating individuals, an insurance safety net, but it needs to be structured in such a way that it avoids creating perverse incentives or distortions of the market mechanisms. Some lessons from abroad may be helpful.

The **United Kingdom** has established a fund, called the Pension Protection Fund to compensate members of defined benefit retirement plans that are under funded and whose employers are insolvent (Dasgupta, 2006). The objectives of the fund are to compensate those who, by virtue of circumstances beyond their control, face potential poverty, and to increase public confidence in defined benefit schemes. The arrangement is funded through levies on all defined benefit funds. One of the main objections of the system is that soundly managed funds subsidise those with weaker management and those taking undue financial risk. This concern has been addressed through the introduction of a risk-based levy, creating incentives to reduce risk. The fund has not been in existence for sufficiently long to judge its effectiveness or financial stability.

The **United States** also has a fund designed to provide protection to the members of defined benefit to cover the risk of the loss of benefits in the event of employer insolvency. This fund, which has been in existence for longer than its UK counterpart, is called the Pension Benefit Guaranty Corporation. Levies to the fund are also based on the financial position of participating funds, but more directly on the current position rather than a composite of a variety of risk factors.[15]

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[13] Few would argue that the United Kingdom has a poor regulatory system of pension funds and financial services providers, but it has recently announced a process of reviewing the need for the full range of regulatory, mediation and compensation organisations currently in place (Thornton, 2007).

[14] Quoted in Dasgupta (2006)

[15] "Pension plans insured by the PBGC pay both a flat-rate, per-participant premium and a variable rate premium equal to 0.9 percent of unfunded vested benefits." (Deloitte, 2006:19) The transparent approach may be clearer to retirement plans, but leaves open the possibility of some form of gaming, based on distortions in the regulated assessment of funding levels.

A key problem with funds like these is the enormous accumulation of risk that it may bear as a provider of last resort and the need for it to push this risk back to the retirement plans that it covers (Schieber, 2003). In the United States, the flat-rate contributions per member increased, in 2006, from $19 per participant annually, to $30 (Deloitte, 2006:35). The PPF in the United Kingdom recently announced that it plans to raise approximately £675 million in levies in financial year 2007/08, more than double the previous levy, to the unsurprising dismay of commentators.[16]

Protection of participants does not have to take the form of an insurance arrangement. Protection in **Chile** is provided in two forms: investment returns from pension funds that, relative to their peers, meet certain standards, and a government safety net. The safety net applies to members that, subject to having contributed for 20 years, fail to accumulate sufficient to support a pension above a stipulated level, and to members who, drawing down their retirement capital on the stipulated basis, reduce the pension that may be funded by the capital to below this stipulated level. But it also applies to the members of failed private sector providers. Under these conditions the State guarantees a specified set of benefits. Since government itself provides this protection, as part of a larger commitment to minimum levels of social security benefits, the system does not introduce the potential for distortions or perverse incentives to the same extent as its counterparts in the UK and US, but it certainly is not free of risks.

Protecting the participants of a system takes a variety of forms. It is urged that last-resort insurance be considered as a possibility, but note the potential for distortions that such an arrangement might introduce. A number of system models exist around the world and should be considered in detail to determine their potential for South Africa.

Concluding comments

> Whilst regulation has traditionally focused on the prudential soundness of insurers, there is an increasing need for regulation that focuses more directly on issues of consumer protection, including the conduct of providers and intermediaries as well as the features of the products they sell. (National Treasury, 2006:7)

We are quite clearly in an environment of change. The policymaker and regulator have recognised the need for change and are implementing modifications to existing structures that serve to strengthen the extent to which they lead to increased levels of consumer protection.

It is argued in this paper that such changes do not go far enough to providing this protection in an environment underpinned by mandatory contributions. The conduct of providers and intermediaries and the features of the products that they sell most certainly fall within the scope of the regulatory framework proposed by this document.

[16] *For example, Daniel Brookshank, writing for Investment & Pensions Europe, 21 December 2006, www.ipe.com.*

2.2 Governance principles

Governance is the framework of the retirement system that imposes checks and balances on the roles played by all parties to a retirement arrangement and provides security of the accumulated savings and the benefits in a retirement fund.

Governance should be considered at two levels. The foundation of a good system is the set of principles describing the fundamental characteristics of the system, such as

- who bears responsibility for the security of retirement savings,
- what the obligations of these parties are, and
- how they ought to relate to other parties to the fund such as service providers and the regulator and, most importantly, the current members and the beneficiaries.

But the principles can only go so far. A governance system that complies with these principles can be implemented in practice in a variety of ways. The principles are set out here, but some of these practical implications are considered in more detail in section 3.

International precedent & discussion of options

Two primary sources are used as input information to the task of drafting a set of governance principles. The private pensions unit of the Organisation for Economic Co-operation and Development (OECD) pays significant attention to the issue of governance. It carries out research into the practices of the 30 member countries of the Organisation and a number of others, and translates this work into a set of principles that apply to occupational arrangements and those covered by the type of personal pension systems contemplated in this paper.

The Canadian Association of Pension Supervisory Authorities has also put significant attention into defining the code of practice that should determine how parties responsible to a pension arrangement should carry out their duties. A draft for comment (CAPSA, 2001) was followed by a set of guidelines (2004).

These documents have been summarised in Appendix 1 for information and they are used in the section that follows to put forward a proposed set of principles governing the accredited arrangements.

Recommendations

The following principles are proposed as crucial to the effective operation of the system of accredited providers. The legal entities into which member contributions are deposited are *mutual pension funds* (MPFs), owned by their members, and managed by *accredited retirement institutions* (ARIs), to distinguish them from existing pension, provident and preservation funds. As in today's collective investments environment, the ARI is a management company mandated by the owners of the fund to manage its assets on a contracted set of terms and fees.

The recommendations set out below apply to the ARIs, which are themselves legally separated from any shareholding corporate entities like today's life insurers or asset manager.

1. **Trustees.** Every ARI is subject to the oversight of a Board of Trustees, subject to the provisions of South Africa's trust law. The members of the Board must exercise due care in carrying out their duties to members, beneficiaries and the regulator.
2. **Written objectives and identification of responsibilities.** The Board must identify and document the governance objectives of the ARI and it must identify and assign operational and oversight responsibility to each of its members and all of its service providers. Both of these – and any changes to these – should be communicated to members, beneficiaries, employers, the regulator and to any bargaining agents that have an interest in the fund. The governance framework must be reviewed from time to time, no less frequently than once every three years. The governance objectives must be supported by a code of minimum suitability standards and a proposal covering succession planning and the selection and appointment of new members.
3. **Reporting.** Reporting channels between all parties involved in the administration of the ARI must be established and documented to ensure effective transmission of information and smooth administration of the ARI.
4. **Skills, auditing and actuarial services.** The Board must, collectively, have the skills required to carry out its responsibilities with confidence. It must identify and obtain the services of suitable external advisors to provide advice in those areas in which the Board does not have sufficient skill. External auditors, with whistle blowing responsibilities, must be appointed to provide an assessment of the finances of the fund. An actuary, also with whistle blowing responsibility, should be appointed if regarded by the Board as appropriate to the needs of the fund and mitigation of its risks.
5. **Code of conduct and conflict of interest.** The Board must establish a code of conduct and an approach to the identification and management of conflicts of interest. This must be written and be made available to the parties in item 2, on request. Active monitoring of adherence to the code and monitoring of potential conflicts must be demonstrated by the Board.
6. **Transparency and accountability.** The Board must establish and document a plan for communication of all relevant aspects of the ARI to its members, beneficiaries and the regulator and other relevant parties. This must comply with the set of disclosure requirements set out in regulation and should exceed this where the Board has any doubt concerning whether these requirements are sufficient to meet its fiduciary responsibility to any party with an interest in the success of the ARI. The Board should be legally liable for its actions, as should each of its members.
7. **Performance measures.** The Board must establish a code of performance standards for themselves and all service providers and advisors to the ARI and carry out a formal assessment of the extent to which these performance standards are achieved at least once a year. The code must include provision for redress in the event of failure to meet the required standards.
8. **Risk management.** The Board must assess and document the risks to which the ARI and its members and beneficiaries are exposed and establish a set of actions to provide appropriate levels of protection against these risks. The risk management plan and the extent to which mitigation is in place must be reassessed every year.
9. **Access to information.** The Board must ensure that it has, at all times, clear and timely access to any information required in the execution of its duties and that its advisors have similar standards of access, according to their needs. All information should be provided directly from the originating source.

10. **Oversight and compliance.** Appropriate mechanisms to oversee and ensure compliance with the legislative requirements governing ARIs must be established and documented.
11. **Custodian.** Custody of ARI assets must be carried out by an independent custodian, who must keep separate the ARI assets from its own, may not entrust the assets to a third party and is required to take on whistle blowing responsibilities.[17]
12. **Redress.** Pension plan members and beneficiaries must be granted appropriate levels of access to statutory redress mechanisms. The existence and operation of these mechanisms must be included in communication to members at least once a year.

Governance is receiving considerable attention around the world and global absolutes are difficult to pin down, as demonstrated by a confidential OECD paper (2005b) that surveys the changes introduced by a number of countries.

For example, governance rules should not restrict the corporate form of the administrator, unless such a restriction is appropriate. The Australian Superannuation environment, while not perfect from the perspective of managing conflict of interests, has the flexibility to allow both non-profit and shareholder-owned pension fund administrators. Refer to the case study in appendix 6.

Establishing a market that competes on the basis of the security offered to members is also important. At a regulatory level, a number of principles are sufficient to put in place minimum standards but not to protect members to the greatest extent possible. The position taken here is that protection is difficult to enforce through a set of rules and that the market needs to embrace good governance and give it the standing of a competitive differentiator. The ways in which this might be done are the subject of section 3 of this paper.

Finally, separate attention needs to be given to the form of governance of the MPF itself. A variety of working models are in successful use around the world. In all Latin American countries except Mexico, pension funds are owned by their members, legally separate from the fund administrators. The authorities in Mexico have taken this one step further: funds in that country are independent legal entities with their own boards of directors. The model of legal separation and mutual ownership by fund members is supported at this stage, as suggested by the term Mutual Pension Fund, but consideration should be given to the additional support of a separate board of directors for the MPF.

2.3 Supervisory responsibilities

The earlier discussion makes clear the view that the regulatory system envisaged for members' opt out savings needs to be substantively different from the existing system. The number of providers would be significantly lower, the scale in each higher and the consequences of failure much higher. A more proactive approach is called for, founded on the regulator provision of the type of information to the supervisor that would allow early signals of non-compliance or financial difficulties to be identified.

[17] *The assets of the fund are, in the first place, legally separated from those of its administrator and all sponsoring employers. The model of ownership most strong supported is that of mutual ownership by the members, as in South Africa's collective investments environment (see discussion in section 5.1).*

> Private pension funds have now successfully been implemented in a wide range of settings and circumstances. The extent of variation observed in the structure and operation of supervisory programs throughout the world inevitably raises questions about optimal design and best practices. Commonality of objectives suggests greater similarity in approaches than is evident in experience. Despite this variation in organization and practice there is, at present, no compelling evidence of the inherent superiority of any one type or style of pension supervision. This suggests that differences in the organization and operation of pension supervision programs are substantially a function of the extent to which they are aligned with the environment in which they operate. (Hinz & Mataoanu, 2005:4)

The supervision of financial services markets is a complex yet under-researched subject. As these World Bank researchers suggest, there is no single perfect model. The discussion below is not intended to be prescriptive, but to open the debate with a proposed set of characteristics of the supervisory infrastructure by referring insights gained from around the world.

Guidelines on form

The World Bank (2005, headings below quoted from page 172) allocates possible supervisory responsibilities into two sets. The less controversial rules and tasks for the supervisory body, with comments on their application to South Africa, include the following:

- **The need for a politically independent, proactive, well-financed and professional staff.** This almost goes without saying but is frequently not implemented with the diligence that it deserves. It is discussed in more detail in section 2.1.
- **The vetting of the application for licensing.** A key responsibility of the supervisory authority is to determine whether applications to provide service to the industry are approved or not. This is discussed in section 2.4.
- **The undertaking of off-site surveillance and on-site inspection.** The supervisor must be established with sufficient power to satisfy itself that the operations of the provider are compliant with legislated requirements and provide sufficient protection of the financial interests of participants.
- **The elaboration and issuance of regulations.** The system is to be launched with a set of empowering regulations, but these cannot be regarded as static. The supervisor is in the best position to motivate modifications to these regulations and should be given sufficient authority to do so effectively.
- **The consistent and timely application of sanctions to rectify problems and establish a credible deterrent to abusive practices.** Sanctions must be enforceable in order for them to be effective. The supervisor must have the power to impose these sanctions. Refer to the discussion in section 2.8.
- **The publication of reports and statistics.** This is an increasingly important responsibility of the supervisor, particularly in an environment in which consumer education and knowledge of the salient product facts is so important. The supervisor should play a strong and active role in the provision of both industry statistics and product information, including comparative charging and performance statistics. This requires it to invest in taking a strong public role in the system.

- **Collaboration with other regulators.** Whether the supervisor of this industry falls within or outside of the FSB, it must establish strong co-operation agreements with all other members of South Africa's regulatory framework.

Some of the more controversial rules and tasks that some supervisory bodies might consider are not directly relevant to South Africa. The list of possibilities set out by the World Bank (2005, with headings below quoted from page 172):

- **Establishment of effective collaboration with other regulators and supervisors for the many institutions offering retirement-income products.** This need not be a controversial issue. Whether or not the supervisor of accredited providers falls within the Financial Services Board, it must make sure that it co-operates effectively with all other supervisors of retirement products, despite the fact that the approach to supervising these providers is likely to be far more proactive in nature. Among the many reasons for this, two stand out. Firstly, the more stringent standards applied in this environment may provide useful information to supervisors of other pension vehicles. Second, there is likely to be considerable overlap of providers, with most or all accredited entities offering voluntary pension savings products as well.
- **The best way to guarantee the independence of the supervisory body in a weak political environment.** We do not have a weak political environment, but this must still be given proper attention, as discussed in section 2.1, not least to provide ongoing protection to system participants into an uncertain future.
- **Oversight and accountability of the supervisor.** Independence of the supervisor is not negotiable, but accountability is still required, most logically to the Minister leading the government department under which the supervisor falls. One option is to mandate independence of a specified proportion of the members of the governing council of the supervisor. Another is to hold the supervisor accountable to a board of advisors, itself required to report to the Minister. These are both supported. Yet another possibility is to have the supervisor answerable to a group of departments, for example, the Social Cluster, the National Treasury and the Presidency. This could become rather complex. All things considered, it is recommended that the supervisor is run by an executive and guided by an advisory committee. The members of both of these teams must be nominated by the responsible Minister, approved by another specified Minister and approved by Cabinet. The same process applies to appointment and dismissal.[18]
- **Creation of a single-purpose or dedicated supervisory agency.** This paper makes the case for a supervisory entity with a particular focus on accredited pension providers. It neither suggests that this entity should fall under the FSB nor recommends against it, but it strongly supports the view that this environment is sufficiently distinct from others already in existence to warrant a dedicated supervisory team.

Some of the advantages and disadvantages of a separate regulatory entity are best set out by the World Bank. The discussion is closed with a quotation from this institution.

[18] *This does not rule out the possibility that the authority responsible for supervising the accredited provider environment falls under the existing FSB infrastructure, but it is strongly urged that the framework for ensuring the independence of the supervisory authority is clearly safeguarded.*

> Often the threshold decision related to the supervision of funded pensions is whether to establish this as an independent authority (as in Chile and most Latin American countries) or to integrate these functions with the supervision of similar financial entities, such as banks and insurance companies (as in Australia, Hungary, and the United Kingdom, among others). Both models have proven to be effective in achieving the objective of sound and reliable supervision, so there is no simple answer to the organizational question.
>
> The appropriate approach is likely to be a function of the design of the system and effectiveness of existing supervisory bodies. Pension funds that operate in a highly specialized manner as very distinctive financial institutions can be effectively supervised by independent authorities, while those that function as adjuncts to existing financial institutions are best addressed by an agency with integrated authority.
>
> ***The form of the institution is secondary to the independence, adequacy of resources, quality of staff, and clarity of mandate.*** The most compelling impetus for an integrated supervisor is the need for consistency and coordination of oversight across similar financial institutions, which are much better facilitated in a single authority. A central counterargument is that an integrated supervisor with a weak governance structure will face conflicts of interest in controlling the activities of institutions within its authority that compete or play multiple roles in a pension system (for example, asset managers, banks, and insurance companies) or be weakened in its ability to protect the system in the face of competing priorities. (World Bank, 2005:172-173, emphasis added, paragraph breaks introduced in the interest of clarity)

What the supervisor does and how well it is skilled is more important than how it is structured.

Guidelines on structure

Much of the experience of individual account regulators from around the world is relevant to our purposes. Some of the lessons from these countries are discussed here.

Hinz & Mataoatu (2005) list the primary elements of supervision as:

- licensing,
- monitoring,
- communication,
- analysis,
- intervention, and
- correction.

More detailed recommendations on these elements form the bulk of sections 2.4 to 2.8 of this document.

Demarco *et al* (1998) provide a detailed set of guidelines on the principles of good supervision. These are based largely on the strict Latin American model, so they illustrate perhaps the most detailed set of activities available.

The authors suggest that the supervisory authority should be headed by a director, with full powers to apply regulations and issue new ones, with an advisory board that does not limit the decision-making ability of the director. They go on to recommend three operational divisions and a supporting infrastructure, responsible for information technology, administration and human resources. The three operational divisions should be responsible for:

- the **control of provider activities**, with departments covering
    - institutional issues, such as licensing and bookkeeping,
    - financial issues, like investment limits, returns and guarantees,
    - membership issues, for example, joining funds, transfers and claims, and,
    - benefit payments, that is the calculation of annuities and both disability and survivor benefits;
- **statistics and research**, with publication facilities;[19]
- **legal affairs**, with departments responsible for
    - sanctions, and
    - legal advice, including complaints

The authors also provide detailed information on the key areas of supervisory responsibility under the headings institutional control, financial control, membership & benefits, information and legal issues.[20]

SFPA (2003) provides analogous details on the main functions and the divisional structure of the Chilean Superintendency.[21]

Evidence on the cost of supervision

Almost invariably providers argue that the supervisory structure is expensive, increasing the cost to members. Demarco and his colleagues (1998) show that costs can be relatively high in the early years of a system but are likely to be much lower as the system reaches maturity. Table 1 shows the cost, in the late 1990s, of running a number of supervisory authorities.

Some would argue that these figures do not represent the full cost of supervision, suggesting that compliance activities carried out by providers and intermediaries add to the cost borne, ultimately, by the member. The counter to this position is that the large majority of these activities would be carried out by a diligent provider in any case.

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[19] *A publication facility must include the capability to provide consumer-friendly information, on paper and electronically, that educates customers on the environment and informs them about the available products. Refer to the discussion on this subject at the end of this section.*

[20] *Interested readers are referred to pages 17 to 47 of that paper. The detail is useful. Provider inspections, for example, can be broken down into a activities covering the control of individual accounts, information to members and beneficiaries, accounting practices, the registration of participants, documentation on investments and reserves, the operations at providers' branches, the complaints and claim procedures, and verification of payments to third parties like providers of survivor benefits.*

[21] *Chapter 4, section 3, pages 55 to 59.*

Table 1. Performance indicators for selected Latin American supervisors

	Launch year	Employees	Budget	Employees per million participants	Employees per provider	Budget / assets	Budget / contributions
Argentina	1994	183	$ 12.5m	30.5	10.2	0.14%	0.36%
Chile	1981	134	$ 7.0m	23.2	10.1	0.02%	0.28%
Colombia	1994	30	-	11.9	3.3	-	-
Mexico	1997	214	$ 26.3m	19.1	12.6	0.42%	0.95%
Peru	1993	85	$ 5.1m	73.9	14.2	0.34%	1.23%
Uruguay	1996	21	-	45.7	4.2	-	-

The authors do not indicate the year to which these figures apply, but it is most likely, based on their publication date, to be 1997. Sources: FIAP (2007) for launch dates and Demarco et al (1998) for all other information.

These figures support the view that regulation along the lines put forward in this paper can be carried out at reasonable cost to participants.

Communication by the supervisor

A clear commitment of supervisory resources to communication to participants has a number of benefits, among them:

- improving product comparability,
- increasing the understanding of participants,
- aligning the interests of providers to their customers, since these providers must compete on the basis of issues that really matter to participants.

A growing number of supervisors, both in mandatory national individual account systems and outside of these countries, take communication seriously. This should take a number of forms, for example:

- public profile on policy and monitoring issues,
- regular overviews on the industry, its supervisory challenges and the manner in which these challenges are being met, not only in formal annual reporting, but also in much more regular communication at the level of the participant,[22]
- industry statistics and comparisons that enable participants to exercise choices with the benefit of independently produced and verified information.

The Chilean regulator produces numerical information which is requires providers to send to their participants three times a year (see section 4.8 for a description of this information). Argentina, along with other Latin American authorities, provides comparative statistics to participants via the internet. The

[22] The FSB currently produces a number of formal and informal reports. A special focus on savings in accredited providers is definitely required on the formal side, but informal communication channels for this market are worth serious consideration as well.

United Kingdom does the same, despite the greater inherent complexity of its financial services environment.[23]

Clear communication of industry information is an important element of the proactive ethos recommended for the supervisor of the accredited provider market.

Variations within the fundamentals

The paper sets out what is believed to be the best framework for a proactive system of regulation appropriate to a relatively low number of providers each with substantial scale. Before moving on to a discussion of some of the details of the proposed supervisory activities, it is noted that:

- the real world is more complex than can be managed with an "either-or" approach, and
- an inflexible, extreme position often produces undesirable outcomes.

Hinz and Mataoatu (2005) list the following characteristics of, on the left, an intensely constrained system and, on the right, a considerably less conservative approach:

- restrictive - open
- proactive - reactive
- comprehensive - exception based
- directive - negotiated
- corrective - deterrent

While an ethos learning towards the left hand side is recommended in this paper, further thought should be given to the detail of the supervision along the lines of each of characteristics.

2.4 Registration

All regulators, in all parts of the financial services spectrum, specify requirements of product providers on registration. They do so in two main areas. The first is a set of capital requirements, to ensure that customers are protected by a capital buffer in case of financial difficulty. The second is a set of criteria for authorisation, most commonly including a business plan providing specified details.[24] A number of other requirements often supplement these two primary thrusts.

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[23] *The Argentine and UK information are available at www.safjp.gov.ar/SISAFJP/Informes+Periódicos/Comisiones/ and at www.fsa.gov.uk/tables.*

[24] *In some instances a lighter approach to licensing may be more limited, most often to facilitate the establishment of pension schemes in the country concerned. But in such instances "… it is critical that a well-developed and effective ongoing legal regime be in place in order to promote a similar level of protection of pension entities as the one that can be achieved through the implementation of these guidelines." (OECD draft discussion document, 2006:4)*

OECD recommendations

A draft discussion document by the pension policy unit of the OECD (2006a) suggests the following elements for the registration of private sector providers of pension products:

- **Legal provisions** must be in place for licensing pension entities with the relevant authorities, for the licence to be withdrawn under certain circumstances and for the right of entities to appeal withdrawal decisions.
- **Governing documents** describing the pension plan's objective, governance structure and outsourcing provisions must be drafted and submitted.
- A **risk control** mechanism must be in place, together with **internal reporting and auditing** plans.
- Defined benefit arrangements must have a **funding policy** and entities responsible for managing multiple arrangements must have **separate policies** for each of these.[25]
- The pension entity must have a **governance** policy and must keep separate those staff responsible for investments and those responsible for settlement and bookkeeping.
- The **business plan** should include a description of the funds that the entity is to manage, the types of obligations that the entity is expected to incur, the setting up costs and means to raise finance and the projected development of the business.
- Where a pension entity is incorporated[26] it must have access to adequate resources. This is most often enforced by requiring the entity to hold at least a specified amount of unencumbered capital, which should not be used to cover start-up costs and often must be separately housed as a deposit. **Capital requirements** are particularly relevant for entities taking on insurance risk, but are standard procedure in many countries also for product providers not taking on such risk.

The discussion document goes on to recommend steps for establishing the role of the licensing and supervisory authorities, suggesting that:

- the legal provisions should set out with clarity the procedure for applying for a licence,
- the licensing authority should have the power to undertake all of the steps necessary to assess the application thoroughly, together with some flexibility to take case-specific peculiarities into account, and that it should provide guidelines to prospective applicants helping them to understand how they can best meet their obligations, and that
- the licensing authority should have properly established power to reject an application, modify the terms of a license or withdraw a licence, and that it should have a mechanism in place to review the modification or withdrawal of a licence on application by the pension entity.

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[25] This paper does not envisage defined benefit arrangements falling under the opt out arrangements, but similar principles could be extended to the provision of insurance cover, which may also fall under the responsibility of accredited providers.

[26] That is, the pension entity has shareholders, which is the case for pension management companies and most likely for the ARIs envisaged in this paper.

These recommendations, and any modifications that follow from them, should form the minimum standard for the licensing framework under the accreditation arrangements for the South African mandatory defined contribution system.

Mexico provides practical illustration of these principles. Quoted below is correspondence received from David Madero, General Co-ordinator of Economic Studies at CONSAR, regulator of the Mexican mandatory individual account system, describing the licensing requirements (AFORE is the term given to a provider under the system):

> The AFOREs must present a request to CONSAR in order to obtain the license. The request must be submitted along with the general data of the company (including the background of the applicants); it is also required to present a governance plan and several operations programs including the dissemination of information, and the program of capitalization and reinvestment of profits. A feasibility study must be submitted as well. The fees the AFORE will charge to its clients has to be approved by the Pensions Board (*Junta de Gobierno*) which is formed by Federal Government, Central Bank, Social Security, and Labour and Employers sectors representatives (CONSAR, 2007).

Capital requirements

Regulators of the mandatory individual account systems of Latin America set minimum capital requirements for providers. The required capital on deposit varies across countries as shown in Table 2.

Table 2. Capital requirements in Latin American mandatory individual account systems

	Reserve	Notes
Argentina	USD 3 000 000	Required stability reserve higher than in other Latin American countries
Chile	20 000 UF [27]	Strongly outweighed by the stabilisation reserve backing the minimum return guarantee
Colombia	USD 4 000 000	Contributions also required to financial sector guarantee fund
El Salvador	USD 570 000	Five firms established by time of Queisser had five times this capital at set up
Mexico	USD 3 000 000	Special stabilisation reserve of approximately the same amount must be held and each investment fund must hold a minimum reserve
Peru	USD 200 000	More may be required if fund investments are risky
Uruguay	60 000 a/c units	Roughly equivalent in mid-1995 to USD1m

Sources: Queisser (1998), CONSAR (2007), Rocha & Thorburn (2007)

Notes: most Latin American providers must hold stabilisation reserves as well, to support the requirement that returns at least as great as the stipulated minimum are granted each year.

[27] *The UF, or unidad de fomento, is the monetary unit for all pension payments and is indexed to the consumer price index. The level of 20 000 UF, around USD 500 000, is a maximum for providers with a high number of members; new entrants are required only to deposit 5 000 UF, approximately USD 130 000.*

Investment managers in Hong Kong must meet stipulated capital requirements of HK$ 10 million,[28] but they are not entities registered solely to provide asset management services to Hong Kong Mandatory Provident Fund system (MPFA, 2007).

The managers of Australian superannuation funds, referred to as trustees, must meet capital requirements where the fund is not employer-sponsored. The stipulated requirement is AUS$ 5 million[29] but the requirement can be met in various ways, through an approved bank guarantee, for example, or through an external custodian meeting the requirement.[30]

Recommending a complete set of capital requirements is beyond the scope of this paper and should be considered in conjunction with similar requirements for existing arrangements. What is clear is that separately registered ARIs would be required to put up sufficient capital to provide reasonable levels of protection to their members.

Regulating the intermediary channel

The regulatory framework for most individual account systems includes rules governing the behaviour of independent advisors and tied sales intermediaries. The Mexican system, for example, includes a set of rules to which all sales agents are subject (regulation 05-7, CONSAR, 2007).

South Africa has recently promulgated legislation, the Financial Advisory and Intermediary Services (FAIS) Act, 2002, designed to regulate the behaviour of intermediaries. Monitoring compliance with the Act is the responsibility of a department of the FSB.

Establishing a market with accredited entities providing regulated products ought to reduce the need for regulation of advice, not least because of the considerable pressure on commission scales. It would be incorrect, however, to believe that the need for advice disappears or that advisors would no longer have incentives to frame consumer decisions in a manner that benefits them rather than their customers. Furthermore, the market for voluntary provision will remain vibrant and customers will continue to need financial advice.

It is recommended, at this early stage in discussions concerning system design, that the framework established by this legislation, and its supporting regulatory and supervisory infrastructure, be regarded as foundational for what might be required under the accredited environment. Modifications to this infrastructure should be considered as part of the process of designing the system of accredited advisors in more detail.

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[28] *This is equivalent to just over USD 1 275 000 at March 2007 exchange rates.*

[29] *This is just over USD 4 000 000 at March 2007 exchange rates.*

[30] *This information was obtained through direct correspondence with the Australian authorities.*

2.5 Premium collection mechanism

Appendix 2 provides a full discussion of the issues around premium collection.

It asks whether contributions should be collected centrally or by the accredited providers. It also asks, assuming that they are collected centrally, whether providers should manage assets on a wholesale "blind account" basis, without any knowledge of who has chosen to divert assets to them, or whether they should manage on the retail "individual account" basis, giving them access to their clients but an explicit responsibility to service them

Recommendation

The discussion in appendix 2 ends with a recommendation that, in the circumstances contemplated for the pay-as-you-go and individual account systems, contributions under the defined contribution portion should be:

- collected centrally through the Government Sponsored Retirement (GSRF), though the collection agency itself could be the South African Revenue Services (SARS),
- in the absence of any instruction from the member to the contrary, transferred to the default fund, and,
- where the member has elected to redirect contributions to an accredited provider, transferred directly to an account in the name of the member, managed by the provider concerned.

Benefits

The proposed approach is intended to combine a number of advantages:

- contributions are collected as effectively as possible, using the same vehicle that collects the corresponding contributions under the mandatory arrangement on behalf of the GSRF, for example SARS,
- the GSRF takes the responsibility of central data manager, a natural role for it to play in combination with its responsibility to manage contributions and benefits under the mandatory system,
- bulk transfers are made to the public sector and all private sector entities, together with the required data records, enabling scale efficiency to be retained, but
- accredited providers are entrusted with the responsibility to manage the assets entrusted to them, together with communication to savers and responsibility for managing payouts.

Spin-offs in the voluntary sector

Accredited providers should not rule out the potential for collecting contributions on an individual basis, as they are likely to be in a good position to seek business from the voluntary sector. The economies of scale developed as providers to the mandatory pillar and the effort required to meet the stringent governance and administrative requirements could be put to good use in the voluntary market, which should increase in efficiency as a result of the standards established for the accredited provider environment.

Consideration should be given to establishing the accreditation criteria for both wholesale and retail contribution collection in an effort to provide best practice guidelines to third pillar providers seeking to establish benchmark standards for their customers.

Third party collection points

The Indian proposal envisages a separate layer of customer servicing outlets, what it refers to as POPs (Points of Presence) which would operate purely as contact points with customers to carry out a range of activities. Customers could open accounts, obtain information on their existing accounts and take receipt of benefit payments.

The motivation for this network is that it is much wider than can be established by pension providers themselves, because it includes banks, post offices and all types of deposit-taking institutions registered with the Indian pension authority as service providers to the system. The POPs would have direct access to the central database of all member details and act effectively as sub-contractors to the private sector entity, the Central Recordkeeping Agency, or CRA, responsible for setting up and running this data management system.

Such a system may be regarded as unnecessary at this stage, because of the premium collection mechanism that could piggy-back the corresponding collection of contributions to the PAYG system, but the policymaking authorities would welcome proposals motivating the wider network of contacts that this would provide. It merits careful consideration if the PAYG system is not included as part of the reform package and it has the potential also to stimulate further saving in the voluntary, third pillar environment.

2.6 Prudential management

The FSB is currently responsible for the prudential oversight of all non-banking financial service providers in South Africa. This form of oversight has been the chief responsibility of the FSB since its establishment. Though regulatory intervention under an opt-out system needs to extend to other areas like products and disclosure, prudential oversight remains a crucial responsibility of the supervisory authority.

Licensing

The registration and monitoring process set out in section 2.4 is one part of prudential regulation. The legal framework needs to establish the responsibility of the licensing authority (which may form part of the supervisor, but may also be separately established) and the obligations and power of this authority to make and review decisions and it should also make clear the framework for financing the licensing authority.

An important part of the licensing process is the capital deposit that helps to protect the fund participants against the adverse impacts of financial failure. The level of the deposit should be established from the outset but the supervisor may retain the right to vary the level of this deposit in the case of applicants with unusual characteristics. The establishing legislation should also provide flexibility for overall changes to the level of this deposit.

Prudential monitoring

The extent to which ongoing monitoring of the finances of the ARI is required depends significantly on the nature of the risks that it takes on. It is recommended that the supervisory entity consider the types of actions required to safeguard the finances of the pension provider, bearing in mind the imperative that the financial interests of participating members are very carefully guarded. It is submitted that the conditions that ARIs should be required to meet to demonstrate this attention to financial security should be much stricter than the corresponding conditions currently applying to insurers and pension providers.

Reporting requirements

Reporting is covered in many parts of this document. In section 4.7 the models for product disclosure to members and the general public are considered and section 4.8 asks what types of reporting information should be provided to investing members. Here the general point is made that the standards of report to the supervisory authority should be designed to support the objectives of the prudential regulation determined by the supervisor.

ARIs are also required to provide standardised information to the GSRF as part of their obligation to maintain the integrity of the database that consolidates the financial interests of all members in both the PAYG and DC elements of the mandatory system. The GSRF should specify these data obligations with precision at the outset of the system.

Actuarial reviews and external audits

ARIs are also expected to meet standards of due diligence. This certainly mandates an external audit by an accredited auditor. It may also imply review by a suitably qualified actuary, but in pure DC arrangements, it is not clear how much value an actuary adds to the process.

> The increasing importance of consulting actuaries is a key feature of pension fund governance in recent years. These can play an important role of pension fund management. However, recent accounting scandals in the United States have served as reminder that incentives matter in getting auditing done effectively — it is not merely an issue of mechanical checks. (Besley & Prat, 2003:6)

Any service provider needs to demonstrate independence from the recommendations that it makes. Incentives matter in all professional services, not just auditing. Actuaries, for example, must be very careful concerning the potential for conflicts of interest. The Myners review of Institutional Investment in the United Kingdom noted a highly concentrated investment consulting industry and a high frequency of instances under which actuarial advice and investment consulting were bundled together (Myners, 2001).

The Morris review of the actuarial profession notes that re-tendering for actuarial service occurs infrequently and that the bundling of multiple services is widespread, even in the absence of any provisions by providers to formalise such bundling. It also raises concerns with the high potential for conflicts of interest to affect the integrity of actuarial advice.

> Effective oversight of actuarial advice has been constrained by the limited degree of market testing, lack of widespread scrutiny, the extent of expertise amongst users and, in some cases, insufficiently transparent advice. This is further complicated by the extent of joint provision of related but distinct services, and by the increased scope for conflicts of interest to impinge on the work of scheme actuaries. (Morris, 2004:37)

Entrenching statutory responsibility to any professional grouping may increase the potential for undesirable market practice. It establishes a captive market, entrenching the strength of the profession concerned and it increases the potential for bundled services and conflicts of interest.

With this in mind, it is difficult to defend the position that regular actuarial review of defined contribution arrangements should be entrenched and it is considered inappropriate to require such review of accredited providers, particularly as they are likely to employ appropriate risk management resources in fulfilment of prudential regulatory requirements.

It is recommended that the governing body that bears fiduciary responsibility for the integrity of the ARI takes responsibility for determining the necessity of actuarial review, subject to the regulator retaining the right to mandate such actuarial review should this be deemed necessary.

Independent auditing if the accounts of ARIs is considered essential.

2.7 Number of players

What is the ideal number of market participants in the accredited opt out environment?

> Concentration in the pension fund management industry is found to be higher in the new pension systems of Latin America and Eastern Europe than in most OECD countries. Concentration might be because the new pension markets are smaller than in countries with more established funded pension systems, but it could also be because of restrictions on industry structure. (Srinivas *et al*, 2000:6)

An environment with a low number of providers gives each one of them economies of scale, assisting efficiency, but also creates the potential for collusion and other oligopolistic practices. This is worsened if barriers to entry are high, reducing the potential for new entrants to take advantage of unfair business or pricing practices. On the positive side, an industry with few providers presents a lower regulatory burden, all else being equal, and it is easier for customers to select from the available providers.

A higher number promotes better competition on price and product design, within the range of options permitted by regulation, but reduces the potential for economies of scale. Customers have a wider range of products to choose from but might find it more difficult to select the product that best meets their objectives. Regulation could be more complex or expensive, or the compliance resources available for each regulated entity could be lower.

The discussion in this section is linked to the thoughts expressed in a number of other areas. Section 5 considers the issue of investment choice and the impact of the range of products available. Appendix 3 discusses the potential for an auction process to produce an optimal outcome. In the discussion that follows, some of the sub-themes around the issue of provider numbers are considered.

Minimum number of providers

> The level of concentration of the Pension Funds is related to a considerable extent with the economies of scale existing in the industry. The social security administration industry presents significant economies of scale, and this favours the concentration of the sector. (SPFA, 2003:111)

Since some competition is a necessary requirement for the effective operation of the market, the founding regulation may stipulate that the system may not be established without at least a specified number of providers licensed to operate in the system.

This could be achieved in a number of ways. For example, if the initial conditions for operating in the market are such that very few firms deem the opportunity sufficiently profitable to enter, another round of applications could be opened with slightly weaker conditions for entry, for example, higher maximum charges. This type of action should not be entered into lightly because it changes the environment for those firms that have already indicated their determination to enter, reducing the potential market size for each of them. It may also undermine consumer confidence in the saving environment.

An auction system could be used to set the number of providers exactly, as is contemplated in India (see Appendix 3), or an initial round of market-testing could be used to establish the type of price at which providers would seriously consider entering the market. Each approach is prone to disadvantages. One of the generic difficulties with any strategy to establish a minimum number of providers is that it begs the question, assuming that the market is running at the stipulated minimum, of how the regulator should respond to the failure of one of the providers.

Setting and committing to a minimum number of providers appears to introduce the potential for significant difficulty. An alternative approach is to encourage the entry of new providers, even after the launch of the new system. The Mexican individual account system had, at February 2007, 21 providers, of which five had entered during the course of 2006. The regulatory authority does not compromise its standards or rules – all applicants are required to have their proposed prices approved by the regulator, for example – but it does encourage and assist the entry of new providers.

It does so in three principle ways:[31]

- **Cost level**: the operator of the central database, called *Procesar*, introduced corporate governance and technological improvements that reduced costs across the industry. Adding to this cost reduction was the decision to centralize in *Procesar* some of the processes until then carried out by the managers. The regulatory authorities stress that, together with the contribution collection service provided by the Mexican Social Security Institute, these initiatives are fundamental to efforts to improve the contestability of the market.

[31] *This information has been obtained in direct correspondence between the author and the Mexican authorities.*

- **Default fund**: workers that do not chose a retirement fund manager within a stipulated time period are assigned every two months, by the regulator, to the managers that best meet certain conditions. The criterion used until recently is the fee, so the cheapest managers gain the new members.[32]
- **Cost mix**: primarily through the formula used to determine supervisory fees, the authorities are switching the emphasis from fixed costs to variable, making it easier for small companies and encouraging new entrants. The logic behind this initiative is that small firms should not pay a disproportionate part of the fees charged for using common infrastructure.

The proposal for India does not envisage any difficulty meeting minimum numbers of providers. The plan is to license six providers at launch and allow new entrants, one by one, as assets under management reach certain pre-specified levels. This suggests that any minimum number should be considered variable to allow for changes in market dynamics as the industry grows.

Minimum share of the market

Should the regulator intervene if providers lose customers and become too small to be viable? The proposal for India is that they should be closed if market share falls below 5% and their members transferred to the default manager.

This runs the risk of significant market distortion. Providers then have a strong interest in "picking off" the customers of their weaker competitors, particularly those approaching the limit, with the potential to achieve significant gains in customer numbers when they are closed.

All else being equal, providers with fewer clients would be operating at lower profit margins because they must cover similar fixed costs. This dynamic is likely to drive consolidation of providers in any case, making a mandated minimum market share unnecessary and unhelpful.

Competitive forces

The experience in Latin America is that the number of providers reaches a peak at or soon after the launch of the mandatory system, declining quite rapidly thereafter as firms without the required economies of scale are absorbed by their competitors and then settling to a natural floor (OECD Social Policy Division, 2006a).

Of course this trend can be interrupted by changes to the environment, as may be seen by the example of Chile (SPFA, 2003). In 1981, the Chilean individual account system opened with twelve providers. This remained constant until 1985 when the merger of two of these entities brought the number of providers down to eleven.

In 1983 and 1987, the reserve requirements and minimum net worth requirement of providers were reduced. This had a significant stimulatory impact on the market. Three new providers opened their

[32] *This has recently been changed, to the benefit of members. The criterion used in the new regulation is the net return over the preceding 36 months. This should encourage providers (1) to focus on the costs that they incur in the pursuit of investment return, but not exclusively on this measure, and (2) to avoid taking too short-term a view on investment returns, a strategy often detrimental to customers in the long run. The approach is heartily endorsed.*

doors in 1986, 1988 and 1990 respectively, six more in 1992 and a further three in 1993. One more firm entered the market in 1994.

But by then the consolidation had started. One merger took place in 1993, three in 1995, three more in 1996 and four in 1998, followed by two more in 1999 and 2001 respectively. Together with the liquidations of firms that became bankrupt or were not in compliance with the minimum net worth requirements, this represented a period of significant increases to industry concentration.

By the time of writing SPFA (2003), there are only seven entities looking after 3.5 million contributors and nearly USD37 billion in assets. Two of these seven providers each manage less than 3% of the assets or members. Now there are six.

Analysis of the operating costs of providers shows clear evidence of economies of scale, but the benefits of these economies are now unevenly distributed. The success of the regulators in stemming the expensive switching of participants from one provider to another may have succeeded in entrenching the competitive advantages of the dominant players, the largest of which now has 42.4% of all contributors on books.

Similar experiences characterize other systems. The Czech Republic is unusual among its piers in not having established mandatory saving. It depends on a reasonably strong voluntary saving industry, which half of the workforce was saving into by the end of 2000 (Lasagabaster *et al*, 2002). Starting out with 44 providers more than ten years ago, a recent merger announcement is set to reduce this to nine.[33]

What is clear from this description is that the accredited industry can be expected to be characterised by oligopolistic characteristics, making it very important that regulation caters for the difficulties to which this gives rise. The Competition Commission should also be involved in establishing the regulation that governs this industry and in working with the regulator to assess applications for mergers.

Concluding comments

The World Bank suggests[34] that, across its experience of many countries, the number of providers has proved to be less significant a driver of system performance as the way that these providers are structured to enhance competition in the legal and supervisory framework. Giving excessive attention to a target number would therefore be inappropriate if it resulted in insufficient focus being given to the other issues discussed in this paper.

Regulating minimum market share or member levels appears to be unnecessary and counterproductive. It is recommended that the controls should be implemented primarily through the application of a strict set of standards, including possible charge ceilings, which would force financial sector firms to think very carefully before applying for a license for accreditation. Apart from the requirements of accreditation, there would then be no limitations on providers.

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[33] *Article by Barbara Ottawa, writing for Investment and Pensions Europe, 27 April 2007, www.ipe.com.*

[34] *Author correspondence with Richard Hinz*

If there were systematic flaws in the system, consideration could be given at a later stage to implementing more significant interventions in an effort to stem the in- or outflow of provider numbers, with the corresponding consequences of each for market efficiency.

2.8 Sanctions

Regulation is ineffective without appropriate sanctions for non-compliance and an effective customer complaint infrastructure.

Provider sanctions

It is submitted that the regulator should be granted the power to consider a range of possible sanctions, among them

- fines,
- public censure,
- removal of office bearers, and
- closure of the organisation with an order to transfer members as stipulated by the regulator.

A framework for sanctions should be established, but the regulator should retain a degree of freedom to exercise its discretion from case to case. An appropriate system of appeals must be put into place to protect providers and ensure that the legal framework is consistent with other parts of South Africa's law. Providers themselves need to be given sufficient confidence in the legal integrity of the system to consider participating in the first place.

It is also submitted that sanctions on the individuals running accredited providers are an important means to ensuring consistency of approach across all providers, particularly between the private sector providers and their public sector counterparts.

Closure of a provider is a last-resort action that should not be a common event because

- it reduces the number of providers participating in a market that risks becoming characterised by oligopolistic practices, and
- it is an impractical sanction against the public sector provider, rending it ineffective in that case and providing an undesirable competitive advantage to the default fund.

Customer complaints

Attention also needs to be given to establishing an effective channel for participants to have their grievances heard and attended to. The office of the Pension Funds Adjudicator (PFA) would probably be the best institution to handle these complaints. The accredited entities are not the same as retirement funds – hence the proposed difference to the regulatory framework – but that office has a strong skill set and would appear to be a good place to start.

It is suggested that the authority responsible for handling customer complaints is given power, separately from the regulator, to raise finance through levies, to ensure the independence of this entity.

3 GOVERNANCE AS A MARKET MECHANISM

> Effective regulation of the governance structure of pension funds includes the establishment of a transparent framework for the division of responsibilities in the operation and oversight of the pension fund, and the accountability and suitability of all parties involved in the pension fund process. Governance regulations must also define the mechanisms for internal control, communication, and redress for pension plan members and beneficiaries. (OECD, 2003: 13)

Governance is an elusive concept with many facets. It is fundamentally about how the rights and interests of members and beneficiaries are protected and balanced. Many think of governance as being established by a set of rules. In reality, the letter and the spirit of governance can be described as consisting of a number of components, for example

- a set of laws providing an overarching legal framework,[35]
- regulations specific to the industry, for example, the market for pension saving,
- a national or industry infrastructure,
- the organisation-specific means for complying with the requirements of the law, and even,
- the extent to which organisations are seen to be complying with requirements and making an effort to stretch themselves beyond these standards.

This section of the report focuses on the final two points. Legal systems and regulations, it is argued, can only take an industry so far in implementing governance requirements, particularly those aspects of governance that are more difficult to define in law.[36]

> From an economic point of view, pension funds are a network of overlapping contractual arrangements that specify obligations on the part of all of these key players. If all behavior were the subject of verifiable contractual arrangements and there were no information problems, the governance structure would be largely a veil – any incentives available under one governance structure could be replicated by another by appropriate choice of contracts. We argue that incompleteness of contracts is a key feature of pension fund governance and will imply the need to match the governance structure to the incentives of the various parties and the nature of the pension contract being used. (Besley & Prat, 2003:6)

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[35] Besley & Prat (2003) refer briefly to the variety of legal frameworks in place to safeguard the system known in common law countries as the trust system. They point out (page 6) that the pension fund "... can be a foundation with a foundation board (NL, CH), a mutual association with a board of directors (Germany), or a pension fund management company supervised by a control commission (Portugal and Spain)."

[36] A conflict of interest is a concept that can be difficult to define in practice. Organisations routinely disagree on whether a relationship might constitute a conflict, not least because the conflict itself has the potential to blind a player to the possibility that such a conflict could exist.

Since contracts are incomplete, governance effectiveness cannot rest solely on a set of rules. This section argues that the quality of governance must be a competitive differentiator for it to develop into an effective form of member protection. It considers how such an environment might be encouraged by designers of the system.

3.1 Governance in practice

> Pension funds should have appropriate control, communication, and incentive mechanisms that encourage good decision making, proper and timely execution, transparency, and regular review and assessment. (OECD 2005:16)

The OECD principles of good governance from which this quotation is drawn (see appendix 1) are set out in two broad sections called *Governance Structure* and *Governance Mechanisms.* The mechanisms suggest ways in which organisations should be looking to improve the implementation of governance principles. It follows that providers could seek to differentiate themselves from their competitors by demonstrating the extent to which they implement and build on these guidelines.

The OECD recommendations are set out in four sections:

- **internal controls** are concerned with the mechanisms in place to improve the operation of the organisation and the attention given to the security of member interests,
- **reporting** is concerned with the flow of information between the parties involved in the administration of the retirement arrangement,
- **disclosure** covers the information that needs to be provided to stakeholders to the plan, in particular members and the supervisory authorities, and
- **redress** addresses the requirement that members of retirement arrangements with grievances have access to reliable and reputable channels for assessing these grievances and ordering compensation where appropriate.

The supporting guidelines to the OECD principles of good governance provide excellent examples of methods for implementing the recommendations that should be considered in detail both by those responsible for regulating this environment and for firms considering application for the right to provide services to this industry. They provide practical advice on how the principles might be put into practice and have been reproduced in appendix 1.

Their recommendations include:

- regular assessment of the performance of all parties involved in the operation and oversight of the pension fund,
- regular review of the compensation mechanisms of all parties involved in operation and oversight, with an assessment of the extent to which the incentives that they provide are correct, in addition to separate identification, monitoring and correction of conflicts of interest,
- regular review of operational infrastructure like software, accounting and reporting systems, and all information processes,
- the establishment of mechanisms to sanction the improper use of privileged information,

- the implementation of adequate risk measurement and risk management systems, with external audits,
- regular assessment of the system that supports regulatory compliance,

At the heart of many of these recommendations is a culture of self-scrutiny, an untiring determination to assess whether the actions of the trustees, administrators and all service providers are taken with the interests of members and beneficiaries at heart, and what changes should be made if they are not:

> Mechanisms are needed to assess regularly the performance of the pension entity's internal staff as well as the external service providers (e.g. those providing consultancy, actuarial analysis, asset management, and other services for the pension entity). It is also good practice for the governing body to undertake self-analysis and for an independent, external person/organisations to undertake a review of the internal controls of the pension entity. Where the governing body consists of an executive and a supervisory board the latter may be assigned with the task of assessing the performance of the executive board. (OECD, 2005:13)

The OECD recommendations provide merely a starting point. It is recommended that more detailed consideration of the regulatory framework for accredited providers should include a careful assessment of the impacts of the choices made by regulators around the world. Furthermore, we must learn from the regulatory experience of our counterparts in other financial services industries in South Africa, banking, collective investments and medical schemes, to name but a few.

Customer complaint channels

The regulatory framework must provide for a credible, independent, well-funded organisation established to hear the complaints of participants and able to rule on these complaints in a binding manner. An Ombudsman covering the customers of accredited providers must be established and co-ordinated with similar existing offices.

Questions on whether such a channel should be separate from or integrated with the PFA, the entity responsible for hearing and ruling on the complaints of pension fund members, are dependent on the broad nature of member supervision. Such discussion belongs properly with the corresponding issues around the regulation of accredited providers (see section 2.8).

Complaints can usually only be ruled on by the Ombudsman after the fact; that is, when financial loss has already been incurred. What is important in the context of governance is that providers are encouraged to make every effort to resolve customer grievances before customers take actions that may damage their accumulated savings. Consideration should be given to establishing a framework to encourage competitive behaviour around customer servicing. Thoughts on measurement of customer service are set out in section 4.8.

Professional oversight

The need for professional oversight is noted in section 2.6 as an important element of the monitoring of prudential management standards by the regulator. The existence of professional oversight standards and rules requiring mandatory sign-off by professionals with the necessary experience considerably enhances the effectiveness with which the regulator can meet its responsibility to ensure that providers are meeting prudential standards.

The existence of professional standards also assists providers to demonstrate to the saving public that they are making every effort to ensure that their operation is safe and properly run, and the use of such professionals, where appropriate, is endorsed. This does not do away with the need for due care in the process of selecting and remunerating these professionals.

3.2 Reporting principles

As the OECD points out, reporting to a number of external entities is an important part of the responsibilities of all providers.

Reporting to members

Standards of reporting to members must be established at outset to ensure that consumers overall have confidence in the system and in the accredited providers that they select to manage their accumulated saving. This is the rules-based part of governance. To this should be added encouragement or explicit incentives to providers to go much further than this.

Disclosure is one of those subjects that feels as if it should be easier to implement. Obtaining the agreement of all parties that it should be done is a start, but designing and putting into place a code that adequately meets the needs of a very wide variety of consumers can be extremely difficult in practice.

The purpose of this section is to highlight disclosure as an important element of the governance framework. Details of the approaches that might be taken to developing appropriate minimum disclosure standards are set out in section 4.7 and principles of minimum standards of customer service in section 4.8.

Reporting to the central collection agency

Providers play a crucial part in maintaining the integrity of the complex web of data that forms the old age savings system. Since contributions are collected by a central agency and, based on the elections of participants, passed on to providers, the providers themselves have a responsibility to demonstrate to the collection agency that they are managing the assets of the individuals whose contributions have been directed to them. Information sharing and reconciliation will form an important part of the relationship between provider and collection agency. Minimum standards of the frequency and quality of information sent by providers must be established as part of the overall system architecture.

This is of particular importance should the decision be taken that the responsibility for benefit payment is to be centralised, because data and assets must be transferred from the providers back to the payment agency.

Disclosure to the wider public

The marketing efforts of providers should include at least some element of education that is in the public interest, rather than being geared primarily to making their products the most attractive to the detriment of competitors.[37] As such educational efforts may take place only to a limited extent, it may be necessary for the regulator to impose standards on general provider disclosure, perhaps requiring providers to contribute to the costs of maintaining a central information repository to display industry and product information like comparative charges and investment performance.

Setting standards and policing compliance

Who should be responsible for setting disclosure standards? In Australia, the pension industry supervisor, the Australian Prudential Regulation Authority, does not take on the role of for setting disclosure standards. This is the responsibility of the Australian Securities and Investments Commission, which sets standards for all forms of company disclosure.[38]

This approach would seem to be the exception rather than the rule. In most countries the entity responsible for pension regulation also takes on the task of establishing disclosure rules and policing the compliance of providers to these rules. It is recommended that a similar approach be taken in the South African accreditation environment.

[37] *Refer to the discussion in section 4.4, administrative charges, and appendix 2, contribution collection, for more on the issue, covered particularly well by James et al (2001).*

[38] *Refer, for example, to discussion and information documents written by the Australian Securities and Investments Commission (ASIC, 2004a & 2004b), available through the ASIC web site.*

4 PRODUCT REQUIREMENTS

In an environment as important as this one, to the providers of products and to all citizens of the country, controls form a crucial part of system design. This section of the paper starts by justifying the need for minimum products standards and then covers the subject under a number of headings:

- contribution and switching flexibility,
- form of benefit,
- administrative charges,
- commission models,
- group arrangements,
- disclosure principles, and
- standards of service to participants.

A number of these issues overlap with one another and with the discussion in other parts of this document and cross-references are noted wherever relevant. Each of them is addressed as concisely as possible, but supported by the additional information set out in the appendices:

- contribution collection (appendix 2)
- survivor benefits (appendix 4), and
- annuities (appendix 5)

4.1 Minimum product standards

Product standards for financial services offerings are rare in South Africa, and non-existent in pension arrangements. The FSB does not enforce product standards and has no regulatory power to do so. Emphasis on financial soundness has led insurers to err in favour of shareholder rather than customer, one of the strong underlying causes of difficulty in the market for individual retirement products:

> Underwriters of retirement annuity funds appear in the main to be complying with the Long-term Insurance Act in calculating early termination values, but are exercising such discretion as they have in favour of the shareholder. The legislative framework governing insurers has historically focussed on financial soundness concerns, rather than provision for more explicit consumer protection measures in the form of market conduct or product regulation. (National Treasury, 2006:13)

This is one of the strongest motivations for the introduction of minimum product standards in the opt out environment, but other reasons for introducing such standards can be added:

- In a mandatory environment, **customer protection** is of paramount importance because these participants do not have the option of diverting their savings to providers outside of the industry.

- Providers that survive the first few years of the system are likely to become **enormously powerful**, with high concentration of assets in the hands of a few. Though free market dynamics may go some way to ensuring that they act in the interests of their customers – and it is the operation of these dynamics that forms a significant part of this paper – they may alone not be sufficient to give participants the confidence that they are paying their contributions into a safe industry.
- **Cost efficiency** is a very important objective of the system. A set of product standards should help to keep down the cost of product provision and the cost of supervising these products.
- **Consumer comprehension**, and hence confidence, would be enhanced by a set of rules that makes products reasonably easy to understand and to compare with alternatives. Complexity discourages participation and reduces the satisfaction of participants[39] while simplicity enhances the willingness to participate.[40]
- **Portability of products**, an important aspect of an industry that should be as competitive as possible, is enhanced by similarity of design and ease of comparison.

The main difficulties with a product-constrained regulatory structure are:

- the limitations that this approach places on innovation of product design, and
- the potential for higher regulatory and compliance costs.

On the claim of innovation limitation, there is substantial evidence that product innovation in this country has not been driven primarily by customer need but by the objectives of providers to:

- differentiate offerings from the corresponding products of competitors, and
- maintain or enhance, perhaps only implicitly, the information inequity between themselves and their customers that tends to support their position as product provider.[41]

The respective papers of work of Iyengar *et al* (2003) and Beshears *et al* (2006) respectively demonstrate the damaging impacts of complexity and the benefits of simplicity.

The financial services industry frequently cites the issue of regulatory cost as damaging the overall value for money provided to customers, but evidence either way is thin. Just as it is difficult for the regulator to demonstrate that any new regulation brings with it a benefit of greater value than the additional cost passed on to customers, the financial services industry finds it a challenge to show the opposite. Section 2.3 provides figures showing that the cost of regulating a mature individual account system need not be high.

Product standards provide participant security and facilitate product comparability. They are not just about minimums, like imposing a floor on the frequency and clarity of communication requirements; they are also about maximums, like setting a ceiling on the number of investment funds made available to participants.

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[39] The research of Iyengar et al (2003) confirms this position, a point that Turner acknowledges in his review of the United Kingdom environment.

[40] Beshears et al (2006) demonstrate this empirically.

4.2 Contribution & switching flexibility

The flexibility to allocate contributions across providers and to switch accumulated assets between these providers is, at first glance, a desirable trait of a mandatory defined contribution system, because it entrenches freedom of choice to participants.

Unfortunately, it may also produce unanticipated consequences, increased overall system cost, for example. Policymakers in some Latin American countries have successful reduced system costs by constraining the frequency with which participants may switch between providers. This constraint reduced the emphasis that providers had laid on winning participants at all costs, resulting in cuts to intermediary channels and a significant reduction in overall costs.

This section summarises a set of recommendations on the issue, supported by a longer discussion in Appendix 2. The complex set of considerations may be summarised into four key questions:

- Should the contributions be collected separately by accredited providers or together in a central hub?
- If contributions are to be collected centrally, when transferring the contributions to private sector providers, should the information on the members also be furnished to these providers, the alternative being that the providers merely manage the assets without the possibility of interacting with participants, the so-called 'blind account' approach?
- Should splitting of contributions between providers be permitted or should they always be allocated only to one accredited entity?
- Should participants be free to switch contributions or accumulated assets between providers and, if so, how frequently should such switching be permitted?

Contribution collection

While this discussion is about the degree of centralisation that is appropriate for collecting contributions, the issue is only partly about financial flow. Information also needs to be recorded appropriately. Since contributions to the system – social security or individual account systems – are mandatory, centralisation of information is an essential element of the system, at the very least to monitor compliance. Whether or not finances follow the same route, serious investment in information systems in some public-sector agency is a requirement.[42]

If a contributory social security pillar is implemented, then it is difficult to imagine a situation in which, at least for this part of the old age system, the private sector would be better able to collect contributions than the public.

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[41] *This is often complemented by a corresponding information inequity between the primary distribution channel of the provider – the intermediary network – and the customer.*

[42] *The tax collection agency is a candidate; so is the social security agency; but an independent entity focused purely on information management should not be ruled out either.*

Policymakers assume that similar arguments can be used to justify the centralisation of contributions in an individual account pillar as well. This is not necessarily the case, as many countries have decided. Demarco & Rofman (1999, refer to the more detailed information in appendix 2) suggest that the following factors should form part of the consideration around the locus of contribution collection:

- economies of scale,
- efficiency of existing collection agencies,
- timing and speed of transfers,
- the need for control mechanisms,
- the potential for co-operation across collection entities,
- efficiency incentives,
- enforcement power,
- cost,
- sources of financing the collecting operation, and
- the potential for corruption.

The view of the author at this early stage is that the centralised collection systems recently implemented in a number of countries – Sweden and Latvia are examples – and under serious consideration in others, like India, is the strongest available model:

- to manage system finances cost-effectively,
- to co-ordinate the twin goals of tracking information and finances, and
- to reduce to an acceptable level the costs and market distortions that can arise under the alternative private-sector collection approach.

This is an initial view that must be rigorously tested against the criteria listed above. Both private companies and their public sector counterparts have an important role to play in showing the best way to establish a safe, cost-effective premium collection mechanism.

Private sector involvement: wholesale or retail

On what basis should accredited entities be managing the pension savings of participants? In some countries, contributions are redirected to the providers chosen by the savers, but information on the participants is withheld from the accredited entities, turning them into providers of wholesale asset management only.

This has the advantage of reducing marketing costs, limited under this scenario to broad advertising of investment capabilities and track record, though hopefully also to competitively differentiable approaches to governance. James *et al* (2001) show that the potential saving can be considerable, arguing that marketing efforts are seldom focused on the consumer education aspects that would characterise such activity as a social good.[43]

It is submitted that accredited providers should be held responsible for administering the accounts in entirety, managing the client servicing and the payment of benefits. For this reason, the view is taken that, whether contributions are collected centrally or by the accredited entities, they must be given access to individual information so that they can meet these servicing commitments.

The potential for undesirable consequences must then be managed in other ways, for example, through cost controls, high standards of disclosure and both a rules-based and market-based approach to high standards of governance.

Contribution splitting and switches between providers

Most of the individual account systems established in Latin America over the last two decades laid a strong emphasis on simplicity of administration in order to improve the level of understanding of the system by participants and to keep costs down. In most instances, capital markets were poorly formed and participants were further protected by the requirement on providers that they meet certain investment return guarantees.

With this in mind, the paternalistic and restrictive requirement that participants allocate all of their contributions **and** their accumulated funds to only one provider is not as bad as it may otherwise seem to observers in countries with mature capital markets and sound regulatory systems. There was little practical difference between providers, so the emphasis on this restrictive choice did not subject participant interests to high risk of inappropriate choice of investments or provider. It also constrained costs by preventing the fragmentation of the accumulated savings of participants.

Policymakers, particularly in Chile, have more recently been inclined, with improvements to the depth of capital markets, the understanding of participants, and the experience of providers, to lift some of the investment limitations and the restrictions on member choice that have existed up until now. However, they are also very concerned about the potentially negative consequences for system cost of unfettered switches between providers.[44] The consensus view appears to be that limitations on switching are acceptable[45] and that gradual liberalisation on product and investment restrictions is a sound way to

[43] The Australian Prudential Regulation Authority makes it clear that it expects marketing material to be geared towards education, on the basis that the trustees of a fund should not be spending what amounts to current member money with the primary goal of attracting future members. The following paragraph ends a letter from APRA to all trustees of APRA regulated superannuation funds, 14 March 2005: "In the past, APRA has taken action where advertising or promotional expenditure has not been primarily to inform and educate existing members. Expenditure on marketing and promotional activities will continue to be considered in the normal course of our supervision activities in regard to the superannuation industry."

[44] In an environment of unfettered switching, providers develop an all-or-nothing approach to winning customers from one another and invest heavily in distribution channels, pushing up industry costs in the process. In a mature system, switching is a zero-sum game, but the spending on distribution pushes down net overall benefits to participants.

[45] A discussion document by a consumer watch organisation concerning the Peruvian system suggests that permitting more frequent transfers between providers would encourage them to compete more aggressively on investment performance (Instituto de Defensa de Consumidor, 2002). This view appears to be in the minority.

promote wider choice to participants. The view that participants should be required to commit all of their savings to one provider appears to have prevailed despite the disadvantages of such an approach, notably concentration of risk.

A final question concerns the responsibility for choice of provider. Until recently, the choice of provider was exercised in Australia by the employer. This has recently changed and individuals are now permitted to elect the provider to manage their savings. In an opt out environment, it would seem appropriate for individuals to be given the responsibility and freedom to exercise their right to redirect contributions from the default public-sector provider to an accredited private-sector alternative.

The author is inclined to support the combination of views:

- that individuals must allocate contributions and accumulated assets to a single provider; and
- that they may switch between providers at any time, but a period of at least one year must have elapsed since their most recent switch.[46]

However, it is strongly submitted that some choice of investments should be permitted so that individuals are able to select from a range of providers, safe in the knowledge that each makes available a product with allocation to investment classes suitable to the particular needs of the participant. It is recommended that each provider be required to make available a limited range of investment options, each with specified characteristics and asset allocation limitations. This is motivated in section 5.4.

4.3 Form of benefit

Are accredited providers to be responsible for administering both retirement and survivor benefits? Do they pay out benefits in cash or can they provide annuity products as well? These are just two of the difficult decisions that fall under the heading of form of benefit.

It is not appropriate to attempt, in this broad paper, a detailed discussion of the issues that impact on the range of benefits that may be offered by accredited providers. The issues are fraught with complexity, some of which is set out briefly in appendix 4, which discusses survivor benefits, and appendix 5, covering the subject of annuities. This section provides a brief synopsis of the main issues and some thoughts on the way forward.

Survivor benefits

With a few country exceptions, firms offering mandatory individual accounts are required to provide risk protection as well, most often in the form of both death and disability cover. This is sometimes supported by the existence of further benefits payable from the PAYG first pillar.

The current system in South Africa exhibits considerable variation in the levels and cost of cover enjoyed by citizens and this cover is in any case available only to the formally employed.[47] There exists

[46] *A fixed switching date for all participants is strongly recommended against. The 'mating season' approach may provoke inappropriate marketing and behaviour by providers as they put all of their effort into attracting participants from competitors.*

a strong rationale for some form of minimum risk cover, through one or both of the first and second pillars.

Since the key competency of an insurer is intermediating risk, South African insurers have a strong claim to providing products that cover these types of risk, but this is not the only available channel for the provision of death and disability benefits.

Some of the advantages of such an approach, discussed in more detail in Appendix 4, are

- the experience of the insurers at pricing and risk management,
- the administrative simplicity of permitting the same entity to provide both saving and risk products, and
- the consistency with the recommendation that providers be held accountable for servicing system participants.

There are also a number of disadvantages to this approach. Effort to overcome these would be worthwhile if the benefits of competitive product provision, within certain constraints of standardisation, are to be attained. These disadvantages are

- the potential for conflicts of interest or corrupt relationships, if accredited providers are permitted to outsource their book of risk benefits, bearing in mind the scale of the business opportunities contemplated,
- if providers must offer both saving and risk cover, the systematic disadvantages to firms not currently providing risk benefits, yet possessing outstanding skills in administration and asset management,
- the potential for lower standards of transparency due to the fact that two products are being wrapped into one, and
- the possibility of unfair advantage for the public-sector provider with its very different approach to the quantification of risk and treatment of it in its pricing strategy.[48]

The discussion in appendix 4 motivates for the provision of death and disability benefits from both a PAYG pillar and its individual account counterpart. It suggests that, with sound approaches to mitigating the risks involved, it is feasible to permit the opting out of death and disability benefit to private sector entities, perhaps after a certain minimum level of cover has been provided through centralised approaches to protect the most vulnerable in the system.

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[47] This is supported by a broad-based state system of disability grants and some cause-specific death benefits, for example from the Road Accident Fund and Workmen's Compensation Funds. However, there is currently no coordination of benefits across state agencies and little effort to seek complementation of private sector provision with state benefits.

[48] A not-for-profit entity is likely to take a less conservative approach to the profit margins required to compensate it for taking a risk than would the shareholders of a profit-seeking entity, who, if not rewarded for additional risk, would have a rational preference to invest elsewhere.

Annuities

Providing annuity products is very different to providing the facility to save for retirement. The supplier takes on considerable financial risk over a very long period of time that requires a sophisticated set of skills to measure and manage. Annuity pricing is keen and the possibility of financial loss not insignificant. Appendix 5 provides a full discussion of the issues around form of benefit on retirement.

That discussion puts forward the case

- that firms licensed to provide administration and asset management of mandatory savings should not automatically be permitted or required to sell annuity products,
- that the accreditation of annuity providers should continue to fall under the licensing requirements of the Registrar of Long-term Insurance,
- that those firms accredited to provide administration and asset management services – perhaps also risk benefits – that are also providers of annuity products should not be permitted to obtain a systematic market advantage of their counterparts who do not provide annuity products,
- that retirees should therefore be able to exercise their right to purchase an annuity, on retirement, from any provider, and in fact should be strongly encouraged to exercise this so-called "open market option", perhaps even demonstrating, should they stay with the same provider, that they have applied their minds to the possibility of moving to alternative annuity providers,
- and that some requirements be placed on the range of products that annuity providers must make available in order to ensure that some product standardisation is available and that each standard product is available across a sufficiently broad range of providers to encourage reasonable levels of competition.

It also motivates the possibility of a public-sector provider aimed at low-income annuitants to address the systematic price disadvantage to which market-led practice exposes this group. Clear delineation of customers would address concerns of unfair competition between this entity and its private sector counterparts.

These issues are not straightforward and it is recommended that they be given deeper consideration over time.

4.4 Administrative charges

> In principle, competition among plan administrators should make regulation of fees and commission unnecessary. In practice, agency and information problems can lead to distortions in the structure of fees and commissions. Because mandatory saving schemes are by definition compulsory and economies of scale in the pension industry may result in concentration, investment companies may end up charging more than they would in a purely voluntary competitive system. (World Bank, 1994:223)

This section describes the financial significance of charges to the system participant. It points out that charges are of concern to policymakers around the world, despite being lower in many instances than in South Africa. It discusses the policy options available to keep charges down while managing the risk of market distortion. It asks the key question of whether there should be a cap on charges in the accredited environment and sets out some recommendations.

The term *charges* is used in this section to describe all forms of fees levied against the accumulated fund of the saver. Fees may be charged at the time of the contribution, on a regular basis during the term of the saving (in fixed rand terms or as a percentage of the assets under management) or at the time of withdrawal from the system. [49]

The significance of charges and the complexity of the policy decisions

Charges matter in a defined contribution because:

- they are levied against the individuals saving in the system, and
- they are usually of permanent effect, today's charge directly impacting the accumulated level of saving, hence the prosperity of the saver in retirement.

Charges are significant. Rusconi (2004) shows that, over a life time of saving and on a reasonable set of financial assumptions, an increase to annual asset-based charges of 1% products a decrease in accumulated savings at retirement of 19%.[50] This represents permanent damage to the income of the retiree, reducing it by nearly one rand in five.[51]

Any systemic reduction in the fees paid by system participants makes a difference to their well-being in retirement. This must be an objective of the policymaker, a core principle underlying the design of the system. Scale is one way to reduce charges, but it brings with it a different set of problems, the potential for monopolistic practices that could themselves have the impact of putting upward pressure on prices.

> The presence of economies of scale [in the Chilean pension system] has facilitated saving on costs over time. The increase in the number of people contributing in the Administrators has made it possible to make use of economies of scale, and this came about in two ways: on the one hand by the obligatory incorporation of new contributors entering the System, and on the other by the reduction in the number of Administrators, which has produced greater concentration in the industry. The savings on costs mentioned above have been passed on in part to the members, and in part have gone towards increasing the income of the Administrators so that they have obtained greater capital returns. (SPFA, 2003:211)

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[49] More detailed discussions of the types of fees charged by providers are available from a number of sources. In South Africa, Rusconi (2004) describes the analysis of total charges for a variety of South African retirement savings vehicles and Rusconi (forthcoming) sets out in detail the range of fees levied by providers of endowment savings products. Internationally, Whitehouse (2000) provides an outstanding discussion of the international framework and the Steventon & Sanchez (2007) consider the charging options in the context of the current United Kingdom reform.

[50] Rusconi assumes that contributions increase at a rate of 7% annually, roughly in line with salary growth, and that assets return 10% a year. The result is little impacted by changes to these assumptions.

[51] A variation in charges of 1% a year is not inconceivable. Rusconi shows, for example, that the average difference between investing in an active equity portfolio and its passive equivalent is 0.86% annually (Rusconi, 2004:103), food for thought since there is no evidence that active investment over a lifetime outperforms passive. He points out that the difference between saving in an insurer-provided retirement annuity and a unit trust equivalent is, at the high end of the asset fees, 1.5% (pages 127 & 128). He shows that investing in individual retirement annuities could cost over 3% of assets annually, while those fortunate enough to be a member of a large occupational fund may pay total fees of as little as 0.8% of assets (pages 86 & 127).

The policy trade-offs form the core of the discussion in this section, which draws on material from a number of countries in order to put forward a coherent set of recommendations.

Evidence of high charges in South Africa

Rusconi's analysis raises very serious concerns about the efficiency of the system currently in place in this country, hinting at the possibility of widespread market failure due to the apparent absence of price sensitivity on the part of participants.

Using methodology consistent with that of international counterparts, he shows that some parts of the retirement saving industry appear to be very expensive, both against local alternatives and against international benchmarks. Under the best-case scenario of a disciplined, uninterrupted lifetime of saving, he calculates that insurer-provided retirement annuities consume between 27% and 43% of the before-charges accumulation of savers. He computes similar statistics, which he refers to as charge ratios, of 22% to 33% for unit trust-based retirement annuities and between 17% and 27% for occupational retirement funds, expressing concerns that the experience of smaller funds may exceed these bounds.

These figures are conservatively calculated, assuming an almost unrealistic discipline on the part of the saver to put away a gradually growing contribution over an uninterrupted working span. Any deviation from this would push up the costs, as has been so clearly demonstrated by the controversy around poor early termination values.

By way of comparison, he quotes the personal pension system in the United Kingdom, the equivalent of South Africa's retirement annuity industry, as producing an average charge ratio of between 23% and 25% (Murthi *et al*, 1999; Whitehouse, 2000b; Devesa-Carpio *et al*, 2003). He quotes analysis of the equivalent ratios in the largely immature private sector-managed individual account systems of Latin America that run at charge ratios of between 13% and 26% (Whitehouse, 2000b; Devesa-Carpio *et al*, 2003) except in Bolivia where a structural duopoly runs at lower fees. With one or two exceptions, the Eastern European systems appear to be running at similar levels of efficiency, with Poland at between 17% and 21% (Chlon *et al*, 1999), the Czech Republic at between 14% and 18% (Lasagabaster *et al*, 2002) and the young Hungarian system at between 17% and 28% (Rocha & Vittas, 2001).

What are the causes of high costs in South Africa?

> In general, concerns with respect to excessive costs point to a market in which competition is less effective than it could be. Competition is deemed effective if there is a significant number of product providers or there is a credible threat of new entrants; consumers are empowered to make rational choices and can exercise these choices at low cost. (National Treasury, 2004:13)

National Treasury goes on to suggest that the primary causes of these costs, manifesting in an environment of generally weak competition, may be:

- low levels of competition and transferability between products,
- poor disclosure,
- low levels of consumer understanding,
- highly complex product design, and

- weak governance arrangements combined with significant vertical product integration.

National Treasury adds to this the concern that regulated commission levels become the norm rather than a ceiling below which competition takes place to reduce prices.

Concerns within the life insurance sector are being dealt with through a variety of mechanisms, from reviewing the commission ceilings and setting minimum values for early termination values, to re-writing parts of the pension fund legislation. These are outside of the scope of this paper. The reason for raising the issue of poor competition in the context of a discussion on charges is to emphasise the need for lessons learned to be applied to the design of the system of accredited providers to the mandatory pension saving sector.

The right of the policymaker to intervene

> Competition between the fund management companies [in Latin America] was meant to provide the highest quality of services at the lowest prices for workers. Instead, the mechanism has produced cut-throat competition among companies for the individual accounts and high prices for all workers. The largest component of the operational costs are the expenses for marketing and advertisement. (Queisser, 1998:74)

What is clear from the description in the previous section is that the operation of the free market has been flawed. With the scale available to South African providers – total assets underlying pension savings are now valued at well over R1,000 billion – charges such as those experienced in parts of the retirement saving industry signal a systemic problem. This alone is sufficient reason for the policymaker to intervene and justifies the types of intervention contemplated by South Africa's policymakers and discussed in this paper.

A second and much stronger foundation for intervention exists in the event that retirement saving becomes mandatory. It then becomes essential that the policymaker does everything possible to ensure that the environment into which South Africans are forced to deposit savings is as efficient as possible and operates as a free market should.

This implies, at a minimum, that the framework is sound, as discussed in other parts of the paper, that governance structures are fair and supervision effective. It also implies that participants are assisted as far as possible to make decisions that are in their financial interest, not in those of the providers selling the products or the intermediaries facilitating the transaction. This requires high levels of disclosure and simple, easy-to-compare product structures. Price-increasing market distortions must be addressed so that participants are not paying unnecessarily high charges. And consideration must be given to the need for a price cap as a final level of protection because other protection measures may fail to work to the benefit of consumers. This is a system of accreditation and price needs to form part of such a system.[52]

[52] This view is supported by evidence from Chile that profit margins are unacceptably high, signalling a failure of competitive mechanisms to push price down to appropriate levels (SPFA, 2003; Niemietz, forthcoming; a)

A third reason for intervention is that it can reduce aggregate system costs in a way that the free market alone may not achieve.

> Competition… only precludes excess rents; it does not ensure low costs. Instead, the structure of the accounts determines how high the costs are. Furthermore, centralized approaches – under which choices are constrained and economies of scale are captured – appear to have substantially lower costs than decentralized approaches. Low administrative costs thus may be possible under an idealized set of accounts – one that involves a centralized approach – but not under a decentralized approach. (Orszag & Stiglitz, 1999)

This appears to have been borne out by the experience of a large and supposedly extremely competitive environment in South Africa.

The Turner report (UK Pension Commission, 2005) alludes to this point as well. It acknowledges that, without structural changes, there is a part of the market that it is impossible to service at less than a certain fee, say 1% or 1.5% of assets annually, and that those who find themselves in this part of the market therefore have rational disincentives to save. Only through structural reform of the market is it possible to create the environment for a much larger set of potential customers to participate at a price that is rationally acceptable to them.

International experience

> The amount of fees or charges levied on financial retirement products is an area of considerable debate and research. For critics of a funded pillar, these fees are much too high, in particular compared with the (best) unfunded and public benchmark; they reduce the net rate of return to sometimes unacceptably low levels and thus eliminate the potential return advantage of a funded pillar; and the structure of fees is often nontransparent and antipoor, which prevents a broader pension coverage of lower-income groups. Also, supporters of a funded pillar (including the Bank) recognize the need to bring fee levels down and to rework fee structures. But they see the problem as much more manageable, with fee levels in client countries much more in line with those of popular financial services in developed countries and falling after start-up costs have been covered. (World Bank, 2005:158)

There is no doubt that, around the world, the levels of charges in mandatory individual account systems have been cause for concern. A comprehensive recent study looking back at the successes and failures of all of the new Latin American systems (Gill *et al*, 2003) raises system cost as an area of particular concern. This view was expressed some time earlier by Monika Queisser, writing a summary of the second wave of reforms to the Latin American environment, stating that *"… the individual account management by specialised fund management firms has proven to be very costly…" (Queisser, 1998:15)*.[53]

Countries take different approaches to regulating the fee structure of pension providers. Some countries take the view that there should be **no control** exercised over fees. Australia, Hong Kong, the United

[53] At the risk of repetition, note that these issues have been raised concerning systems that appear, according to Rusconi (2004), to be considerably more efficient than the existing South African alternative.

Kingdom and the United States have very few, if any, explicit limitations on charges, relying mainly on the broader standards of prudence established by the trust-based system (World Bank, 2005:158).

- Parts of the **Australian** system are notable for their unexpectedly high costs. This suggests that disclosure cannot be regarded as a panacea for the problems of high fees. Australia has one of the toughest disclosure regimes in the world. Refer to the case study on the Australian system in appendix 6.
- Researchers in the **United Kingdom** have expressed their concern at the high levels of charges experienced in that country (Murthi *et al*, 1999). The UK policymaker has certainly demonstrated a willingness to implement fee caps where necessary, as demonstrated by the 1% of assets cap on the stakeholder pension system.[54] Included in the recommendations of the recent Turner Commission is a proposal that fees in the mooted auto-enrol system are limited to an annual 0.3% of assets (UK Pension Commission, 2005).
- **Hong Kong** has confirmed that it does not regulate fees, but it is currently carrying out a study of the charges of providers in the industry (direct correspondence with the regulator).
- In the **United States** private pensions are voluntary, reducing the rationale for imposing any limitations on charges.

Many countries **limit the structure** of charges, but **not the level**. Many of the Latin America reformers fall into this category.

- **Argentina** permits flat and variable fees on contributions and a separate entry fee, but no exit or asset management fees.
- In **Peru**, variable fees calculated either as a percentage of collections or as a percentage of assets are permitted, but both fixed and variable fees on benefit payments are allowed. Unusually, exit fees are also permitted in Peru, discouraging excessive transfers between managers.
- **Colombian** providers are not restricted in the fees that they charge, but must limit the total of fees and the contributions for survivor benefits to 3.5% of wages.

There are some exceptions to the broad approach of these reforming countries. **Chile** permits all fee types, but requires that fees are the same for all members of the same type[55] and for all funds offered by a pension fund manager. In practice, only contribution-based fees are utilised (SPFA, 2003). **Mexico** permits fund managers to choose both the type and the level of commission, but all fee proposals must be approved by the regulator (CONSAR, 2007).

The most recent proposal for introducing mandatory individual accounts in **India** (IIEF, 2004) recommends that providers be allowed to charge an asset based fee and that the supervisory authority specify entry and/or exit fees that apply to all providers to cover brokerage fees and custodial charges.

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[54] This was more recently revised to 1.5% of assets in the first 10 years of a policy, which has a very small impact on the overall charge ratios of long-term savings.

[55] The distinction is made between employed members, participating on a mandatory basis, and the self-employed, who participate on a voluntary basis.

Table 3. Summary of international charge management strategies

No restrictions	Australia Hong Kong UK (personal pensions) US (401k)
Cross-subsidies to low-paid workers	Mexico
Limits on charge structure	Argentina Chile Hungary
Partial ceiling on charges	Poland
Variable ceiling on charges	Sweden
Competitive bidding, multiple portfolios	US (thrift savings plan)
Fixed ceiling on charges	El Salvador Kazakhstan UK (stakeholder pensions)
Competitive bidding, single portfolio	Bolivia

Sources: Whitehouse (2000a, 2000b, 2000c & 2001)

A few countries limit a part or all of the charge that providers may levy, but these are in a minority (World Bank, 2005). **Poland** is an example of such a country. It limits asset-based fees to 0.05% monthly and permits pension funds only to levy fees, apart from this, on contributions and on transfers out within two years of joining the fund (Polish SPF, 2000). [56]

Table 3 summarises the approaches used to manage system costs across a number of countries.

Options for intervention

> … experience so far suggests three promising approaches [to enhancing system efficiency]. First, limit costs by saving on the administrative costs of contribution collection, account administration, and so forth (that is, adopt the clearinghouse approach). Second, limit the incentives for marketing expenditures by pension funds through blind accounts or constraints on the ability of individuals to change funds as a result of laws or exit fees. Last, but not least, limit asset management fees by restricting the choice of individuals, including the use of passive investment options, employers' choice of financial provider, or competitive bidding for a restricted number of service suppliers. (World Bank, 2005:162)

A number of writers have considered the options for intervention to reduce costs. Some of these involve direct intervention in the pricing process. Most are actions expected in consequence to produce downward pressure on the charges imposed on participants. All of these are considered as part of the larger set of recommendations covered by this document.

[56] *Costs covered by the fund directly from the assets, for example, on the acquisition or disposal of assets, may also be charged, but these are implicit charges reducing fund performance.*

1. Establish centralised contribution collection

The World Bank (2005) proposes this as a promising way to reduce costs. Sweden and Latvia, among others, have introduced a clearing house system.[57] India has proposals, in advanced stages of development, to do so. Variations are possible, but the central element of a clearing house system is that all contributions are directed through one pay point and that flows are directed to providers in an efficient, aggregated manner.

Cost savings result from the simplification of the payment process for employers, the economies of scale and, in countries that choose to implement this approach, the absence of contact between individuals and pension fund providers, reducing the potential for marketing costs.

2. Limit marketing incentives

One of the advantages of the clearing house is that it can be structured in such a way as to cut the link between the participant and the provider, removing the potential for direct marketing. The so-called 'blind accounts' method, discussed in more detail in appendix 2, is without a doubt an effective way of reducing costs. It could remove the need for accreditation standards completely, since private sector entities would provide asset management only, fees would be negotiated by the clearing house and asset managers already have a system of licensing.

Similar objectives, easier to implement but less effective, can be achieved in the absence of the clearing house, for example, through limiting the freedom of individuals to change funds, either through laws or through exit fees.[58]

Chile reduced the number of fraudulent transfers by tightening the administrative requirements for these transfers, requiring the provision of certain information to providers on application for transfer. This had the effect of dramatically reducing the number of agents in the industry, the proportion of total provider cost attributable to agent salaries and marketing budgets, the number of transfers in the industry and the total marketing cost per participant (Uthoff, 2001; SAFP, 2003).[59]

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[57] Palmer (2000) and Sundén (2004) provide descriptions of the Swedish clearing house system.

[58] This is controversial and is outlawed in a number of countries because it creates a disincentive to switch providers that may not be in the best interests of the participant. An alternative approach is to permit loyalty bonuses that encourage long-term commitment to a provider rather than discouraging exit, but this probably serves to add to the complexity of the decision, making it more difficult for individuals to assess the trade-offs in their decision-making. Peru permits an exit fee, but sets it at a level that is uniform across the industry (Queisser 1998:75), establishing perhaps the best balance of the trade-offs involved: participants should be free to move between providers but excessive movement increases costs, mainly through pushing up marketing activity, and should be discouraged.

[59] Some suggest that more movement between providers should be permitted, not less, to encourage participants to move to providers producing the best returns, for example the Peruvian consumer interest group, Instituto de Defensa de Consumidor (2003). This argument is a little one-sided, emphasising the potential benefits of frequent movement and ignoring the downsides. There is, in any case, little evidence that investment returns are repeatable, potentially rendering frequent movement of little benefit and significant waste.

3. Implicitly limit asset management fees

These charges could be managed in a variety of ways, for example, by requiring that the employer select the provider, or by limiting the range of funds available to individuals, perhaps motivating the use of passively managed funds.[60]

4. Increase disclosure

As market failure is often built upon the information inequity between provider and customer, and the inability or unwillingness of the customer to select product on the basis of appropriate criteria, like price, the policymaker should consider carefully the options for improving disclosure to increase the likelihood of appropriate product selection. In some countries, the regulator takes a strong role in providing disclosure that makes provider comparison easier.[61] Such an approach for the South African market for accredited providers is strongly encouraged.

5. Standardise offerings

Product comparison is easier if the products themselves are straightforward. South Africa's insurance industry appears to be characterised by very high levels of complexity, entrenching the information advantage of providers and perpetuating the dependence of customers on these providers and the intermediaries that facilitate the product sale. Simplified, standardised products would facilitate product comparison and improve the operation of the market.

Limiting fee types is one way of standardising offerings and should receive strong consideration – see the discussion of this option below.

6. Introduce competitive bidding of service suppliers

Auctions have been used in a variety of circumstances to control costs, from the fledgling individual account system in Bolivia (Von Gersdorff, 1997) to the huge saving program for public servants in the United States, the $65 billion Thrift Savings Plan (James *et al*, 2001). Consideration should be given to this approach to reducing costs, noting that suitable controls on all parts of the system are crucial. Further discussion on the subject is provided in appendix 3.

7. Allow more than one account per worker

The intention behind this recommendation is that the units over which providers are competing will become smaller, because workers can spread their savings across a number of providers, reducing the incentives on providers to compete for large accounts. This appears to be a logical approach, addressing systemic provider risk as well as the marketing risk.

However, allowing more than one account will not prevent providers from trying to attract all of the accumulated assets of participants. It would also introduce the possibility that participants will opt out of making any choice, spreading their savings across a large number of providers and

[60] This forms part of the recommendations of the Turner review of the UK system (UK Pension Commission, 2005).

[61] Refer, for examples of regulator-provided information, to the pricing comparison of the FSA in the United Kingdom (www.fsa.gov.uk/tables) and the SAFJP in Argentina (www.safjp.gov.ar/SISAFJP/Informes+Periódicos/Comisiones/).

increasing the unit costs in the process. This issue requires careful consideration of the trade-offs of the alternatives.

8. Allow multiple types of providers of pension fund management services

Insurers have traditionally dominated the South African retirement saving environment, particularly for individuals and small employers. This approach is attractive from a competition point of view, but proliferation of providers potentially increases regulatory costs, reduces the potential for economies of scale, increases the volume or complexity of information faced by participants and reduces the confidence with which participants make their decisions.

System designers should find ways to open the opportunity to as wide variety a set of providers as possible, while set accreditation standards that are sufficiently challenging to reduce to an acceptable level the number of providers with the scale to find this market attractive.[62] The issue is considered in more detail in section 2.7 of this paper.

Similar arguments apply to the suggestion that barriers to entry ought to be lowered.

9. Permit employers or other groups to negotiate discounts

This suggestion also merits serious consideration, bearing in mind the limitation that it may place on the freedom of individual members to move from the existing provider. The potential for group arrangements within the mandatory saving system is considered in more detail in section 4.6.

10. Establish a government co-contribution

Since unregulated fees can be regressive, one way to balance this is for the government to contribute to members accounts at a flat rate. This is done in Mexico, where each worker receives from the government a contribution of 5.5% of the minimum wage, roughly equivalent to 2.2% of the average wage (Grandolini & Cerda, 1998). This has a higher proportional benefit of low-paid workers, who contribute less to the system.

Since redistribution in the proposed South African system is intended to take place through the mechanism of the PAYG system, which includes a flat-benefit social grant, this approach is less likely in this country, but further consideration may be given to the possibility.

11. Negotiate fee levels centrally

As an alternative to setting a fee benchmark through accreditation standards, consideration could be given to the options under which fees could be negotiated centrally. The Turner enquiry appears to have this in mind when it suggests, in its second draft report, that the National Pension Savings Scheme[63] *"… should negotiate fund management mandates covering major asset classes (e.g. 6-*

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[62] Care should be taken not to impose inappropriate constraints on the form of entity able to provide services to the market. A fund owned by its members is a strong model accepted by many, but the possibility that the administering company is also a mutual entity is less frequently regarded as a possibility. Australia's industry funds operate on a not-for-profit basis and offer much better value than their equivalents in the profit-seeking part of the market, the master trusts. Care should be taken not to set out the legal characteristics of accredited entities in such a way that it effectively bars the entry of unanticipated forms of providers.

[63] This is the auto-enrol individual account system proposed by the Turner report.

10 in number) aiming for very low fees in return for the expectation of large fund volumes." (UK Pension Commission, 2005:376). It confirms this view in its third report on the issue, which followed extensive further consultation. The Mexican authorities have put in place a process that amounts to a form of negotiation. Fees that providers propose to charge must be approved by the Pensions Board.[64]

It is recommended, in contrast, that serious consideration be given to the alternative possibility that the accreditation standards themselves include fee limits, which might then be reviewed from time to time.

12. Restrict the types of charge

South African insurer-provided savings products are difficult to compare mainly because they are characterised by a large range of charge types, making it extremely difficult to compare the total impacts of charges for one product with the corresponding impact on another. Permitting only one or two charge types would facilitate clearer comparison of products.[65]

13. Restrict the level of charge

The ultimate regulatory restriction is to impose a limit on charges. Pricing limits can distort the operation of markets and should be imposed with care, but such limits would not be without precedent and being seriously considered for the new individual account system in the United Kingdom (UK Pension Commission, 2005; Department of Work and Pensions, 2006a and 2006b).

This long list of possibilities serves to illustrate the complexity of issues affecting the system. A number of initiatives should be considered in combination.

Are price limits a serious possibility? In the light of persistently poor levels of competition across many parts of South Africa's financial services industry, price ceilings deserve serious consideration, at the very least, particularly in the context of policymaker imposed compulsion and the consequent obligation to safeguard the interests of participants.

The next two parts of the discussion assume that price ceilings are to be considered and sets out some of the information required to assess the level and type of such a ceiling.

Setting a ceiling: level

This paper recommends that the fees of accredited providers are made subject to a ceiling. In practice, it must be decided what types of fees are to be permitted and what maximum level each of these fees should be subject to. The level of the cost ceilings is considered first.

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[64] This is formed by Federal Government, the Central Bank, Social Security organisation and representatives of the Labour and Employers sectors (CONSAR, 2007).

[65] Consideration should be given to other objectives when establishing a limit to the types of fees that may be charged. Gill et al (2003:117) show that fees are proportionally higher for low-income contributors than for their high-income counterparts. Vittas (1998) reminds us that certain types of fees are regressive (flat fees are the most obvious example) and that there are other ways to address the cost problem.

> A number of regulators around the world have elected to impose maximum charges on market players, but with great care to avoid unintended consequences. If the ceiling is set too low, market players are driven out of business, reducing the existing competition. If the ceiling is set too high, aggregate costs may rise as providers drift towards the ceiling, leaving the consumers in a poorer position overall. (Rusconi, 2004:114)

The discussion below focuses first on the total allowable fee, considering it in asset-based terms, and then turns attention to the potential for the fee to be levied in alternative forms.

Adair Turner and his co-authors (UK Pension Commission, 2005) provide a good discussion of the process by which they arrived at their recommended fee limit. While the details of the argument are not particularly helpful, since they compare the UK system with the equivalents in Sweden and in the United States, which have much greater scale than is contemplated for South Africa,[66] the elements of the discussion are useful.

They suggest that the envisaged system could not be expected to operate as cheaply as a PAYG, which could be run at around 0.1%, but should be able to obtain the cost efficiency of a large retirement fund, which they define as having around 5,000 members. Well-established independent analysis of the cost-effectiveness of the retirement fund industry, by fund size, is available in the UK and this is how the commission arrived at its proposed cost ceiling of 0.3% of assets per year.

Naturally there has been a great deal of discussion concerning this target, but the UK government has indicated its belief that it may be achievable, albeit only in the long-term. In the process it illustrates some of the cost-reduction techniques discussed earlier in this section.

> The current system of private saving has a number of costs that can be reduced or eradicated in the system we are proposing. The use of automatic enrolment should drive down the costs of marketing and acquisition. The establishment of a central body would increase portability, reducing the number of times high start-up costs for accounts would be incurred. And the establishment of a central body would ensure that persistency of saving is increased, further reducing the costs of saving through fewer, but larger, pension funds. The exact cost of the scheme will be dependent on the final design, the financing of the scheme and the service it offers to consumers. We believe that 0.3 per cent may be achievable in the long term, depending on decisions we take on scheme design. (Department of Work and Pensions, 2006a:61)

Rusconi (2004) suggests that larger retirement funds in South Africa can be administered at as low as 4% of contribution, equivalent approximately to an annual 0.25% of assets under management at current industry ratios of contributions to assets. His analysis of the data provided by an Alexander Forbes survey suggests that asset management fees for large funds average between 0.4% and 0.5%. Industry commentators have suggested that the survey of asset management fees err on the high side, since managers quoted the fees that they would hope to earn, not the fees that they actually achieve.

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[66] The total operating cost of the Swedish system, with its clearing house, is 0.37% (of assets per year) for investors selecting the default option, higher for those who choose to invest in non-default funds, and is expected to come down to below 0.2% by 2020. The US Federal Thrift Savings Plan runs at a cost of 0.06%, but this probably ignores some cost arising elsewhere, like payroll and human resource costs. The President's Commission on Social Security Reform in the United States suggests a cost benchmark of around 0.30%, even with a wider range of funds that includes actively managed funds (UK Pension Commission, 2005:398).

This suggests that asset management fees, for large arrangements like these, closer to 0.3% are quite feasible.

Putting administration and asset management together, and allowing a small margin to cover costs of other administrative functions such as communication and regulatory submissions suggests a fee of around 0.6% of assets per year. This is acknowledged as a benchmark, a first step for the discussion that must follow this paper. Furthermore it should be a long-term target rather than an immediate system objective.

Some allowance should be made for the cost of servicing individual members,[67] but a target of 0.6% for the very large arrangements envisaged by this proposal would be sufficient to permit sufficiently large providers to enter the market. This is significantly lower than current costs experienced across the industry, except in the largest occupational funds, but is twice the benchmark put forward for consideration in the United Kingdom, and would be considered by some commentators to be generously high.

Using the conversion factors implicit in Rusconi (2004), this suggests an equivalent fee of 10% of contributions.[68] The issue of how fees might be charged is considered next.

Setting a ceiling: type

As recent South African experience shows, charge types can be enormously complicated. While it is imperative that in an opt out system, charges are simple and easily comparable, careful thought needs to go into how fees may be levied and how any maximums should be expressed.

The UK's Department of Work and Pensions (2006b, page 96) suggests that a charge structure for a personal accounts system should have a number of qualities. It should be

- simple and easy to understand, enhancing comparability across products,
- fair to all members, taking into account an individual's ability to pay, and it should
- incentive providers to maximize fund value,
- incentive members to assist to keep costs down, and
- provide significant revenue in the early years of operation, reducing the amount and length of initial operating losses, and reducing financing costs.

The final point is important. There is no market without providers. Set up is not cheap and this cost must be met. The manner in which fees may be levied has considerable impact on whether providers choose to enter the market at all.

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[67] This assumes that the recommendation against blind allocation of assets to wholesale investment managers is accepted in favour of accredited entity responsibility for client servicing and benefit payment.

[68] The conversion of one type of fee to another was carried out by Rusconi with reference to the then-current relationship between industry assets and contribution flows. The relationship between asset-based and contribution-based fees needs to be more carefully considered because it depends on a range of factors.

Steventon & Sanchez (2007) carry out detailed analysis of five alternative structures for the UK system:

- an annual management charge, percent of the assets in an individual's account,
- a flat joining charge combined with an annual management charge,
- an annual flat fee, the same for all participants,
- a contribution charge, a percentage of each contribution, and
- a contribution charge combined with an annual management charge.

They show, not surprisingly, that the ideal charging structure depends on the priorities assigned to each of the attributes set out by the Department of Work and Pensions.

This is not an easy issue to resolve. Substantial further analysis will be required. To simplify the discussion in this document considerations are limited to the asset management charge and the contribution charge.

> Analysis of the impact of different fee structures on workers and management companies shows that a management fee based on assets implies a lower cost for workers upfront but a higher cost in the long run. For management companies, a fee on assets implies a longer break-even and payback period, but greater profits in the long run, provided the level of fees is not reduced by market competition. But for newly created mandatory systems, asset management fees may have to be very high to ensure that management companies do not suffer huge losses at the start of the system. (Vittas, 1998:21)

As the Vittas quotation alludes to, a key factor for providers considering entry to the market is the speed with which they are able to recover the capital expenses incurred in setting up the system. Asset-based fees make it more difficult for providers to survive the first few years of existence but may be more expensive for participants in the long-run, depending of course on the proposed level of the fee and its alternatives.

Consideration could be given to permitting providers to charge on a mix of contribution-based and asset-based fees, to give them some scope to manage these financial risks. Three options, of roughly equivalent overall value on the mix of contributions and assets assessed by Rusconi (2004), might be:

- 10% of contribution,
- 0.6% of assets under management, or
- a combination of 5% of contribution and 0.3% of assets under management.[69]

Opportunities for gaming would need to be closed out. Examples of these are

- modifying the charging basis during the course of a contract, starting out with contribution-based charges and switching to asset-based charges as the level of savings grew, and

[69] Great care must be taken in assessing the equivalence of different charge measures. The relationships current at the time of Rusconi's analysis will not remain constant over time. Furthermore, what works for the industry as a whole doesn't apply to sectors of the industry. These figures are put forward merely as examples.

- using a basis that differentiates by the age of the customer, insisting on asset-based fees for younger customers who, by virtue of their longer expected saving span would generate greater profit this way and, conversely, requiring contribution-based fees from older customers.

Providers should not be given the freedom to change the basis for charges during the course of a contract and the charging basis chosen by a provider would be required to apply to all pension business sold in that period.

Even with conditions such as these, substantial potential for cherry-picking behaviour remains. The safest way to manage this would be to permit only one type of charge, contribution-based or asset-based, and require all providers to manage their businesses at or below the specified charge ceiling.

Should higher charges be permitted for more sophisticated mixes of assets, as is the case in Sweden (Whitehouse, 2000b & Palmer, 2000)? This is recommended against. If it is possible to gain higher investment performance through stock picking then managers should seek to achieve this performance at their risk with the reward of attracting future customers as a result.

Some may suggest that tight charge limits would encourage widespread the adoption of passive investment strategies, detrimentally reducing liquidity and increasing the volatility of market prices. This argument is self-defeating. If market volatility increases, active managers would seek to take advantage of this, in turn increasing the volume of trading, improving liquidity and tempering the volatility. Turner considered the possibility of market distortion through increased use of passive management and ruled out the potential risks (UK Pensions Commission).

Loyalty bonuses

The proposed basis rules out exit charges by omission, but it does not rule out the possibility of fees that reduce over the term of a contract to encourage savers to stay with their existing providers. Consideration needs to be given to the alternatives of allowing it, on the basis that it discourages wasteful movement between providers, or explicitly outlawing this to prevent distortionary incentives to stay with providers even if they provide uncompetitive investment performance or service.

Another possibility is to legislate a fixed exit charge, sending a signal that movement between providers is not cost-free (and should not be) but controlling the extent to which providers could provide incentives to retain existing customers or attract the customers of other providers.

On balance, a small fixed exit charge is considered a possibility, but 'disloyalty penalties' are not supported.

Recommendations

It is recommended that the following thoughts receive further consideration:

- a contribution-based charge limit of 10% be considered in the long-term,
- a mark-up on this limit of half again be permitted at launch, in other words 15% of contribution, and that

- charge limits should be reduced every year for a phase-in period until they reach the long-term target, and this phase-in period should be no more than ten years in length.

Later consideration of changes to the type of limited charge could be considered for new contributions, but not for accumulated assets, which would already have suffered the entry charge.

4.5 Commission models

Commission is a key subject of discussion at present. The South African long-term insurance industry is characterised by regulated commission scales, a series of rules setting out maximum levels of commission payable for each product. In many cases, the intended ceiling has become the *de facto* commission level, entrenching high costs and creating the impression that it is impossible to sell insurance products without paying commission at the maximum level.[70]

The impact of commission scales

> Much of the discussion that has taken place over the last year between policymakers and industry players has focused on the subject of commission. This paper seeks to demonstrate that commission is not the only source of the problems that have arisen, but that current commission scales are not in the best interests of policyholders and are a significant contributor to the inequitable burden of costs. (National Treasury, 2006:28)

The existence of the commission scales has been identified as one of the drivers of high costs in the South African personal pension saving (retirement annuity) environment, but only partly due to the cost impact of the commission itself. The scales have implications that reach much wider than this, for example,

- reducing the potential for a customer to negotiate commission levels with the intermediary,
- creating high up-front expenses for providers selling commission-paying products,
- perpetuating unfair distinctions between different types of providers falling under different regulatory frameworks,
- raising barriers to the entry of new providers who have to absorb these start-up costs, and
- reducing incentives to the intermediary to provide advice to the customer that is objective and only in the customer's interests.

The subject has been well covered by the National Treasury (2006) publication on the subject, which has indicated that commission scales are not expected to survive the retirement reform process but must, in the interim, be reviewed in order to reduce their potential to perpetuate some of the market distortions listed above.

[70] This generalisation creates a dangerous impression. Rusconi (forthcoming) shows that it is inaccurate, pointing out that, for endowment products targeted at low-income individuals, commission at the ceiling level is actually rare, most providers requiring that intermediaries share the costs of reaching a relatively unprofitable market.

Preconditions for removing commission scales

National Treasury (2006) proposes a number of conditions required for the safe removal of commission scales.

> While there is a strong case for deregulation, consideration must also be given to the conditions under which a market-determined approach to commissions would be appropriate. A market-driven approach should result in investor gains, provided that the market is characterised by effective competition. Preconditions would include: (a) an effective system of disclosure; (b) appropriate consumer and intermediary education; and (c) a financial safety net for investors (such as minimum early termination values). (National Treasury, 2006:30)

The National Treasury has indicated its view that commission scales are unlikely to survive the retirement reform process. This perspective is shared by the author of this paper. It is submitted that the terms set out in this paper meet the requirements for deregulation proposed by the team at National Treasury. Disclosure standards will be significantly higher (see sections 3.2, 4.7 and 4.8) and consumer education greatly enhanced by the simplification of product design, mandated by the system (section 4.1) and in practical terms enforced by the charge ceilings (section 4.4) that it is recommended receive serious consideration.

The fact is that, under this set of proposals, commission scales will be rendered unsustainable for the mandatory defined contribution environment by the terms set out in this paper. Entry to the system will be mandatory, but the choice of provider (and the decision of whether to opt out of the default fund) at the discretion of the saver. Providers will find creative ways to market and distribute their products.

Charges are likely to come down in the voluntary saving environment as well but this is the area in which face-to-face advice would be important and where advisor commission or fees may play a significant part in the process.

4.6 Group arrangements

One of the benefits of the current South African system is that, where participants are arranged into groups, they are able to negotiate significant reductions to fees through the economies of scale that they offer. Recognition of the potential cost saving is entrenched in some systems, for example, in Switzerland, where employers are required to provide occupational retirement cover (Queisser & Vittas, 2000) rather than forcing individuals to select providers.[71]

This paper considers at length the options for servicing members of the system, for example, deliberating the possibility of establishing barriers between providers and their customers to reduce costs. All things taken into account, it seems best to allow the relationship between providers and customers, establishing a culture of customer service and forcing the provider to take responsibility for the form of benefit (see section 4.2 and appendix 2). But this has a downside, since providers must service customers in their capacity as individuals of potentially raising system costs.

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[71] *Switzerland was the first country in the OECD to mandate firms to provide access to occupational pensions to their employees.*

Niemietz (forthcoming; a) suggests that group contracts should be permitted in the individual account system in Chile. Any effort to promote competition between providers and reduce system costs is supported. Significant economy of scale is possible at the take-on phase of the provider-customer relationship even if servicing thereafter has to take place at the individual level.

The notion that arrangements could be entered into with employers, unions or other affinity groups that would offer the members of that group entry to the opt out arrangement of a particular provider at a price that they would probably not be able to obtain in the absence of the group arrangement is strongly supported. It is recommended that this is limited to the take-on phase of the relationship. The concept should not be extended to the servicing of these members, because this runs the risk of a parallel market in group arrangements forming that would compromise the standards of servicing proposed in this paper (see section 4.8). Neither should providers be permitted to approach groups on condition that all members of the group sign up to that provider. This significantly compromises the freedom of choice underlying this system.

Group arrangements might also permit providers the financial "breathing space" to consider paying significant incentives to intermediaries that bring such groups into the system. It is recommended that disclosure standards require that any remuneration is clearly communicated to representatives of the group and to all of the members covered by the group.

Finally, consideration may need to be given to a framework of governance for the group that appropriately protects their interests. If other requirements are properly safeguarded, this may prove unnecessary on the basis that the freedom of choice of every individual is entrenched in the system, but the reality is that individuals often wish to leave financial decisions to group representatives. Where they do so, the fiduciary obligations of these individuals must be clearly set out, perhaps extending to a trust arrangement of some description.

In summary, efforts to introduce economy of scale to the system by finding ways to aggregate individuals into groups of any size are supported, but it is recommended that

- such aggregation of servicing apply only to the take-on phase,
- it not be extended to a second, compromised, set of service standards,
- compulsory participation of all members as a condition of service be forbidden, as well as any pricing strategy conditional on a certain proportion of the group joining,
- disclosure standards make absolutely clear to group representatives and every member what rand amount of commission is being paid to an intermediary, and
- consideration be given to the governance structures that would safeguard the security of the members of the group.

4.7 Disclosure principles

This section aims to set out some of the principles underlying the disclosure of product characteristics by accredited providers to the customers and potential customers. It should be read in conjunction with the somewhat overlapping discussions of reporting principles (section 3.2), primarily in the context of governance, and member information (the next section) in the context of servicing requirements.

> Some of the practices questioned by the [Pension Funds] Adjudicator include a significant reduction of the policy value on premature cessation or reduction of premiums. This situation results from a business model that recovers unrecouped expenses on early termination, but lacks appropriate up-front disclosure of, and agreement to, such practice in policy documents provided to the member of the retirement annuity fund. … While disclosure standards in the South African contractual savings environment have improved in recent years, they still fall short of international standards. (National Treasury, 2006: 10, 11 & 16)

The standards of disclosure of insurers providing retirement annuity products have come under intense scrutiny from the National Treasury review of the contractual savings industry. Poor disclosure, currently subject only to industry self-regulation, has undoubtedly contributed to the difficulties experienced in this environment, not least in the surprisingly high charges imposed by providers. Consumers are clearly not sensitive to these charges (Rusconi, 2004).

A more recent study into the entry-level endowment products sold by insurers raises concerns about high charges, but notes particularly very wide range of charges, suggesting very low levels of sensitivity of consumers to charges. This may not be surprising, in light of one of the other findings of the study, that disclosure appeared sufficient to meet the self-regulated standards set by the Life Office Association, but that very little effort had been made to ensure that policy documents could be understood by the intended policyholders (Rusconi, forthcoming).

It would seem that we have a very long way to go before we can claim that disclosure standards in South Africa are sufficient for consumers to make choices based on the criteria that they ought to be using, those that are in their best interests.

In the notes that follow, some of the principles behind the disclosure standards in other countries are discussed. Then a set of criteria believed to be a requirement to guide the development of the disclosure system for the accredited opt-out environment in South Africa is proposed.

Disclosure in Australia

The disclosure rules in Australia are not set by the body responsible for pensions regulation (APRA, the Australian Prudential Regulation Authority) but by the Australian Securities and Investments Commission (ASIC), which has a much broader mandate over the activities of financial services firms. Since the code covers a variety of product types, it must be comprehensive, and it is.

ASIC (see 2004a and 2004b, for example) sets out detailed prescriptions on disclosure, for example, requiring providers to furnish dollar values, not percentages or other figures that could be misinterpreted. It also sets out a set of good disclosure principles, in recognition of the fact that setting appropriate detailed disclosure requirements in every instance could be difficult.[72] These principles (ASIC, 2005) are summarised as follows (as quoted also in National Treasury, 2006). Disclosure should:

- be timely,

[72] *While the South African authorities are probably in a good position to set the detailed requirements, since the opt-out environment is expected to be reasonably standardised, these principles should still be taken into consideration when drafting these disclosure standards.*

- be relevant and complete,
- promote product understanding,
- promote comparison,
- highlight important information, and
- have regard to consumers' needs.[73]

Latin American individual account systems

> Rules governing disclosure to plan members, external audit and reporting to the supervisory authority are also applied widely and effectively in Latin American countries. (Gill *et al*, 2003: 44)

The comparability of products in the mandatory savings systems of Latin America is considerably enhanced by a degree of forced uniformity on products, in design, contribution levels and charge types. The regulators in the region take very seriously the importance of improving consumer understanding of products and the effectiveness of their choice of provider, and play an active role in providing accurate comparison of products (see footnote 61 in the discussion of charges, section 4.4).

More details on the types of information provided to members in Chile are discussed in section 4.8.

United Kingdom

The UK authorities set high standards of disclosure. It adds to these by adding a further layer of requirements for a product to be described as "accredited" by the regulator (Johnston, 2000). The CAT standards, as they are known, set minimum requirements in three areas:

- **Charge.** Products must met limitations on the mix of allowable charges and on the overall level of the charge.
- **Access.** Standards are set that specify minimum acceptable lump sums and regulator contributions (which is really about affordability rather than access) and these are combined, for some products, with minimum portability and flexibility requirements
- **Terms.** Additional requirements concerning the conditions under which products may be provided.

South Africa has made some progress in this regard through negotiations that fall under the Financial Sector Charter. This has resulted in a set of minimum standards for bank accounts and a similar set of standards for funeral products provided by insurers. So far, no equivalent benchmark has been established for savings products, ostensibly because there remains too much policy uncertainty in this environment.

[73] *Further details on the Australian approach to disclosure, together with an appraisal of these disclosure standards against international alternative, including South Africa's, are available in Clare (2002).*

Recommendations

> Costs are opaque. This is particularly so in the life insurance and retirement funds environments. My difficulties gathering data suggest that industry consumers would find it very challenging to compare providers on the basis of cost. … Simple summary figures, with straightforward explanations, would assist the investor (1) to understand the real impact of charges, (2) to compare intelligently across products and (3) to make informed decisions regarding the savings channel appropriate to their needs. (Rusconi, 2004:112)

Establishing the disclosure obligations of providers to this industry is not easy and proposals on the details of such disclosure are beyond the scope of this document. It is recommended that the following steps are taken to identify the needs for disclosure and put into place a system that addresses these needs:

- A degree of product standardisation, to make products easier to compare, acknowledging that this is a mandatory environment and that the regulator has an obligation to establish a safe system. Providers can exercise more freedom in the voluntary space, and perhaps should do so.
- Standardised, regulated disclosure requirements, established by the regulator and tested with consumers prior to implementation and on an ongoing basis thereafter.
- Certain public disclosure responsibilities for the regulator, for example, an accessible set of comparative prices.

National Treasury has earmarked improved disclosure as a high priority for the future and provided an excellent set of principles proposed as appropriate to accredited providers just as much as to the insurers for whom they were designed. National Treasury recommendations in their discussion of possible changes to the contractual savings industry that the following principles be used to guide a revised set of disclosure standards:

> - **Timing of disclosure**: Relevant information concerning potential policies and the advice backing these policies must be provided in a timely manner.
> - **Frequency of disclosure**: Relevant information should be provided on a regular basis, at least annually.
> - **Independence of disclosure standards**: Self-regulation of transparency standards, whilst useful, can never be truly independent. The standards of disclosure must become part of the regulatory framework, as is the case in most countries.
> - **Clarity of presentation**: Language must be clear and simple, numerical descriptions straightforward and unambiguous and disclosure documents must not be cluttered with unhelpful information.
> - **Consumer testing**: Disclosure only works to the extent that it is understood. All disclosure proposals should be rigorously tested for their potential to improve consumer understanding.
> - **Comparability**: Disclosure standardisation must permit clear and easy comparison of equivalent products. (National Treasury, 2006: 19 & 20)

These principles are heartily endorsed here and recommended as key to the establishment of the standards required of participants to make informed choices.

In closing…

> … information disclosure in the insurance industry is poor in practically all jurisdictions (World Bank, 2005:163) …

It should be of little consolation to South African insurers that they share a poor trait with their counterparts in many other countries. Poor disclosure in a voluntary saving environment indeed requires serious attention, but in a mandatory environment, sub-standard disclosure is completely unacceptable.

4.8 Service requirements

This section discusses an issue that has links with a number of others covered earlier in this paper, the minimum standards of customer service that accredited providers will be required to meet. Cross-references are noted where relevant.

The need for service standards

Why should service standards be set and monitored? The focus of the discussion here is the participant. The imperative to protect the interests of customers through establishing standards not only of governance and product but also of service is designed to meet a number of system objectives:

- high levels of public confidence in the system,
- high levels of participation and correspondingly low levels of evasion,[74]
- establishing a sound basis for public comparison of provider charges, on the basis that they all meet (high) minimum servicing standards, and
- reducing the potential for providers to cut corners on service delivery in order to reduce costs and increase profitability.

The most important disadvantage of setting service standards is that some form of monitoring needs to be undertaken, preferably with a profile sufficiently high to convince service providers that compromises will not be tolerated and sanctions imposed in line with the provisions of the regulation.

Since it is expected that the number of providers is to be small, one option is for statistics to be gathered on each provider on issues relating to the integrity of the sales and customer servicing process, for example:

- **persistency statistics**: the proportion of customers remaining with a provider 6 months, 1 year and 3 years after purchase,
- **sales satisfaction**: customer approval of the sales process, based on data surveyed within a limited period following the sale, by an independent organisation,
- **customer response times**: audited statistics on the success with which participant queries are resolved by providers, and

[74] *Mandatory participation does not guarantee compliance. The difficulty is measuring compliance: those who manage to avoid participating are likely to be rather difficult to detect.*

- **customer satisfaction**: participant approval of servicing levels, based on randomised surveys of participants, also by a credible independent provider.

This could be implemented in the absence of clear service requirements, but objective measurement would be assisted by the existence of such standards. The goals of such measurement, apart from improving the levels of public and participant confidence in the system, include promoting competition by providers on the basis of customer service standards.

The benefits of these initiatives need to be weighed up against the cost of funding the surveys. The same reasoning should be extended to the provision of minimum service standards in general terms. In an environment of the scale envisaged for the accredited opt out industry, these costs would not appear to be unreasonable.

Communication requirements

Minimum communication standards are referred to in those parts of this document that cover reporting principles (section 3.2) and the options concerning disclosure (section 4.7). Here we are concerned not so much with the technical content of documents but with the standards of communication required of service providers to their members.

The Chilean authorities require pension funds to provide the following types of information to participating members (SPFA, 2003):

- **Four-monthly summarised statement**. All members whose account has shown movement[75] are sent a summary of all deposits, charges and balances, both in pesos and in UF.[76] The form for such communication is specified by the regulatory authority so that members experience consistency of communication across providers, and statements must be provided separately for different types of accounts.[77]
- **Comparative standardised performance information**. Included in the four-monthly statement is a table, calculated by the Superintendency, which shows standardised performance for each provider, at five different income levels and over five different historical periods, net of costs. Note that both the calculations and the format are specified by the regulator and that this information is sent to members every four months. This surely has positive impacts on the comparability of providers on the basis determined most appropriate by the authorities.
- **Performance of the fund**. The statement shows the performance obtained by the individual but also the yield of the whole fund, the latter being independent of accumulated balance or charges and therefore the same across all members of the fund.

[75] *The 'movement' referred to by SPFA excludes fluctuations in investment value, it is assumed, otherwise statements would need to be sent to all participants whether active or not.*

[76] *The UF, or unidad de fomento, is the monetary unit for all pension payments and is indexed to the consumer price index.*

[77] *Voluntary Savings Accounts and Compensation Savings Accounts are separately defined from the main mandatory contributions under the legislative framework.*

- **Comparative charges and social security cost**. For each of the income levels at which the standardised performance income is published, also with each four-monthly statement, providers must include comparative tables showing the charges of each provider and a calculation of the monthly social security contribution.
- **Default fund assignment**. The default investment mix for members depends on their age. In those instances where the age of a member would result in a reallocation of their accumulated balance from one investment fund to another in the absence of an election to the contrary (see the discussion in section 5.4), information about such a transfer must be sent to the member. Communication on the issue must commence a year before the first transfer of funds and continue for up to a year after the final transfer.
- **Social security book**. The fund must provide to the member a social security book, in which the member may request the balance in their account, in pesos and UF, whenever they think it fit.

In addition to this, all providers must produce two other types of information. They must make available, in every branch office, an information board that meets the specifications of the regulator concerning charges, details of the provider and details of each of its pension funds. They must also produce information leaflets for the general public, written in simple language and covering a list of specified subjects.

Other countries follow similar approaches. Regulations issued by Mexican authorities, for example, include detailed specifications of the material that must be made available in provider branches and on their web sites.

Some of the difficulties

The Turner review of the United Kingdom environment provides excellent food for thought to those responsible for determining exactly what types of material should be included in standardised communication. The report suggests that careful consideration is required concerning a number of aspects of the communication design:

- **The benefits of information and guidance versus the dangers of implicit advice and false assurances**. While it is clear that basic statistics concerning the account balance and the investment return recently gained must be provided, there are some areas in which care must be exercised over the manner in which information is presented. It is natural to describe investment options in terms of expected high and low returns and corresponding high and low risk, but the guidance must make it clear that no guarantee is implied by this expectation. Indicative projections provide the opportunity to educate members about the benefits of delayed retirement – if it is possible – but also carry the risk of a guarantee.[78]
- **The trade-off between comprehensiveness and operational complexity**. In theory, the centralised pension arrangement in the United Kingdom could produce benefit statements that

[78] *The report includes example tables from the Swedish system that show admirable balance between displaying all of the relevant information concerning the current account the potential retirement benefits, but do so in a way that retains simplicity. Turner criticises it for taking too conservative a view on investment returns, but it is particularly effective at showing the benefit of delaying retirement (UK Pension Commission, 2005:390 & 391).*

include pension saving from all sources. In practice this would be prohibitively complex and expensive. The report recommends that benefit statements combine all savings in mandatory arrangements with accruals already gained in state PAYG systems and likely to be accrued in the future. It suggests that the potential for combining this information with private pension savings be considered at a later stage. This would seem to be a reasonable approach and it should form the starting point for considerations in South Africa.

- **Appropriate frequency of communication**. Statements sent with greater frequency than, say, annual would be appreciated by some members, but increase the cost of communication and risk being ignored. The Pension Commission recommends the provision of high quality annual statements, arguing that this is the benchmark that has been established by private sector counterparts, and that, since existing state pension projections are carried out annually, an integrated account balance with projections could be sent no more frequently than this.

There would seem to be some middle road possible, with projections on an annual basis and simplified account summaries sent more frequently than this, twice a year or quarterly, perhaps even every four months as the Chilean providers do.

A comprehensive proposal on member communication standards requires careful consideration of a range of issues and is beyond the scope of this paper. The point made here is that the issue must be given adequate attention by system designers and regulators. Prospective providers should be prepared for compulsory regulated member communication of a high standard and should consider ways in which they might compete on the quality of the information that they provide.

Management of data

Data management is touched on in the discussion covering governance requirements (section 2.2) and their practical implementation (section 3.1).

The subject is included in this section as a reminder that data management ought to be subject to system security requirements, giving the supervisor the power to establish early warning of potential breaches, and to order providers to make the appropriate changes to computer systems in order to maintain the security and integrity of all member data on record.

Treatment of member resignations

A crucial area for minimum standards concerns the treatment of members on resignation, technically a request to switch contributions or transfer assets away from the current provider.

If system rules require that members invest with only one provider then a contribution switch automatically involves a loss of existing business with a transfer of assets. Minimum rules concerning the treatment of such requests form an important part of the overall standards of servicing across the industry.

Probably the most important measure of the effectiveness of a provider's service to an exiting member is the speed with which it executes the instruction to disinvest assets and transfers them to the receiving provider. This is noted in the OECD's core principles on occupational fund regulation:

> Individuals have the right to timely execution of the request to transfer the value of their vested benefit accruals. (OECD, 2004:8, paragraph 5.11)

Regulation should set standards for turnaround of such instructions and the information provided to the transferring member together with provisions for compensating members disadvantaged by provider inefficiency or unwillingness to act on instruction with appropriate speed. Other provisions should be established to support regulation designed to mandate service standards to exiting members.

The possibility of an exit fee is touched on at the end of section 4.4. Unlimited exit charges are not desirable because they prevent legitimate and informed movement between providers, but a standard statutory exit charge may be appropriate to cover the costs of such transfers and help members to recognise the consequences of switching between providers.

The charge should be approximately sufficient to cover the costs of the transfer. Arguments that exit charges should also cover some of the sunk costs of the provider are of merit in today's environment in which the costs of issuing a contractual savings product are high, particularly with commission-incentivised intermediaries. Similar arguments are far less likely to have validity in the environment established for accredited providers in which limits on overall fees – explicit or implied by the operation of the market – are such that distribution and take-on costs are substantially lower than in today's environment.

5 INVESTMENT REQUIREMENTS

At the core of a funded retirement saving system is the investment of the accumulated assets of participants. The investment strategies chosen by participants can have a significant impact on the value of retirement benefits, but also on the risks to which these accumulating personal assets are exposed. The importance of sound selection of asset classes, complex as it might be, is difficult to overstate and participants need to be guided carefully through the process, if indeed they are to have any choice in the matter.

> Extensive regulation is needed because workers often lack the expertise to invest wisely and because private pension companies might exploit their ignorance. Some private investment managers might take too many risks to maximize yield and attract affiliates, whereas others might be too conservative to keep up with productivity and inflation. Given the long term of pension investments, it may be too late for workers to recover financially through new saving once the damage becomes evident. … Regulations are designed to protect both individual workers and society from perverse competition in the face of information deficiencies. This protection is particularly important in a mandatory program. (World Bank, 1994:218-219)

In this part of the paper, aspects of the investment of participant assets are discussed, starting with consideration of how these assets are to be protected and moving on to the subject of which asset classes should be permitted and whether the allocation to these investment types should be specified or limited in any way. A number of countries require providers to guarantee investment returns at a specified level. Consideration is given to the issue of whether there is any place in this system for such guarantees. Finally, the thorny question of whether participants should be given investment choice is discussed and, if so, how this process might be controlled.

In many of the recently reformed countries, capital markets were weak prior to the implementation of mandatory saving requirements and private sector providers did not have a great deal of experience managing large pools of assets. In many of these cases, the authorities adopted a very careful approach to the management of assets − some describe it as “draconian” − stifling competition in the interests of member protection:

> The herding instinct among pension fund managers is particularly worrying in the context of an industry that is increasingly the dominant investor in bond markets. To the extent that a few pension fund managers that invest in a similar way dominate capital markets, it is unlikely that market liquidity will grow to the levels observed in OECD countries. The increasing process of concentration in the pension fund management industry, while efficient with respect to economies of scale in account management and record keeping, will only put investment decisions into even fewer hands. (Gill *et al*, 2003:52)

Many of these countries subsequently introduced a gradual liberalisation of these rules as markets developed[79] and both customers and providers grew in experience and competence.

Despite the importance of establishing a South African system appropriate to the conditions and needs of South Africa, we must learn the appropriate lessons from these countries. We can expect our system to share with theirs the key characteristic that, despite the planned allocation of half of the contributions to the PAYG system, the fund will grow to become a significant portion of total investable national assets. As this happens, the potential for government intervention will become more significant.[80] Protection against this possibility must be established at system launch, not when the conflicting priorities become a reality.

5.1 Management of investments

Rules governing the management of investments by the accredited retirement institutions (ARIs) are inextricably linked to governance and regulatory requirements, discussed elsewhere in this paper. This section concentrates on two aspects specific to investments, administrative requirements and custody rules, but it starts by considering briefly the overarching principles that would help to establish the seriousness with which ARIs are expected to take their responsibilities to their members.

Legal framework & fiduciary responsibility

The structure within which the investment of assets takes place is very important to the successful operation of the asset management process, to the benefit of members. In all Latin American countries bar Mexico, the pension funds themselves are legally separated from the fund administrators and the funds are owned by their members. In Mexico, the funds are independent legal entities with their own boards of directors.

The approach of legal separation is supported. The assets of the fund must, in law and in fact, belong to the members, as in South Africa's collective investments environment, separate from the administering entity, the ARI in our case. The ARI is no more or less than a management company mandated by the owners of the fund to manage its assets on a contracted set of terms and fees.

The second overarching principle concerns the responsibility of the managers of the funds.

> In Chile, the pension fund administrators must have some independent directors whose duty is to guard the interest of the affiliates. Chilean regulations also set forth a high principle of fiduciary responsibility: AFPs [registered pension managers] should ensure the adequate profitability and safety of the investment of the funds they manage. They are obliged to reimburse the pension fund for any direct damages they may cause, whether by omission or commission. (Gill *et al*, 2003:43)

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[79] *Between 1998 and 2002, the assets held by pension managers, expressed as a percentage of GDP, grew from 40.3% to 55.8% in Chile, in Argentina from 3.3% to 11.3%, in Bolivia from 3.9% to 15.5%, in Mexico from 2.7% to 5.3% and in Uruguay from 1.3% to 9.3% (Gill et al, 2003:49).*

[80] *Chilean managers hold more than 60% of all government debt and their Bolivian counterparts more than 30% (Gill* et al*, 2003:50, figures from 2002).*

This provides the type of principles that should flow through the regulations into the investment and management practices of the ARIs.

Administrative requirements

A strong case could be made for the position that the supply side of South Africa's investment market is unnecessarily complex and that elements of the sometimes long chain between the first supplier and the end user, the member of the fund, do not add sufficient value to justify their contribution.

The fundamental issues are that

- not all of the suppliers provide services that add value to fund members in excess of their cost,
- significant vested interests perpetuate this inefficiency, and
- defensive positions are often adopted by trustees to protect against potential negative outcomes rather finding the best balance between downside risk and upside return potential.[81]

It is suggested that ARIs be required to provide investment services on a straightforward, transparent basis that improves accountability and competitive forces. Wrappers should not be permitted. ARIs must manage their own investments, with outsourcing where necessary but without any additional layers. This would spread investment decisions across a broader range of portfolio managers who are directly accountable to the fund.

This is a complex policy area. The merits of this arrangement versus fully outsourced arrangements be assessed thoroughly.

> The investment of pension funds [in Latin America] is subject to a comprehensive prudential regulatory framework. In each country that has reformed, all liquid financial assets bought by pension funds must be traded in secondary markets and valued at market prices. For the less liquid assets, the supervisory authorities of some countries, such as Mexico, set a valuation mechanism based on historical prices and valuation of related securities. *Such a method was originally designed with a view to ensuring the comparability of pension fund portfolios and permit adequate monitoring by the regulator, CONSAR. It is now expected that insurance companies and mutual funds will be required to use the same valuation method.* (Gill *et al*, 2003:44-45, footnote included in italics)

Rules for the administration of ARI assets must include specification of the valuation of all assets and calculation of investment performance. This should not present significant difficulty in the current South African framework with its strong focus on assessing assets at market value, but monitoring of the calculation methodology and implementation must form part of the responsibilities of the supervisor, properly resourced.

The investment rules must manage conflicts of interest, which occurs most commonly through self-investment, but can take place in other ways.

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[81] *The widespread prevalence of fund-of-fund arrangements in a market with a very limited set of investable securities appears to support the premise that trustees aim to avoid trouble rather than focusing on obtaining the best outcome for their members, all things considered.*

> Possible conflicts of interest [in Latin America] between pension fund managers and related entities arising from the investment of pension funds are also strongly regulated. All countries set low limits on investment in securities of issuers related to the pension fund managers. (Gill *et al*, 2003:45)

Many countries also explicitly address the potential for collusion between pension fund managers, a potentially serious issue in an environment with a low number of providers. In Chile, funds may not "form an association or act in a block in order to exercise their shareholder rights" (source: regulatory code) though the regulation leaves scope for explicit authorisation to be granted to managers to act jointly at board elections.[82]

Custody

Countries take various approaches to the issue of custody. **Chile** requires a substantial portion − notably not all − of a fund's assets to be held in custody:

> Securities [in Chile] representing at least 90% of the value of the Pension Funds must be held in custody, in the Central Bank of Chile, in foreign institutions authorized by the CBC or in private securities deposit firms. … This service must be provided by institutions which have the necessary infrastructure and oversight to perform these activities. (SPFA, 2003:81)

While Chile does not insist on separation of custody from asset management, **Hong Kong** mandates independence of the custodian from each of the investment managers appointed by the pension funds. The legislation governing the Mandatory Provident Fund System does not specify registration requirements for custodians, but limits the entities that may assume the role of custodies and stipulates eligibility criteria for custodians assuming the role of custodians. (MPFA, 2007)

Custody is discussed in section 2.2 and in appendix 1. It is recommended that the custodian be independent of the administrator and asset manager, that it may not entrust assets to a third party and that it must take on whistle blowing responsibilities. A World Bank paper puts forward some ways in which this responsibility might be given effect:

> Custodian institutions, acting as a depository for assets and guaranteeing the integrity of the fund is a central part of the financial regulation of pension funds. Custodians should report to the supervisory agency with the same frequency as managers, and data from the two sources should be cross-checked. Also, custodians should be informed of investment limits and be required to refuse any transaction that would violate these limits. (Demarco *et al*, 1998:15)

[82] Chilean regulations impose significant responsibilities on pension fund managers to attend shareholder meetings of the companies in which they have invested and they must vote in all agreements of these firms.

5.2 Investment classes

A crucial issue for consideration by the designers of the mandatory defined contribution system is how assets may be invested and whether limits should be applied to investment by ARIs in various asset classes. Regulation 28 currently specifies investment limitations for pension entities. Most commentators agree that review of this system is long overdue.[83]

There are good reasons to consider a different approach to investment limits in the mandatory system, for example,

- system participation is compulsory, increasing the importance of appropriate care of the accumulated savings of participants;
- clearly defined ranges for distinct products would make it easier for customers to make choices from among the available options and would add to their confidence in the reliability of the investment characteristics of these products; but,
- tight limits on asset allocation may lead to herding behaviour by managers and investment performance varying within narrow ranges, reducing the effectiveness of competitive forces and the extent to which participants can distinguish meaningful differences between providers; and,
- within a relatively short period of time, accumulated assets will be significant, so investment limits that are too restrictive may distort the distribution of assets through the economy.[84]

This section considers whether limits should be placed on the assets that the ARIs may invest member contributions into. It asks as well whether there are alternative ways to control the risks to which participants are exposed.

Lessons from abroad

> One of the most controversial aspects of pension fund regulation is the use of strict investment rules, not only in the newly created compulsory personal pension plans in Chile and other Latin American countries but also in many OECD countries, especially in continental Europe and Japan. The main criticism is directed at the prohibition of, or low limits on, investments in overseas assets. But the low limits on equities and the tendency to use pension funds as captive sources for financing government budgets or social investments, such as low cost housing and low interest mortgages, have also caused concern. (Vittas, 1998:22)

[83] Some would suggest that South Africa finds itself in a regulatory vacuum, suggesting that the long-awaited changes to Regulation 28 have been delayed by the need for a comprehensive review of exchange control policy. The ordering is probably correct. However, there are aspects of the investment limits on retirement funds which are not affected by foreign exchange policy but do require review. A 75% ceiling on equities may be appropriate for a defined benefit fund, but it is forces inappropriate constraints on the investments of the individual members to which it is now being applied.

[84] This is particularly relevant for government bonds. Policymakers find it difficult to resist the temptation to use the growing accumulation of assets in the mandatory system as a source of demand for debt issues. Sensible controls should be implemented from the beginning to protect against this possibility.

Vittas opens with this paragraph his survey of the types of approaches that might be used to restrain investment risk in pension arrangements. He points out that one of the main defences against inappropriate investment management is not a set of limits but a fiduciary responsibility. The prudent person approach is used in some OECD countries, mainly the Anglo-American instances, but is gaining acceptance in other developed countries. This approach permits fund managers to set their own investment guidelines and avoids, in Vittas's words (p 22), *"the pitfalls of government direction of funds and government interference with market processes and especially with financial innovation."*

Investment limits can be misused when government takes them too far. The potential for government interference in an otherwise private-sector system can have serious consequences:

- Prescribed investments in South Africa in the 1970s and 1980s substantially underperformed their free market counterparts.[85]
- Rofman (2003) lists thirteen actions by the Argentine government that undermined the security of members benefits including forced investment in government treasury bills and the suspension of new annuity contracts which forced workers to remain on a scheduled withdrawal program for two months. Aggregate investment in government debt had reached, at the time of his writing, 77.5% of the total portfolio, hardly a healthy situation considering that the Argentine government had already defaulted on part of its debt.[86]

Demarco *et al* (1998) set out four broad approaches used by regulators to restrict pension funds investments. These are limits:

- on **foreign exposure**, to avoid mismatching assets and liabilities, but also to stimulate investment in domestic markets,
- by **issuer**, to avoid concentration of investments,
- by **risk**, to avoid assets with poor ratings, and
- on **self-investment**, more precisely investment in assets issued by companies with a significant economic relationship with the managing company, to avoid conflicts of interest.

As discussed by Gustavo Demarco and his co-authors, all of these restrictions are difficult to police and require careful supervision.

Vittas (1998) points out that limits on risk are usually expressed as maximums or minimum in asset classes which is easier to comply with and police, but still subject to the creative use of alternative investments by providers. He suggests that investment class limits are much better expressed as maxima than as minima, protecting against inappropriate risk rather than forcing investment in certain

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[85] Real returns on "prescribed investments" in South Africa were -3.6% in the 1970s and -0.9% in the 1980s, compared with corresponding real returns on equities of 13.2% and 5.6% (World Bank, 1994, referring to Vittas, 1994). In the US, special investment stipulations for state and local workers decreased yields. (World Bank, 1994)

[86] Niemietz (forthcoming; b) suggests that this situation is exacerbated by poorly developed domestic markets. Whether the liberalisation should precede the development of capital markets or would stimulate just such a development is a complex subject for discussion that is probably not relevant to the well-developed South African environment. The two often go together.

asset classes, most commonly government-issued debt. He adds another class of restrictions, namely limits on borrowing and leverage.

Country survey

All of the reformed Latin American systems impose limits on asset allocation through ceilings.[87] Hong Kong imposes investment restrictions in three different ways (MPFA, 2007), through

- **quantitative investment limits**, which place explicit limits on investment in individual securities or assets classes, for example a minimum of 30% Hong Kong dollar content;
- **qualitative investment limits**, which restrict investment behaviour in other ways, for example imposing restrictions on borrowing and lending of securities and requiring investment of securities listed only on approved stock and futures exchanges; and,
- **a statement of investment policy**, which supports the limitations through a written policy, bringing into play the prudent person approach that underpins the trust-based foundations of the Hong Kong Mandatory Provident Fund system.[88]

A few Latin American systems impose floors as well as ceilings. These are more dangerous as they are more likely to produce distortions to market mechanisms and substandard investment returns to the members. Costa Rican funds must invest at least 15% in mortgage securities, presumably to stimulate the housing market, but they must also provide an investment return no less than that of the mandatory pension system. In Uruguay, pension funds must invest between 40% and 60% of assets in government securities. At least 51% of pension fund assets in Mexico must be invested in index-linked securities (Gill *et al*, 2003, figures as at the end of 2002).[89]

High levels of investment in government bonds in Latin America (see the table below) are partly due to regulatory policy, but also due to the absence of credible alternatives. As Gill *et al* (2003) point out (in agreement with Niemietz, see footnote 86), liberalisation of these limits need to be accompanied by modernization of the financial market infrastructure and regulatory reform within the financial sector.

Detailed consideration of possible quantitative investment limitations should include the OECD (2006b) summary of the restrictions in existence across member countries.

South Africa cannot afford to be complacent in this regard, but it has a financial sector with good diversification of investment types and a sound regulatory framework. This suggests that the primary consideration around investment limits should be a focus on protecting participants against inappropriate risks and conflicts of interest.

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[87] As at the end of 2002, for example, Argentine funds could invest no more than 80% of assets in government securities, 30% directly in financial institutions, 70% in listed shares, 40% in corporate bonds, 30% in investments funds and 20% offshore. It should be noted that most countries are gradually liberalising their investment limitations. In 2001, Peru first permitted investment in offshore assets (Gill et al, 2003).

[88] Investment limitations do not preclude the use of prudent person principles.

[89] This applies only to SIEFORE Básica 1, the fund designed for above 56 years of age. The portfolio risk of this fund is also subject to a risk threshold, with a 1-day value at risk limit of 0.60% (CONSAR, 2007). Risk-based limits are

Table 4. Investment mix of Latin American pension funds, December 2002

%	Government securities	Financial institutions	Corporate bonds	Equities	Investment funds	Foreign securities	Other
Argentina	76.7	2.6	1.1	6.5	1.8	8.9	2.4
Bolivia	69.1	14.7	13.4	-	-	1.3	1.5
Chile	30.0	34.2	7.2	9.9	2.5	16.2	0.1
Colombia	49.4	26.6	16.6	2.9	-	4.5	-
Costa Rica	90.1	5.3	4.6	-	-	-	-
El Salvador	84.7	14.4	0.5	0.5	-	-	-
Mexico	83.1	2.1	14.8	-	-	-	-
Peru	13.0	33.2	13.1	31.2	0.8	7.2	1.6
Uruguay	55.5	39.6	4.3	-	-	-	0.5

Source: Gill et al (2003:51) from national and umbrella organizations.

Note: information for Colombia refers only to the mandatory system. Empty cells represent zero allocation.

Offshore investment

South Africans have for decades been strongly conscious of the restrictions placed on the free movement of capital out of the country. This is a contentious subject often more emotional than logical. Any discussion of the potential for higher (or lower) limits on investment offshore of assets under the accredited system must properly allow for current policy of gradual liberalisation of exchange controls.

What many may not realise is that restrictions on offshore investment are not rare and exist even among developed countries (figures from OECD, 2006b).

- **Slovakia** requires that at least 30% of pension assets much be invested in local securities.
- **Mexico** imposes a limit on foreign assets of 20%.
- Personal pensions in **South Korea** have foreign assets limited to 20% of the value of the fund.
- **Germany** imposes asset limits specific to investment classes, for example no more than 10% of assets in non-European Union equity and no more than 10% in non-European Union bonds.
- **Switzerland** requires that no more than 30% of assets are invested out of the country.

Advantages and disadvantages of offshore investment limits

The World Bank (1994, page 192) provides an excellent summary of some of the pertinent issues around regulated limits on offshore investment. It suggests that the most common reasons for restricting investment offshore are:

- general capital account restrictions,
- a philosophical belief that savings belong to the home country and should be invested there, and

growing in prevalence and can be designed to address the core of the issue – managers investing in a way that introduces inappropriate risk – without bringing the distortions that conventional limitations are prone to introducing.

- fear that incomplete information about foreign markets would results in poor decision and poor investment returns.

To this could be added two further motivations for restricting offshore investment:

- member liabilities, that is their post-retirement financial commitments and aspirations, are largely in South African rand and it is inappropriate to expose them to currency risk through offshore investment above a level sufficient to diversify the portfolio,[90] and
- investing member contributions in local projects could be seen as being in the best interests of members because it stimulate benefit to them outside of the financial returns gained from the investments.

The World Bank contrasts this with the following advantages of offshore investment:

- it reduces exposure to the country-specific risk of the home country, offering protection against local risk of inflation, for example, and
- it offers the potential for higher investment returns through access to booming economies,

To this could also be added the argument that offshore investment expands opportunities for diversification by providing opportunities to invest in industries not available in the home country, like mining, for a country that has poor natural resources, or technology shares, for a country with poor infrastructural development.

The strongest concern with such limitations is that a capital restriction is effectively a tax that affects the poor more that the rich:

> Any restriction on capital is like a tax. The rich can often avoid the tax by evading capital controls, while middle- and low-income residents with a substantial share of their savings tied up in funded pension plans bear the full brunt of financial repression. Only if part of their funds are [sic] invested overseas are they protected from an increase in financial repression at home. Pension reserves that are confined to domestic markets can be eroded gradually, through modestly negative real rates of return, or more suddenly, through forced shouldering of losses elsewhere in the economy, as, for example, when governments pass large banking system or state enterprise losses on to the pension fund, leaving it insolvent. (World Bank, 1994:192)

Examples of systems badly affected by investment restrictions (to asset classes, not just to offshore investment) are provided by the Zambian National Provident Fund (Bailey *et al*, 1997), which suffered negative real returns for many years, and the Argentine individual account system, required at a critical time to invest in shaky government debt (Rofman, 2003). Both of these systems would have benefited from greater investment outside of their respective local markets.

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[90] Three further points should be made in this regard. First, member liabilities are not all rand-denominated, but it is only the wealthier members of the system who have aspirations to live outside of South Africa in their retirement, or travel widely, so meeting this objective is not a high priority of the policymaker. Second, from a risk-return management perspective, some international diversification is optimal in any case, even with liabilities all in rands, because the diversification outweighs the mismatching, to a point. Third, there are ways to gain exposure to foreign countries through local investment, gaining access to international diversification without investing offshore.

Despite these examples and many others, fears concerning the danger of concentrated local investment are probably mis-placed in South Africa. This country has a strong, diversified domestic market, and it has already shown a strong commitment to liberalising offshore investment limitations, recognising the need to do so in order to retain significant inflows. This supports the World Bank view which follows on from the earlier quotation:

> Governments can minimise the loss [of capital outflows] by improving the conditions for domestic financial markets and easing capital controls more generally. Easy capital outflow helps stimulate capital inflows, because a prime concern of international investors is to be able to get out of a market quickly when the need arises. (World Bank, 1994:192)

South Africa's policymakers are aware of these issues.

Offshore investment: concluding comments

> Allowing pension funds to diversify contributes to the credibility of domestic stabilization policies and is an easily controllable way to begin a wider process of opening up the domestic economy to become part of the global economy. (World Bank, 1994:192)

It is submitted that:

- strongly constrained offshore investment is inappropriate, as it concentrates the risk of investment in the local economy, potentially reducing returns as well as increasing risk,
- this is exacerbated if the size of investable funds becomes sufficiently large to introduce distortions to the supply-demand dynamic in local markets, as it has the potential to do over time,
- the issue of whether and how to liberalise existing constraints on offshore investment forms part of a debate that has implications well beyond that of the pension system, though that debate must consider explicitly the impact of its conclusions on pension fund members, and that
- the existing maximum applying to occupational pension funds of 15% offshore, with gradual liberalisation anticipated, is broadly appropriate to the mandatory opt out system as well, subject to review from time to time.

Passive management

Passive investment management refers to the practice of tracking an index that represents a basket of shares, rather than attempting to improve returns by taking short-term decisions on the shares most likely to outperform the index.

The strategy tends to be under-represented in the publicity produced by the asset management industry because it is cheaper and produces lower levels of profit than its counterpart, active investment management. Also, since performance quite closely tracks the index, this strategy does not result in the headline-grabbing returns that tend to find their way into the marketing material of the active managers.

> Fees and charges on assets have a significant impact on terminal accumulations and are thus of special interest to policymakers. We can achieve lower fees and charges through… (d) passive asset allocation strategies where PFMs do not incur the excessive transaction costs of active funds management and instead track a pre-specified index. Passive funds management also enables

> policymakers, regulators and customers to assess and benchmark the performance of PFMs against the underlying market index. (IIEF, 2004:21)

This quotation is from a discussion of the framework of the proposed Indian mandatory retirement savings system. The proposal is to permit only passive management for all domestic and offshore equity investments.[91] The document leaves open the possibility that, sometime in the future, the regulator may permit some level of active investment management of equities.

The Turner enquiry into the UK pension system (UK Pension Commission, 2005) does not envisage forced investment in passive investment strategies, but recognises that there is a high potential for this to occur given the proposed charge limit of 0.30% of assets per year. The report expresses concern that high levels of investment in index-linked approaches could theoretically have an impact on the effectiveness of capital markets[92] but through its modelling of the development of the system, comes to the conclusion that it is unlikely to be large enough at any stage to impact adversely the operation of the markets.

A case exists for forcing investment in passive investment strategies, on the basis that the marketplace within which the choice of active or passive is made does not operate effectively. The rationale for such a line of argument is acknowledged, but it is suggested also that the main consequence of the inappropriate promotion of active investment strategies over their passive counterparts is higher charges. Through the establishment of a charge ceiling to the accreditation system, providers will be forced to consider passive investment options for a considerable portion of portfolios or provide access to very cost-effective active asset management.[93]

It is submitted that there is no need to require ARIs to allocate a stipulated proportion of assets to index-linked vehicles.

5.3 Minimum investment returns

A number of governments provide some form of guarantee to the participants of mandatory retirement systems. Sometimes these are explicit and sometimes implied.

Chile provides a guarantee to all citizens that have contributed to the individual account systems for twenty years or more, which provides a minimum benefit in the event that the mandatory contributions accumulate insufficient to provide an income in line with this minimum.[94] Participants in **Mexico** choose at retirement to take the accrued benefits from the PAYG system or the accumulated fund in the second

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[91] *Active management of government and corporate bonds is to be permitted only where no standard benchmarks for the asset classes exist.*

[92] *The theory, untested in practice, is that high levels of investment in passives strategies would reduce the pool of players competing in the active investment environment, potentially increasing price volatility and distorting the effectiveness of the market operation.*

[93] *Discussion at the end of section 4.4 addresses the concern that encouraging too much investment in passive vehicles would damage the operation of the market through increasing price volatility.*

[94] *The government also steps in where the provider is liquidated or where application of the income drawdown formula after retirement results in erosion of income to below the level of the minimum.*

pillar, whichever pays a better benefit, so the first pillar system acts as a safety net (Grandolini & Cerda, 1998). Support is no more than structural in **Argentina** where participants must contribute to both the PAYG system and the mandatory counterpart, providing diversification of risks, unlike in Chile where the individual account system is the only pillar to which participants must contribute.

Government guarantees are valuable to system participants, but they are not without risk. They may introduce moral hazard, for example, participants and providers taking less care to safeguard the investments of the pension funds because of the protection offer by the government. In addition to this protection of the government underpin, **Chile** and many other **Latin American countries**, but **not Mexico** (Vittas, 1998) require pension funds to meet relative return guarantees.

In Chile, for example, the annualised real yield for each fund:

- must not lag the average for funds of that type[95] by more than a specified number of percentage points, and
- must not fall below half of the corresponding average for funds of that type.

In the event that the yield does fall below either of these thresholds, the administrator of the fund must draw on its own yield fluctuation reserve and then on the obligatory capital reserve. If available funds are still insufficient to meet these minimum, then the state makes up the difference and institutes liquidation proceedings against the administrator.

Similar arrangements are present in most Latin American systems, providing real returns above a certain level, benchmarked to peers. The consequences of failing to meet the specified performance benchmarks, together with rather tight limitations on investment classes, has resulted in a herding of investment patterns and tight bunching of performance.

While guarantees expressed in relative terms are the norm in Latin America, participants in other countries are protected by absolute guarantees. **Switzerland** imposes a minimum return on mandatory occupational arrangements of 4% a year,[96] which tends to distort and complicate the asset management practices of funds. **Singapore** also has a guaranteed nominal return, 2.5% at the time of writing by Vittas (1998).

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[95] See section 5.4 for a description of the five classes of funds in Chile.

[96] The figure of 4% is reported by Vittas (1998), but note that the minimum rate of return is modified by the authorities from time to time. It was reduced from 4% to 3.25% in January 2003 and reduced again a year later to 2.25%. In the second half of 2004 the rate was raised to 2.5% (Investment & Pensions Europe, 1 September 2004, www.ipe.com). Similar dynamics exist in the German occupational funds market.

Problems with investment guarantees

> Investment limits, minimum profitability rules [investment guarantees] and state guarantees raise many controversial issues in pension fund regulation. On the one hand, there is a need to protect workers from imprudent behaviour by asset managers. But on the other hand, such rules tend to give rise to moral hazard, to stifle financial innovation and competition, and to constrain investment efficiency. (Vittas, 1998:22)

Minimum investment return rules imposed on providers can introduce a number of distortions:

- **Capital cost**. Guarantees are expensive. They require providers to set aside capital to protect themselves against the event of poor investment conditions.[97] Sometimes this forms part of an explicit regulatory rule, for example, in Chile, where capital equal to 1% of the value of the assets must be set aside to protect against the event of poor market returns.
- **Herding**. Guarantees encourage conservative investment behaviour. This is not only because of the cost of topping up returns in a year in which investment performance lags the guarantee level, but because of the consequent damage to market credibility. Constraints on the freedom of asset managers to exercise their best views on investment opportunities reduce the potential for them to deliver high investment returns and may reduce the extent to which participants are able to distinguish 'good' managers from their weaker counterparts.
- **Distorts investment behaviour**. The existence of investment guarantees can adversely impact the investing strategy of providers. At most times, providers will be inclined to err on the conservative side in order to meet the requirements.[98] But towards the end of a measurement period in which performance up to that point lags the guarantee, managers have an incentive to increase the risk that they take to avoid the consequences of missing the hurdle rate. This type of behaviour is seldom in the interest of the fund member.
- **Undermines private sector provision**. An environment in which the authorities permit private sector managers to provide services but limit their ability to compete effectively, particularly with the additional support of a government guarantee, undermines the rationale for private sector provision. This potentially damages the basis on which the private sector is involved in pension provision and can even impact the effective operation of the unconstrained market for voluntary savings.

The argument against investment guarantees is supported by the observation that they usually exist in the thin, unsophisticated markets of reformed Latin American systems. This is not true. While investment guarantees are not common on developed Anglo-Saxon markets, it has been shown already that they play a substantial role in the developed German-speaking countries of central Europe. Furthermore, while Latin American regulators have shown a willingness to liberalise constraints in many

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[97] *South Africa is familiar with this environment, though participants are not as clear as they should be regarding the cost of these guarantees. The so called 'guaranteed' or 'smoothed bonus' products require the payment of an annual fee (often not disclosed) to shareholders to compensate them for the provision of the guarantee. The structured products that have emerged more recently, underpinned by derivative investment instruments, are opaque, involving significant explicit or implicit cost to meet the cost of the guarantee.*

[98] *The requirements must be pitched below the expected average, otherwise they would trigger top-up payments more often than not, making it impossible to build up the reserve fund which feeds these occasional top-ups.*

respects, for example, by de-regulating asset allocation limitations, they have not removed the requirement that providers meet investment guarantees: Chile provides the outstanding example.

Concluding comments

All things considered, the disadvantages of investment guarantees outweigh the benefits. The cost of guarantees can be high – and providers are likely to take a conservative approach to this costing – and the potential for market distortions and inappropriate investment behaviour significant. The existence of product classes and asset limitations separately for each of these classes (see section 5.4), together with very strict disclosure requirements, provides sufficient protection for system participants without risking the distortions that can have a meaningful downward impact on investment performance.

Within the asset allocation constraints set for each of the available fund types, providers may seek to differentiate themselves on the basis of the investment strategy adopted. This is acceptable as long as they do not make spurious claims like suggesting that more aggressive strategies produce higher return, without pointing out that they expose members to higher risks at the same time. The importance of sound disclosure requirements cannot be overstated.

5.4 Investment choice

> … choice is important in retirement-income provision because people differ in their characteristics and their preferences, and both of these changes over the life-course. Flexibility and choice allow people to adjust retirement savings to match their age, expected career earnings path, expected retirement age and their attitudes to risk. … But there are also important counter-arguments to portfolio choice: principally, the cost and complexity. Dividing individual pension contributions between different funds (even when they are offered by the same manager) and transferring investments between funds on members' request can add significantly to the administrative burden. Providing information on different investment options and educating workers about investment choice might also be costly. There is also the risk that workers make the "wrong" choices. (OECD Social Policy Division, 2006: 2 & 3)

Should workers be permitted to spread their accumulated retirement assets across a number of different funds? If they are, can they allocate across different fund managers?

Flexibility and cost are almost inextricably linked. It is difficult to think of an environment in which improved levels of choice do not lead, ultimately, to higher system charges. But charges should not be the only guide of how much choice to offer participants. The benefits of the choice, for example, higher investment returns through investing in more appropriate assets, could outweigh these costs if the range of choices is carefully managed in the system design.

This subject is linked to many others discussed in this paper but raises a few additional considerations that are discussed below.

Multiple funds: limited choice

The Chilean authorities initially decided not to permit workers to invest contributions in more than one fund. Among the most controversial of the investment limitations imposed on members in the initial years of the system was that each worker could have only one account and each management company only one fund. This restriction was imposed to simplify the workers' choice of pension fund manager and the corresponding choice to switch to another (World Bank, 1994:220). This approach not only reduces complexity, it also simplifies compliance monitoring.

However, it introduces a number of disadvantages as well.

> Allowing workers to have accounts with more than one company would let them hedge their bets and reduce their dependence on the performance of a single company. And allowing management companies to operate a wider range of funds would let them develop expertise in market niches and tailor products to different tastes and age groups. … The one-account, one-fund rule reduces variety, choice, and diversification–three potential advantages of a decentralized system. (World Bank, 1994:220)

Consistent with gradual deregulation in a number of areas, Chile has modified its original position and now permits multiple accounts within constraints. Initially each administrator was permitted to make available only one other fund and entry to this fund was limited to members in receipt of pension or with 10 years or less to go to the legal age of retirement.

Significant change was introduced in August 2002. Each administrator now makes available five different funds, labelled A to E, which have different sets of investment limitations to ensure that they have investing characteristics suitable to their purpose (see Table 2). Funds B to E must be established by every administrator, which may choose whether to make available Fund A as well.

Table 5. Chile: maximum and minimum limits in equities, per fund.

	Maximum	Minimum
Fund A	80%	40%
Fund B	60%	25%
Fund C	40%	15%
Fund D	20%	5%
Fund E	0%	0%

Source: SPFA (2003:176)

The Chilean regulator (SPFA, 2003) lists a number of advantages of the so-called *multifund* approach:

- **Expected value of pension**. Investment in assets with a risk-yield combination consistent with the planning horizon of the individual saver permits an increase in the overall expected value of the pension.
- **Preferences and needs**. The system allows members to invest in a way that is more consistent with personal preference or financial circumstances.

- **Incentives to seek information**. The improved motivation to members to obtain details on the performance of funds should impose greater discipline on the administrators.
- **Improvement in service**. More funds leads to more personalised service from administrators to members.
- **Member participation**. Members feel more involved in their pension saving because they have the opportunity to select their funds.
- **Better allocation of resources**. Higher investment specialisation should lead to increased levels of efficiency regarding how resources are allocated to the economy.

The choice of funds is constrained:

- Pensioners may choose only from one of the three least risky funds, funds C, D or E.
- Older members may add to this fund B, but not invest contributions or fund balances into fund A.
- Default fund assignments are made according to age, B forming the default for members up to age 35, C from that age to 10 years before retirement and D thereafter.

The system is not perfect.[99] But it represents a significant improvement to the one-fund approach that preceded it. There are other examples of similar systems. In Estonia, Latvia and Slovakia, pension fund administrators offer three investment alternatives. Again, regulations specify the maximum exposure to equities in each of the alternatives, though the limits applied vary considerably from country to country (Tapia & Yermo, 2006).[100] Mexico and Peru have recently introduced investment choice in their mandatory individual account system. All providers in Mexico, for example, must make two funds available to their participants.

Multiple funds: unlimited choice

Chile provides an example of a paternalistic environment with gradual liberalisation of constraints. At the other extreme are countries that do not limit the investment of mandatory retirement savings in any way.

Sweden offers a very wide choice of funds to participants. Starting out with over 450 funds, by the end of 2005, some 725 funds were available for investment of mandatory contributions (SSIA, 2006). Individuals may invest in a maximum of five funds and switching frequency is unrestricted (Tapia & Yermo, 2006).

Participants in Australia also face a large array of investment funds. According to the June 2005 statistics of the Australian Prudential Regulation Authority, 597 entities in Australia offer investment choice (Tapia & Yermo, 2006), with many retail funds offering more than 60 options. This is similar in many ways to its voluntary counterpart in the United States, the so-called *401(k) system*, under which

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[99] *Modelling shows that the very conservative limits applying to Fund E are sub-optimal and that a small level of equity investment would represent an improvement except in cases in immunity to annuity risk is needed.*

[100] *In the most aggressive fund, the maximum investment in equities is 30% in Latvia, 50% in Estonia and 80% in Slovakia. A number of reasons for these differences are possible, for example the regulators' attitudes to risk and the depth and volatility of the local equity markets, but possibly also a desire to establish demand for government-issued debt.*

investment choice is virtually unrestricted but participation rates are not particularly high (Munnell *et al*, 2002, 2005).

The proportions of members actually exercising a choice is low, both in the systems offering very wide choice, such as Sweden, and in those with limited options, as in Chile. This makes the policy decision on the default fund extremely important.[101] Systems that offer extremely wide choice thus introduce cost that may not benefit all participants. Economies of scale are much lower, regulation can be more expensive and the potential for inappropriate provider behaviour may be greater in an environment in which there is "more room to hide", though any success is likely to attract attention.

Research also shows that the wider the range of options, the more difficult it is to make a choice, the lower the confidence of the participant in the choice made and the greater the probability that no choice will be made at all (UK Pension Commission, 2005 & Iyengar *et al*, 2003).

The Turner Commission in the United Kingdom (UK Pension Commission, 2005) shares the view that unlimited investment choice is inappropriate in a mandatory system, or even the quasi-mandatory auto-enrol system recommended by that study. Referring to the Swedish system, the Commission states,

> It is not the best way to minimize costs. While fund management charges are not the most important consideration in cost control… their minimisation via economy of scale purchase can still make a significant difference to the Annual Management Charge. (UK Pension Commission, 2005:373)

The Commission recommends that the central fund, the National Pension Savings Scheme, negotiates fund mandates at very low fees covering a limited number of funds – it suggests six to ten – in the expectation of high volumes. It leaves open the possibility that other funds might be made available at non-negotiated fees, creating some choice and addressing the potential for criticism to be levelled at the range of funds available in the negotiated pool, perhaps not addressing the narrow needs of specific interest groups.

Switching

The flexibility for members to switch between providers is considered in section 4.2, but not in the context of multiple funds. The main danger of a liberal set of switching rules is that it stimulates providers to inappropriately expensive practices to attract members from their competitors, potentially introducing substantial cost into the system. The secondary danger of switching between the portfolios of a provider – this might be referred to as internal switching – is more about the inefficiency of the pursuit of short-term returns than about the introduction of systemic market cost.

Evidence from other countries suggest that this internal switching is relatively infrequent (Tapia & Yermo, 2006), suggesting that there should not be a great need for regulatory intervention. Regulators themselves take a wide variety of approaches to the issue (Rozinka & Tapia, 2005), some imposing no limits (for example, Mexico) and some setting a limit to the frequency of switches (Estonia, once a year,

[101] The default in the Swedish system is given by the most recent choice of fund (Settergren, 2001), not necessarily the best for the member at the time.

Chile twice and Peru four times). Some permit trustees some discretion to set limits (Australia, Hungary and Italy) and others have no limits at all (Mexico and the Slovak Republic).

It is suggested that it would be inappropriate for the authorities to allow unlimited internal switching in a mandatory saving environment. The evidence suggests that market-timing is generally not profitable and that frequent short-term switching is not needed in the context of a pension saving environment in which changes to needs should be largely anticipated by participants. It is recommended that internal switches be permitted no more frequently than one a year.

Default funds

Any system design needs to cater for default allocation, the steps taken when members fail to exercise a choice. This is particularly important in an environment of multiple funds.

The most logical choice would appear to be that followed by Chile, in which the range of funds is limited to five and the default is based on the term to retirement. The younger the member, the greater the investment risk of the default fund, on the basis that this provides the optimal expected risk-return combination. The approach is not perfect and has been questioned by some, but it is simple to apply, broadly appropriate to the needs of most participants and hard to improve on in a way that gives a better outcome to all members.

Application to South Africa

Limited choice or none at all is usually justified on the basis of poorly developed capital markets or a member profile ill-equipped to exercise effective choices. The South African investment environment and capital markets have the sophistication to manage at least a low level of choice.

However, an unlimited range of investments like those available to savers in the mandatory systems of Australia and Sweden or the voluntary counterpart in the United States is not advocated. Greater care needs to be taken to ensure that the assets in these systems are properly protected from uninformed choices, even poor or biased advice. The burden on the authorities to support such a complex environment with appropriate levels of consumer education and on the supervisor to contain the development of innovative alternatives not designed in the best interests of the customer is considered too great for a system like this at its launch.

So a limited range of investment options is regarded as appropriate at launch. Expansion of the set of investment choices could be considered thereafter. Liberalisation of the system may be in the best interests of participants as their knowledge increases and economies of scale permit greater variety of more effective competition. Perhaps the key question is whether the South African saver has the wherewithal to invest sensibly in such a system.[102]

[102] An alternative to the policy alternatives of one-fund-only and limited multiple funds is the possibility of applying the one-fund restriction to either the accumulated fund or the current contributions but not both. This approach appears attractive because it constrains the possibility for the member to damage their retirement prospects through poor

The recently introduced multi-fund approach in Chile is supported. It is recommended that ARIs, including the public-sector provider, be required to make available five funds distinguishable according to the inherent risk in each strategy. Narrower bands than those permitted in Chile are recommended, establishing more soundly the investment characteristics of each of the funds. These bands are indicated in the table below. The view that Chile's Fund E is too conservative, sub-optimal against the alternative that permits a small proportion of equity investment, is supported.

Table 6. Recommended maximum and minimum limits in equities, per fund.

	Maximum	Minimum
Fund A	80%	50%
Fund B	60%	35%
Fund C	45%	25%
Fund D	30%	10%
Fund E	15%	0%

Source: Author's recommendation

Limitations on other asset classes should be considered with care. A minimum investment in any asset class has the potential to introduce distortions, but some way should be found to encourage or force investment in asset classes that retain their capital values in real terms, such as inflation-linked bonds, for at least one of the more conservative funds. More sophisticated limitations, such as those involving a value at risk, may be considered as well, as is the case in Mexico.

A minimum investment allocation to any classes of investment is not supported, government bonds, black economic empowerment and socially responsible investment included. However, initiatives are currently in place or being discussed that put various forms of incentives in place to invest in ventures that are in the public interest, so-called socially responsible investments. They initiatives should be continued, allowing trustees to evaluate the alternatives in the best interest of their participants.

Asset limitations that control risk and address conflicts of interest are supported. Examples of these are restrictions on the level of investment in:

- risky asset classes, such as unlisted equities or derivative instruments,
- single assets, such as debt issued by a single issuer,
- the parent company of the ARI or a member of the group to which the ARI belongs.

Drafting of the principles behind the limitations is recommended, to aid the regulatory authority, which almost invariably finds itself approached by those involved in product development to obtain some indication of the appropriateness of a proposed investment strategy, usually innovative in nature and often running close to the investment limitations.[103] The principles may also cover more complex

choices, but it produces results that are seldom optimal. It is very rare that investing the accumulated fund in one way and incoming contributions in another is the best way to optimise the risk-return problem.

[103] Some derivative strategies are protective, reducing overall risk or exposure to asset classes, while others are aggressive, employing leverage in an effort to improve returns but increasing risk at the same time. The former may be appropriate, the latter not. If the rules merely state that the allocation to derivatives must be limited, appropriate

aspects of investment restrictions, potentially introducing risk-based supervision like value-at-risk limitations.[104]

Since it is difficult to prevent these types of approaches, the author recommends supporting the process with the appointment of an individual or department responsible for approving and monitoring the investment strategies of the ARIs. As for all other aspects of the management of these firms, regular information provision to the regulatory authority would be mandatory and sanctions would be imposed in the event of non-compliance.

Offshore investment limitations consistent with those established as part of a coherent national approach to exchange rate and capital markets risk are supported. The author urges that this policy takes properly into account the interests of the members of the mandatory defined contribution system and institutes modifications that are applicable to this environment, where such modifications may be appropriate, but recommends that some protection against the possibility of political manipulation is instituted prior to the launch of the system.

strategies employing derivative just above the limit would be barred and inappropriate alternatives employing derivates just below the limit would be allowed. The principles behind the rules, while introducing some complexity, would assist the regulator and providers to determine what types of approaches are appropriate to fund participants, removing the potential for compliant but dangerous practices.

[104] These are being considered by a number of regulators and are currently in place in the more conservative of the two funds that each provider must put in place in Mexico. Refer to footnote 89.

6 CONCLUDING COMMENTS

Defining the structure of a national old age system is extremely complex.

- A range of objectives must be identified and prioritised.
- Design alternatives must be considered with an objective determination of the extent to which each of these might meet the objectives.
- The financial implications of the alternatives must be assessed with care across a range of unknowns, two or three generations into the future, taking into account as far as possible the broader economic impacts of each of the alternatives.
- Second- and third-order implications must be considered, influences on the operation of labour markets, for example, and the cost of doing business.
- Optimal regulatory and operational systems must be designed and implemented.
- Communication to citizens must be planned and executed in a way that maximises confidence in the system and in all of the entities that form part of it.

This paper forms a contribution to this definition, but only a small one. It considers how private sector providers, a crucial cog in the retirement provision engine, might be brought into the system in a manner that aligns their interests with those of the customers that they serve.

Because private-sector provision is only an element of the broader system, the paper touches on a number of issues that require fuller treatment elsewhere. The design of death and disability benefits is an example of one of these issues. It is identified in this paper as affecting the parameters of private-sector provision but it is a subject too complex for full treatment within the scope of this paper. It is hoped that the discussion stimulated by this document proves fruitful for the further development of this very important subject.

The author and sponsor of this paper welcome full and frank criticism of its content in the interests of all South Africans.

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APPENDIX 1 GOVERNANCE PRINCIPLES

> Pension plan governance is about delivering on the pension promise consistent with the pension plan documents and pension legislation. (CAPSA, 2004:3)

Around the world, supervisors and industry participants are growing in their awareness of the importance of sound governance structures in pension systems, particularly as private pension provision grows in significance. This section summarizes two sets of governance principles, one from a multi-country organization, and one from an umbrella body of provincial supervisors.

The Organisation for Economic Co-operation and Development (OECD) has a research and policy unit, focusing on private pensions, that has put significant effort into understanding what constitutes effective governance of private sector pension arrangements, culminating in a set of governance principles (OECD, 2005).

The Canadian Association of Pension Supervisory Authorities (CAPSA) has also put substantial effort into developing a set of principles that could be used by regulators and industry players to establish a sound structure of governance. CAPSA put out a discussion document in 2001 with thirteen principles (CAPSA, 2001) and a subsequent set of guidelines that summarized these into eleven (CAPSA, 2004). The summary below lays emphasis on the second of these, drawing where relevant on some of the material of the first.

In both cases, space does not permit the reproduction of the original documents. What follows is a paraphrased summary of each.

OECD principles of governance

> The Council… recommends that Member Countries invite public authorities and pension entities to ensure an adequate and efficient governance framework for pension funds, having regard to the contents of the Annex to this Recommendation of which it forms an integral part; invites Member Countries to disseminate these guidelines among pension funds; [and] invites non Member economies to disseminate these guidelines among pension funds. (OECD, 2005:6)

South Africa has recently been granted observer status of the pensions unit of the OECD, increasing the seriousness with which it should take the OECD governance guidelines. These guidelines are summarized as follows (excerpts quoted in *italics*; comments in standard text):

Governance structure: *The governance structure should ensure an appropriate division of operational and oversight responsibilities, and the accountability and suitability of those with such responsibilities.*

1. ***Identification of responsibilities****. There should be a clear identification and assignment of operational and oversight responsibilities in the governance of a pension fund.* The notes supporting the governance principles suggest that the primary objectives, the operational functions and the roles of all parties to the fund should be clearly documented. This goes almost without saying and should be the cornerstone of every fiduciary organisation.

2. ***Governing body**. Every pension fund should have a governing body vested with the power to administer the pension fund and who is ultimately responsible for ensuring the adherence to the terms of the arrangement and the protection of the best interest of plan members and beneficiaries. The responsibilities of the governing body should be consistent with the overriding objective of a pension fund which is to serve as a secure source of retirement income. The governing body should not be able to completely absolve itself of its responsibilities by delegating certain functions to external service providers.* The governing body, most often a Board of Trustees in the South African legislative framework, should in fact not be able to absolve itself of any of its responsibility through outsourcing, bearing in mind its primary responsibility to the members of the fund.

3. ***Expert advice.** Where it lacks sufficient expertise to make fully informed decisions and fulfill its responsibilities the governing body could be required by the regulator to seek expert advice or appoint professionals to carry out certain functions.* While the governing body may not delegate responsibility and accountability, it must seek professional advice where it does not have the skills to carry out its responsibilities with competence.

4. ***Auditor.** An auditor, independent of the pension entity, the governing body, and the plan sponsor, should be appointed by the appropriate body or authority to carry out a periodic audit consistent with the needs of the arrangement.* The guidance goes on to suggest that the auditor have whistle-blowing responsibility, reporting facts that may have an adverse impact on the position of the fund first to the governing body and, if that body does not take appropriate actions, to the supervisor.

5. ***Actuary.** An actuary should be appointed by the governing body for all defined benefit plans financed via pension funds.* The actuary is also required to fulfill a whistle-blowing responsibility. The guidance is silent on whether actuaries should be required to assess defined contribution arrangements, suggesting that this is not a requirement. Concerns are expressed that requiring actuaries to assess such arrangements might add to the regulatory burden of these funds, but the author would be more supportive of such intervention in the case of the much larger entities mooted under the mandatory contributions environment. It is recommended that the governing body applies its mind to the question of actuarial oversight of the fund, bearing in mind its responsibility to its members so safeguard their financial interests.

6. ***Custodian.** Custody of the pension fund assets may be carried out by the pension entity, the financial institution that manages the pension fund, or by an independent custodian. If an independent custodian is appointed by the governing body to hold the pension fund assets and to ensure their safekeeping, the pension fund assets should be legally separated from those of the custodian. The custodian should not be able to absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safekeeping.* A different view to that of the OECD suggests that custody should always be independent of the pension entity.[105] It is recommended that the pension fund assets should be legally separated from those of the custodian and that the custodian may not entrust assets to a third party. The OECD goes on to suggest that the custodian may also play an external whistle blowing function. This view is supported.

7. ***Accountability.** The governing body should be accountable to the pension plan members and beneficiaries and the competent authorities. The governing body may also be accountable to the*

[105] The OECD alludes to this: "The appointment of an independent custodian is an effective way to safeguard the physical and legal integrity of the assets of a pension fund." (OECD, 2005:14, principle 6).

plan sponsor to an extent commensurate with its responsibility as benefit provider. In order to guarantee the accountability of the governing body, it should be legally liable for its actions.[106] The principle that the governing body be accountable to the members and authorities is completely supported.

8. ***Suitability.*** *The governing body should be subject to minimum suitability standards in order to ensure a high level of integrity and professionalism in the administration of the pension fund.* This principle is supported, consistent with well-established prudent person principles.

Governance Mechanisms: *Pension funds should have appropriate control, communication, and incentive mechanisms that encourage good decision making, proper and timely execution, transparency, and regular review and assessment.* The four principles that follow are concerned more with implementation of principles than with its structure. These are supported in entirety but it is noted that there are many ways to implement these principles and that participants should be striving to demonstrate that their approach is sound, perhaps better than the corresponding approach used by others. The OECD adds significantly to the framework through practical suggestions on implementation. The discussion in section 3.1 of this paper refers extensively to these proposals.

9. ***Internal controls.*** *There should be appropriate controls in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension entity's by-laws, statutes, contract, or trust instrument, or in documents associated with any of these, and that they comply with the law. Such controls should cover all basic organizational and administrative procedures; depending upon the scale and complexity of the plan, these controls will include performance assessment, compensation mechanisms, information systems and processes, and risk management procedures.*
10. ***Reporting.*** *Reporting channels between all the persons and entities involved in the administration of the pension fund should be established in order to ensure the effective and timely transmission of relevant and accurate information.*
11. ***Disclosure.*** *The governing body should disclose relevant information to all parties involved (notably pension plan members and beneficiaries, supervisory authorities, etc.) in a clear, accurate, and timely fashion.*
12. ***Redress.*** *Pension plan members and beneficiaries should be granted access to statutory redress mechanisms through at least the regulatory/supervisory authority or the courts that assure prompt redress.*

Very careful consideration should be given to the more detailed suggestions of the OECD provided in support of the four recommended governance mechanisms. These suggestions are quoted in full below (OECD, 2005:16 & 17, emphasis added for clarity):

> Mechanisms are needed to **assess regularly** the performance of the pension entity's internal staff as well as the external service providers (e.g. those providing consultancy, actuarial analysis, asset management, and other services for the pension entity). It is also good practice for the governing

[106] *The OECD goes on to suggest that the accountability of the governing body has a number of practical implications, including "… transparent selection mechanisms for the members of the governing body (including the possibility of appointments of representatives of plan members and beneficiaries through a fair selection system)…" (OECD, 2005:14)*

body to undertake self-analysis and for an independent, external person/organisations to undertake a review of the internal controls of the pension entity. Where the governing body consists of an executive and a supervisory board the latter may be assigned with the task of assessing the performance of the executive board.

Objective performance measures should be established for all the persons and entities involved in the administration of the pension fund. For example, appropriate benchmarks should be established for external asset managers. Performance should be regularly evaluated against the performance measures and results should be reported to the relevant decision maker, and, where appropriate, to the supervisory authority, and the pension fund members. The benchmarks should be reviewed regularly also to ensure their consistency with the pension fund objectives (e.g. the investment strategy).

Appropriate compensation can provide the right incentives for good performance. The establishment of a compensation committee and chairperson may optimise the process of evaluating the compensation of those responsible for the operation and oversight of the pension fund, such as asset managers, custodians, actuaries, as well as the members of the governing body.

The compensation policy of sales forces of pension plan providers may also warrant close scrutiny by the governing body, since these costs can reduce pension benefits significantly. There is a risk also that sales staff may not act in the best interest of plan members, offering products that are not suitable for certain individuals. The governing body should therefore ensure that the remuneration structure for sales staff does not create distorted incentives or and lead to ill-advised decisions by consumers.

Conflicts of interest situations should be identified and dealt with in a suitable manner. In certain cases, banning the concentration of functions in a single person or entity that would otherwise lead to a conflict of interests may be the preferred solution. In other cases, disclosure of the conflict of interest to the governing body may suffice, who should be required to monitor these cases closely.

Where the conflict involves a member of the governing body, the case should be reviewed and monitored by the members of it not conflicted. Where appropriate, the governing body may seek independent advice or guidance regarding the service or transaction. In the event of the governing body not being able to resolve a conflict of interest situation that may be judged by some of the members of the governing body as harmful to the interest of the plan members and beneficiaries, this should be reported to the supervisory authority, which will make a decision on whether they should be permitted, and if so under what conditions.

The governing body should also establish appropriate controls to prevent the improper use of **privileged or confidential information**. A code of conduct may be established, requiring employees to observe high standards of integrity, honesty, and fair dealing. Internal review mechanisms may be put in place to verify and sanction the compliance with the code of conduct.

An adequate **risk measurement/management system** and an effective internal audit should be also established. The risk management system should cover both investment and biometric risks. These control mechanisms form the basis of good business conduct, enhanced transparency, consistency as to management decisions, and for the protection of all stakeholders of the pension fund.

Finally, pension entities should have mechanisms to **assess the compliance with the law**. A compliance officer may be assigned to carry out this activity on a regular basis.

CAPSA governance guidelines

The notes below provide in *italics* the full content of the guidelines and in standard text some of the supporting material from CAPSA and additional comments. Supporting material from the corresponding Canadian discussion document (CAPSA, 2001) is also referred to.

1. ***Fiduciary responsibility.*** *The plan administrator has fiduciary and other responsibilities to plan members and beneficiaries. The plan administrator may also have fiduciary and other responsibilities to other stakeholders.* The 'plan administrator' is, in Canadian parlance, the body responsible for the governance of the pension plan, the equivalent of the 'governance body' in OECD nomenclature. Principle 3 of the equivalent draft governance guideline (CAPSA, 2001) makes it clear that the trustee body must fulfil its fiduciary responsibility to members and beneficiaries and *"… has a duty to act in good faith and in the best interests of the plan members and beneficiaries of the pension plan."*[107]
2. ***Governance objectives.*** *The plan administrator should establish governance objectives for the oversight, management, and administration of the plan.* Objectives should be written down and agreed by all parties to the fund at its establishing, marking down the framework for implementation to follow. They should also be made available to plan members and beneficiaries (CAPSA, 2001).
3. ***Roles and responsibilities.*** *The plan administrator should clearly describe and document the roles, responsibilities, and accountability of all participants in the pension plan governance process.* This echoes the OECD call for clear roles and the need for explicit documentation. CAPSA (2001) adds that there should be a procedure for the selection and succession planning of the members of the governing body and the senior management of the pension plan.
4. ***Performance measures.*** *The plan administrator should provide for the establishment of performance measures and for monitoring the performance of participants who have decision-making authority in the governance process.* As trustees have responsibility that can affect the members of the fund in far-reaching ways, their performance should be assessed against an objective set of standards.
5. ***Knowledge and skills.*** *The plan administrator, directly or with delegates, has a duty to apply the knowledge and skills needed to meet governance responsibilities.* This is complimented by the OECD suggestion that the entity referred to here as the plan administrator has an explicit responsibility to seek professional assistance where its skill set is lacking in any way. CAPSA (2001) adds that members of this group should be provided with appropriate training and undertake ongoing education.
6. ***Access to information.*** *The plan administrator and, as necessary, any delegates should have access to relevant, timely and accurate information.* The information should also be timely, unbiased and received directly from the originating source, even if it requires supporting documentation from advisors.

[107] *The Canadian draft document also makes it clear that, when employers or bargaining agents also assume duties of trust as part of the governing body, they must "… use discretion in a fair and impartial manner, and put the interests of plan members and beneficiaries above their own. Instances where conflicts may occur include the establishment of an investment policy, the payment by the sponsor of expenses directly out of the pension fund, ownership of surplus, plan mergers and conversions, and funding policy."*

7. ***Risk management.*** *The plan administrator should provide for the establishment of an internal control framework, commensurate with the plan's circumstance, which addresses the pension plan's risks.* This means that the trustees of a plan must carry out an assessment of the risks to which the pension fund is exposed and take steps to mitigate against these risks.
8. ***Oversight and compliance.*** *The plan administrator should provide for the establishment of appropriate mechanisms to oversee and ensure compliance with the legislative requirements and pension plan documents and administrative policies.* How this is achieved is usually up to the company in question, an example of governance execution in practice.
9. ***Transparency and accountability.*** *The plan administrator should provide for the communication of the governance process to plan members, beneficiaries and other stakeholders to facilitate transparency and accountability.* This should be a documented plan.
10. ***Code of conduct and conflict of interest.*** *The plan administrator should provide for the establishment of a code of conduct and a policy to address conflicts of interest.* This is another example of practical implementation of governance principles.[108]
11. ***Governance review.*** *The plan administrator should conduct a regular review of its plan governance.* The way in which governance structures are implemented in practice needs to be reviewed from time to time in response to changes to guidelines or market structure and practice. Governance standards cannot be considered a set of static benchmarks that never change. CAPSA (2001) suggests that the policy should be reviewed to ensure that the objectives of the policy plan are effectively pursued, adding, *"… best practice for self-assessment reporting would require the governing body to periodically report to pension plan members, beneficiaries, employer(s) and bargaining agent(s)."*

Good governance is not easy. Sound principles provide a foundation, but governance in practice involves a constant assessment of the effectiveness of the manner in which these principles find their practical implementation.

> Good pension plan governance is essential for meeting fiduciary and other obligations; minimizes risks and maximizes efficiency; promotes accurate, timely and cost-effective delivery of pension benefits; promotes consistent administration of the plan in the best interests of plan members and beneficiaries; requires control mechanisms that encourage good decision-making, proper and efficient practices, clear accountability, and regular review and evaluation; and contributes to positive pension plan performance and demonstrates due diligence on the part of the plan administrator. (CAPSA, 2004:3, formatting modified for clarity)

[108] *The Canadian draft principles address conflicts of interest as follows: "The conflict of interest policy should set out a procedure for the disclosure of conflicts of interest to identified decision makers in the governance process and to beneficiaries where appropriate. The policy should guard against both actual conflicts and the appearance of conflicts of interest. There should be mechanisms in place to ensure that differences between the various interests represented on the governing body are appropriately resolved. A due process should allow governing body members unencumbered access to senior management and external advisors." (CAPSA, 2001:8)*

APPENDIX 2 CONTRIBUTION COLLECTION

> Collection, record-keeping and transferring contributions to individual accounts has often proved problematic in practice. Indeed, some reforms have been delayed or abandoned because of collection problems. (OECD Social Policy Division, 2006b)

This appendix discusses the advantages and disadvantages of various models for collecting premiums. Readers are reminded that the context for this discussion falls within a broader proposal that the retirement system in South Africa include the following elements:

- a pay-as-you-go defined benefit system with mandatory contributions and redistributive objectives, including the existing social grant safety net system, managed from the GSRF;
- a funded defined contribution system with mandatory contributions defaulting to the GSRF, but with the option for participants to opt out of the default in favour of an accredited private sector fund of their choice; and,
- a voluntary supplementary system, most likely defined contribution, under which contributions can be directed to accredited providers or to providers falling outside of the accreditation system.

Many of the arguments set out in this discussion are valid under variations to this mix, for example, a mandatory defined contribution system with centralised management and a private sector opt out, or without the involvement of a public-sector alternative to private-sector providers.

> Under a centralised system, a public agency is responsible for collecting contributions and distributing them to different agencies or funds. To do this accurately, the agency needs to identify each individual worker and the amount contributed. In a decentralised system, collection is the responsibility of each agency or pension fund, eliminating the intermediate 'clearing house'. In practice, there is a spectrum of options between these polar extremes. (Demarco & Rofman, 1999:11)

A key issue to be considered is how to collect the contributions paid into the second part, the mandatory defined contribution pillar. World Bank (2005) points out that there are two elements to this process, either of which can be centralised or decentralised, the gathering of data and the gathering of finances. Some form of centralised data collection and management is probably unavoidable, at the very least to ensure compliance with the injunction that contributions are compulsory. Whether financial flows should be centralised is a different matter entirely. That is the subject of this discussion.

Is there any need for discussion?

To some extent, the issue is not controversial. Contributions to an anticipated PAYG system must be collected centrally. It makes complete sense, then, for the same entity to collect the contributions that form part of the funded system and direct them to the providers selected by the members.

Reality is not quite as clear-cut as this.

- First, if the private sector is the more efficient collecting agency, why not have members send all of their contributions to the provider of their choice (defaulting to the public sector fund), leaving the provider to send on to the GSRF the pay-as-you-go element?
- Second, even if contributions are collected centrally, the question of whether they send individual contributions to private sector providers or bulk the contributions due to a provider is important.[109]
- Third, we do not have certainty on the broader design issues, as set out in the introduction to this discussion.

So the real issues are whether contribution collection should be centralised or decentralised and whether providers will have member identification along with the money that they manage.

It is noted, in acknowledgement of the point made at the end of the earlier quotation that, at the level of detail, other options could be considered. These variations are outside of the scope of this discussion.[110]

Assessing the options

This section starts with discussion of the issue of whether contributions should be collected through a public sector entity or through private sector providers. Demarco & Rofman (1999) suggest that the issue is clear in a PAYG system, but point out that the method of collecting contributions for other welfare systems should come into consideration as well.

> If these programmes are also centrally managed, but by a separate institution from the pension system, and also financed through payroll taxes, then either a centralised or decentralised option might be appropriate. A single agency could collect contributions and then distribute the revenue among the different agencies, or the contributions for each programme could be collected by each responsible institution. The choice should be based on efficiency, security and cost. (Demarco & Rofman, 1999:11)

They go on to suggest that the following factors should come into the reckoning of the policymaker:

1. **Economies of scale.** The opportunity for economies is high either where more than one system is dependent on revenues from taxes, or if the bases for personal income tax and social security contributions are similar. In both instances, more than one state agency is using a single collection system.
2. **Efficiency of existing collection agencies.** Weak collection systems may signal the need to establish a new collection system. The establishment of a new vehicle often brings with it the opportunity to utilise up-to-date technology. A number of countries, when designing their systems, took the view that existing systems were not up to the task and chose to delegate the premium collection process to private sector providers.

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[109] In reality, the collecting agency would wire the money in bulk anyway; the issue is whether the provider knows whose money it is and accounts for it on an individual basis or not.

[110] Details of implementation are also not considered in depth in this discussion. Refer to Demarco & Rofman (1999) for more information.

3. **Timing and speed of transfers.** One of the features of a funded pension system, usually unique among social structures, is that contributions are paid monthly and should be credited quickly to member accounts. This suggests collection by the private sector, shortening the chain of communication.[111]
4. **Control mechanisms.** A centralised system needs careful design, but a private sector system requires greater attention to the regulatory framework and supervisory interventions, such as regular reporting.
5. **Cross controls.** A centralised system provides the opportunity for various public-sector entities to work in co-operation with one another to increase rate of compliance. There are a number of potential problems with this, among them technical difficulties, data privacy issues and the possibility of lower overall compliance.[112]
6. **Incentives.** A decentralised system has better incentives to collect the contributions, since this affects its profitability. The corresponding incentives to design and operate an efficient system in the public sector may not be as effective as the simple profit motive.
7. **Enforcement power.** Enforcement is generally better in the public sector. Efforts to require private sector entities to report evasion are not without precedent but almost certainly have a lower success rate.
8. **Cost of the collecting scheme.** This issue does not present an easy answer. A decentralised system ought to be cheaper though its scale and the absence of risk and profit margins, but competitive dynamics in the private sector have the potential to drive costs lower. Also, social security institutions carry out a range of activities and some suggest that it is better for them to stick to one task rather than diversify into a number.[113]
9. **Financing collection.** For those who suggest that system participants should finance the collection of contributions, the decentralised approach automatically manages this while the centralised alternative can do so in theory, but with difficulty where it collects contributions for more than one agency.
10. **Corruption.** Centralisation has a strong potential to reduce corruption because information is shared by a number of different organisations, multiple public sector entities, for example, or alternatively the collection agency and the private sector providers to which if redirects contributions on behalf of participants.

For a particular country, this complex set of trade-offs is not easy to assess. Policymakers should make a candid, careful assessment of existing systems and structures as well as seeking to understand the costs and efficiencies of the private sector alternatives.

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[111] *Timing is definitely a problem in the Swedish clearing house system. Contributions are collected for both the public and private parts of the system at the same time (Settergren, 2001) but contributions may be credited to individual accounts only 18 months, on average, after they are received, primarily because of the need to reconcile employer reports with individual income tax filings (Sundén, 2004).*

[112] *If tax compliance is generally lower than the corresponding level of compliance to a pension system (in which compliance brings with it a clear benefit), linking the systems together might bring compliance in the pension system down to the level of the pension system.*

Analysis by FIAP (2006) of the collection costs under a number of Latin American systems demonstrates how difficult this assessment can be. The authors note that the costs reported – this is probably the key word – under the decentralised collection models are lower than under their centralised counterparts. They go on to explain this discrepancy as follows:

> … part of the potential advantages of the centralized systems lie in the lower costs for the employers and in the lower costs of crediting individual accounts assumed by the Fund Managers, which processes are not included in cost measurement as they do not fit into the definition of "collection" adopted for this study. Furthermore, centralized systems could lead to lower additional collection costs of the combined social security contributions. (FIAP, 2006:2)

The final part of this quotation is a reminder that consideration of the options must include the potential for economies of scale available from combining systems. With this in mind, a cursory assessment suggests that it would be difficult to establish a private sector collection system that is more efficient than its public sector alternative, given that

- the PAYG contributions surely require collection by a public entity, and that
- contributions to the funded system default to a public sector administration and investment entity.

If a PAYG system is not launched together with its mandatory individual account counterpart, then the argument for private sector contribution collection is stronger, particularly in light of the recommendation – see the discussion that follows – that accredited entities be held responsible for servicing their clients.

This demonstrates the complex interaction of philosophical and design issues that must be considered as part of a whole.

Private sector participation: wholesale or retail

Assuming that contributions are collected centrally, should private sector firms provide a retail service to individuals or a wholesale service to the GSRF? Blind asset allocation, under which asset managers are permitted no access to their list of customers, is used in a variety of countries, such as Sweden (Palmer, 2000) and Latvia (Fox & Palmer, 1999).

James *et al* (2001) show that, in the mutual funds industry in the United States, marketing takes around 43% of all fund costs, echoing a similar figure in the Chilean individual account system. Marketing can be described as adding some value to customers, but high allocations to marketing costs are probably not in the best interest of consumers. Reducing such expenses is often one of the priorities of policymakers around the world.

> From a social point of view, marketing probably provides a mixture of useful information, misleading information, an impetus to good performance, and zero-sum game raiding. The possibility of spreading favourable information by marketing probably acts as a spur to good performance and product innovation. *But most methods to keep IA [individual account] costs low involve a reduction in*

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[113] Studies of the US tax system show how badly it administers the earned income tax credit, routinely overpaying. The suggestion is that an entity primarily responsible for collection is not particularly good at managing outflows. Refer to General Accounting Office (1994) and Whitehouse (1996, 1997) for more information.

> *marketing expenses, under the assumption that much of it is zero-sum and not the most efficient way to provide useful information to new investors.* (James *et al*, 2001:16, spelling altered, emphasis in original)

The Indian authorities have been giving considerable attention to the issue of contribution collection in their reform process.[114] The draft discussion document of the IIEF (2004) sets out a rigorous proposal of the process for selecting private sector managers.[115] The document suggests that policymakers need to assess the advantages and disadvantages of blind allocation of assets, under which asset managers are permitted no access to their list of customers, against the alternative of direct access to customers. In both cases, policymakers also need to apply their minds to how to manage and regulate sale and marketing expenses and prevent potential sales and marketing malpractices.

The advantages of blind allocation, according to IIEF (2004) are:

- lower expenses of sales and marketing, since there is no direct access to customers,
- a lower exit cost in case of de-licensing, since lower intangible sales and marketing assets have been created, and
- a lower supervisory burden through a reduced need to regulate the sales and marketing conduct of providers.

Blind allocation would probably remove the need to establish accreditation standards, since South Africa also has a process for licensing financial institutions, with which the clearing house could then negotiate fees.

The disadvantages of the approach are the potential for

- insufficient marketing, creating the need for the regulator to provide enough information for participants to take informed decisions,
- the regulator to bear the burden for increasing system coverage,
- a complete absence of marketing effort, based on the assumption that all other providers would benefit, to some extent, from the marketing investment of any one of their peers, and
- cross-subsidy from existing to potential customers as existing members would have to bear the burden of all sales and marketing expenses.

The corresponding advantages of giving to providers lists of their customers are that:

- this permits offering loyalty discounts and other incentives to retain customers, potentially reducing overall system costs,
- it motivates providers to undertake marketing and education initiatives, under the protection of the overall charge limits for the system,

The disadvantages of this approach are that:

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[114] For a broad explanation of the motivations for reform see OASIS Foundation (2000) and Shah (2005).

[115] Supporting material is available in a second draft paper, IIEF (2006), which discusses the proposed framework for establishing the central recordkeeping agency, but is confidential.

- overall marketing costs might be higher than under the blind allocation alternative,
- larger regulatory resources may be required, and
- sub-optimal financial decisions by members is possible, resulting from the distorted incentives and information resulting from provider marketing efforts.

In consideration of the issue for the South African environment, one significant addition should be made to these lists. Contribution collection is just the beginning of the process of retirement saving. The payout phase can be more complex than the collection phase. As the products envisaged for this environment (see section 4.1) are expected to be administratively straightforward but allow reasonable flexibility of payout and the potential for some flexibility around the design of survivor benefits, it would seem appropriate to delegate to private sector providers the responsibility for managing the accumulated assets, communicating with customers and administering the payout phase.

South Africa has a sophisticated and administratively competent private sector financial services industry that should be able to manage the communication and payout processes with reasonable ease. Consumer protection is required through price caps and standards of disclosure and governance and this is designed to address concerns around system efficiency.

Finally, under the model being considered at present redirecting contributions to the private sector is not mandatory, it is optional. One of the motivations for effecting this redirection would be a higher level of trust in private sector entities, not only to produce higher investment returns, but to exercise greater care in the administration of the account, communication to clients and processing of payout requirements. This would be lost if the system put into place blind allocation to managers in pursuit of charge reduction at the cost of a number of other laudable objectives.

Case study: the United Kingdom

> … the core elements of a new personal accounts system will be automatic enrolment, a simple mechanism for collecting contributions and some centralised functions. However, there is one remaining issue – the administration of the accounts, on which we would like to consult further. The decision we take on this issue will depend, among other things, on the appropriate role for consumer choice in this area of retail financial services. (Department for Work and Pensions, 2006a:50)

This paper, by the UK government's Department of Work and Pensions (DWP), sets out some of the issues being considered by the policymaker in that country. During the consultation phase of this policymaking process, some suggested that individuals should be offered the choice of who should administer their pensions. Note that this concerns administration only: it is already accepted that contributions will be collected centrally.

Turner's Pension Commission recommended that all personal accounts should be provided by a single organisation, providing a single set of standards and contact point for participants, and that day-to-day running of the scheme would be outsourced to a number of pension providers.

An alternative to this approach is that a number of pension providers would offer personal accounts. This is roughly analogous to the suggestion in this paper that providers have servicing responsibilities towards their participants, making them administrators as well as asset managers.

The DWP paper sets out a useful set of questions for public comment. The same questions should be asked of the South African options and they are quoted below (Department for Work and Pensions, 2006a:54, formatting altered):

- Would offering a choice of branded provider add value for the consumer?
- Would a choice of branded provider give individuals greater confidence in the system and greater ownership of their accounts?
- What is the connection between type of choice and cost?
- On what basis would individuals make a choice of pension provider?
- What are the pros and cons of vertically integrated providers, offering both administration and fund management?
- With multiple providers how could charges be set in a way that encourages competition to thrive?
- Would it be possible to restrict the number of providers in the scheme to provide scale economies and drive down costs?
- In each approach what information would individuals need?

APPENDIX 3 AUCTIONS

There are a number of ways to reduce costs in a private or partially private system. Some of these approaches are explicit, for example the imposition of a price cap regime, but can introduce unintended consequences. Other methods, more subtle in their approach, push down prices through altering the dynamics of the competitive process. Disclosure is the simplest example of such an approach, though its effectiveness is not obvious.[116] The clearing house system of collecting contributions (see appendix 2) is another approach to reducing costs.

Another way to limit costs is to require providers to bid for a limited number of places.

Auctions in practice

Auctions have used in systems with limited scale potential, for example, in Bolivia where winning bidders were awarded a five-year duopoly and management of privatised state assets (Von Gersdorff, 1997). Charges under this system at inception were relatively low (less than 10% of contributions; Whitehouse, 2000b; Devesa-Carpio *et al*, 2003) but this is partly due to the subsidy of the additional assets.

The approach has not only been used in small systems. The Federal Thrift Savings Plan, in the United States, despite having 2.3 million participants and $65 billion in assets by 1998 deems cost important enough to auction the right to manage parts of the assets of the fund every 2 to 4 years. Total cost to members in 1998 was 0.11% of assets (James *et al*, 2001). This has been reduced still further to around 0.06% of assets, in other words $0.60 per year for each $1 000 of assets (Barr, 2006).[117]

India is in the process of reforming its pension system, compelling retirement saving in individual accounts first for employees of central government and then for civil servants in regional and local government. The hope is that the take-up of individual accounts among workers in the private sector will follow rapidly after that (OASIS Foundation, 2000 & Shah, 2005).

Given the expectation of very low average contributions to the system, it is important to keep costs as low as possible. Proposals set out thus far include establishing a Central Recordkeeping Agency to provide a single point for the collection of contributions, run by the private sector, and to limit asset management to six managers selected on an auction system, each required to provide three different

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[116] The disclosure system that backs the mandatory individual account system in Australia is onerous on providers. It is governed by the Australian Securities and Investments Commission, outside of the pension regulator, the Australian Prudential Regulation Authority. Despite high standards of disclosure, parts of the Australian system are among the most expensive in the world (Mitchell & Bateman, 2003; Rusconi, 2004).

[117] The auction is not the panacea that would reduce costs to these levels in all cases. The Thrift Savings Plan also simplifies administration by granting to members investment choice from only five options. Then, of course, the sheer scale of the operation permits very competitive bids for asset management

funds, distinguished by their risk characteristics and subject to investment limitations. One of these managers is to be a publicly-owned domestic entity.

The intention is to license a seventh manager once aggregate assets attain a certain level, and more thereafter, according to a similar system of asset thresholds, specified in advance of launching the system. Interested companies are to submit bids with specified technical and financial content, the latter consisting solely of a fee expressed in terms of assets under management. Managers may change their charges during the term of their tenure, but the “infra marginal bid”, the highest fee among the winning bidders, becomes the ceiling below which all managers must operate. This ceiling changes when the next round of bidding is completed.

The aim is to ensure scale efficiencies through:

- the process of price-based bidding for rights to participate;
- the and ongoing fee ceiling that then applies to the fees of the successful bidders;
- opening the market to providers in excess of the initial six only after it has reached a specified overall size; and,
- forcing the closure of providers whose market falls below a specified level, currently 5%.

Pros and cons

The main advantages of the auction system are:

- **Cost reduction.** Charges are cut from the average level that would apply to an open-market environment through the selection of the lowest bids (allowing for the impact of variations in the technical quality of bids), reducing overall costs to participants. The requirement to bid also focuses the minds of potential providers to the lowest possible price at which they are able to operate, cutting out all but the most needed margins in the fee scales for risk and cost.
- **Selection process.** All providers are subjected to rigorous screening and explicit assessment of technical capabilities. Since this happens once, rather than spread out over time as applications are received by the regulator in a conventional system without auctions, concentrated effort is applied to the quality of their bids, which should produce a better outcome.
- **Explicit criteria.** The auction provides opportunities for other criteria to be included in the assessment process, explicitly weighted and properly assessed.
- **Free of the risks of caps.** Though a set of price caps may result, as is proposed for India, these caps are determined by the operation of market forces. This contrasts the alternative price capping approach under which the ceilings are established subjectively by the regulator, which could introduce distortions and unintended consequences.

There are a number of disadvantages of the approach, including:

- **Process failure.** Auctions are not free of risk, particularly of collusion, and these would need to be managed. However, South Africa has recent experience of large secret-ballet bidding exercises[118] and should be able to put this experience to good use.
- **Oligopolistic behaviour.** The possibility of collusion does not end when the bidding is complete. A small number of providers would exert considerable power over a large and growing industry and would be prey to strong temptation to engage in behaviour not in the interest of customers. Prices may well move closer together once the bidding is over.[119] On subsequent bidding rounds, it may be very difficult for other providers to compete with the first set of winners, creating a type of perpetual "last man standing" monopoly.
- **Subsequent corporate activity.** The possibility of financial failure or predatory corporate activity further reducing the number of providers could worsen the problem of oligopolistic behaviour.
- **Financial instability.** Given that the bidding process would force providers to push prices as low as possible, financial collapse of over-ambitious providers is a possibility. A framework for transferring the members of a failed provider to the others (or automatically to the public-sector provider, the default) should be established, but the costs of this transfer might not be within the financial ability of the failed entity. On a related point, the quoted fees may be insufficient for successful bidders to undertake marketing, possibly denying the participants useful information.
- **Prices too high.** On the other hand, initial bids may be too high, as providers take a cautious line to the risks faced, even in the knowledge that caution reduces their possibility of winning a bid. The rules under which providers are required to operate after the bid will go a long way to limiting this possibility.

As this paper shows at great length, establishing a regulated environment for providers of services to a mandatory saving environment is not easy. This appendix discusses just one approach to ensuring that the market for such services operates as cost-effectively as possible. Auctions, carefully considered and executed, could produce an outcome that is in the best interest of all participants while establishing a competitive, profitable operating environment for successful bidders. The possibility should not be dismissed without serious consideration.

[118] The sale of the V & A Waterfront by Transnet and its pension funds in 2006 is a good example of a tightly run secret ballot bidding process.

[119] One way to address this possibility is for the terms of the auction to force a price guarantee from the bidder rather than allowing it to change its prices up to the limit emerging from the bidding after the term of service commences.

APPENDIX 4 SURVIVOR BENEFITS

Government recognises the importance of adding risk benefits[120] to retirement saving as part of an integrated approach to what might broadly be described as an income replacement strategy.[121] The intention is for the PAYG part of the Department of Social Development blueprint to include death and disability benefits as part of the standard set. Full treatment of this complex subject is rightfully part of a separate study, but the questions briefly posed in this section are:

- whether the mandatory defined contribution system should provide survivor benefits at all, and, if it does,
- whether this should be outsourced to private sector providers where members choose to opt out of the public sector default.

Related to this, if the answer to the first question is yes, is the issue of how the public-sector entity is to provide survivor insurance.

International examples

Most countries include survivor and disability benefits with the retirement system. A few examples are discussed in the list that follows.

- **Chile.** Providers are obliged to take out insurance for their members, covering both disability and survivor benefits, using a proportion of what is essentially their share of the contribution paid by the member. Ten per cent of salary, up to a ceiling, must be paid towards retirement, which protects the percentage of salary dedicated to retirement saving. Another three per cent is used to cover insurance premiums and the charges of providers.[122]
- **Argentina.** The corresponding system in Argentina is complicated by the PAYG system that remains in existence and takes in participant contributions. Benefits under the PAYG pillar are pre-defined.[123] Similar benefits are provided under the individual accounts system, but the accumulated

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[120] *The term risk benefits is used to describe the amounts paid to the dependents of a participant in the event of that participant's death, usually paid until the corresponding death of the dependent, and the amounts paid to a participant in the event of permanent disability.*

[121] *This oversimplifies the objectives that government seeks to meet in establishing a coherent old age policy. It seeks to provide some minimum level of provision to those that have no income during their working years. Hence we have a social grant system that is not primarily about replacing income. To the extent that unemployment insurance is a type of income replacement, it should also form part of the overall strategy, but it is usually considered a useful adjunct rather than a fundamental feature of what is essentially a retirement-disability-and-survivor system.*

[122] *Writing some time ago, Monika Queisser (1998) suggested that providers have found ways to reduce insurance charges, but generally keep the balance of the 3% as profit rather than passing it back to customers in the form of lower charges. Later writing by Acuña & Iglesias (2001) suggests that this dynamic had changed, quoting an average fee for insurance and charges of 2.3% of salary.*

[123] *"Disabled workers receive 70% of their salary before the disability and survivors receive between 50% and 70%, depending on the family structure." Benefits are reduced in the event that members have failed to participate in the system in the years prior to the death or disability. (Rofman, 2000:7)*

funds of the participant may be used by the provider to offset the capital cost of providing the benefits in the case of death or disability, protecting against the cost of over-provision.

- **Bolivia** also mandates contributions towards survivorship benefits, but integrates statutory systems commonly separated in other countries. Participants in this system contribute 2% of salary towards the provision of insurance for death and disability from common causes and a further 2% covers the cost of insurance for death and disability from work-related causes.[124]
- **El Salvador**, in common with the models used by many of its larger Latin American peers, requires the fund administrators provide specified levels of insurance cover within the overall fee that they are permitted to charge, 3% of salary since 2001.[125]
- **Croatia** is an example of a country that does not provide disability and survivor benefits under the second pillar. Citizens are protected against these risks through benefits payable from the PAYG first pillar. Compensation, however, is provided to disabled second-pillar members and the dependents of deceased members, in the form of an underpin involving a combination of first-pillar and second-pillar benefits (Anusic *et al*, 2003).
- **Latvia** included disability benefits in its notional defined contribution first pillar system, but established the benefits in a slightly different way to other countries. Disability benefits apply only to the working age period. Thereafter disabled participants receive the old age benefit, or, if higher than that, the disability benefit (Fox & Palmer, 1999).
- **Australia** is unusual in not mandating any survivor or disability insurance.[126] The first pillar pays benefits that start at a specified age, currently 61½ for women and 65 for men,[127] but no benefits in the event of disability or early death. The second pillar “superannuation system” requires contributions of 9% of salary towards retirement, but does not provide benefits in the event of disability or death prior to retirement. The decision of whether to provide for such events is left to the discretion of the individual, just as investment decisions during the accumulation phase and the form of benefits thereafter is also subject to considerable individual choice.

In many of the developed countries with multi-pillar systems, explicit provision for death and disability is not made by the State but is an established part of occupational or collective arrangements, but this is not necessarily co-ordinated with additional provision available through statutory structures.

In summary, disability and survivor benefits are very rarely excluded from pension arrangements and they form an explicit part of nearly all second-pillar mandatory individual account systems. The cost of insurance cover is usually met through additional contributions by the member, expressed as a percentage of salary, and either fixed by the policymaker or combined with the fee paid to the pension provider for administration services.

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[124] *In Chile, work-related benefits are provided from a separate system.*

[125] *Maximums in the early years of the system were higher than this to permit administrators to set up their systems and then gradually reduced as scale developed (Acuña, 2005).*

[126] *The primary source for this paragraph is Bateman & Piggott (2001), but the unusual absence of disability and survivor benefits has also been confirmed directly with a contact at the regulatory authority.*

[127] *The retirement age for women is being raised to 65 by 2014 (Bateman & Piggott, 2001)*

South Africa

This may be contrasted with the system currently in place in South Africa:

- Benefits are provided through occupational funds and supplementary private sector arrangements.
- In occupational funds, trustees usually select the level of benefit appropriate to the members, frequently having to manage upward pressure on risk benefit insurance costs resulting from the HIV/AIDS pandemic and the considerable complexity of paying out death benefits to the most appropriate recipient.
- In individual arrangements, cover levels are at the discretion of the saver and subject to considerable variation. There is a reasonable level of product comparability but this can be confused by the bundling of various types of cover. Underwriting requirements may result in sharply higher contributions or exclude individuals from cover altogether.[128]

In both group and individual arrangements, considerable variations exist in the level of cover and the definition of events giving rise to the payment of benefits. In comparison with standardised national arrangements in place elsewhere, solidarity is lower and administrative costs are higher, particularly in individual arrangements, where underwriting differentiates risks at a higher level of detail and increases costs. In common with all private sector arrangements, some expense on commission and other distribution costs is a feature of the system, and this is also more extreme in the case of individual arrangements.

There appears to be a very strong case for collectively provided minimum levels of protection for members of the retirement saving system, reducing system costs and increasing the potential for risk-sharing through principles of solidarity.

This could be introduced through the PAYG pillar, the individual account pillar, or a combination of the two. Redistribution is best achieved through the PAYG pillar and earnings-related benefits through the individual account pillar, which is also the best provider of additional risk cover. Further analysis is required to determine what would best meet match the objectives of the system and this is the subject of further study. For now, it is assumed that some level of disability and survivor benefits are provided through both parts of the system.

Opt out provision

The remaining question, then, is whether the insured benefit could be provided through accredited opt out providers. A number of advantages of such an approach can be identified:

- **Insurance experience and competitive pricing**. Insurers provide an important intermediation role, accepting and managing uncertainty through the application of shareholder capital and technical skills to an uncertain environment. While they do so in the hope of gaining a profit, competitive forces should keep the price-increasing impact of the profit motive under control. This introduces the risk of suffering financial difficulty or collapse, but prudential management principles keep the

[128] *Suppliers generally regard this type of business as characterized by fairly high profit margins.*

tendency to reduce prices in pursuit of business in check, limiting the possibility of financial difficulty to an acceptable level.

- **Administrative simplicity**. Allowing participants to opt out of a central arrangement into a product of their choice would seem to run the risk of increased complexity, but the reverse could also be true. Since providers will be managing retirement savings, allowing participants also to opt out of centralised provision of survivor benefits **to the same provider** may produce reduced complexity.
- **Servicing accountability**. Other parts of this paper (see appendix 2, for example) argue that it would be better to give to providers access to their member details in order to increase the responsibility to service these members effectively. This creates a mechanism for accountability that is supported by regulatory structures and the establishment of an ombudsman to manage participant complaints. Similar arguments could be used to motivate the inclusion of risk benefits with retirement savings in the hands of private sector providers.

A number of disadvantages would need to be considered as well:

- **Product cross-subsidy.** If benefit and savings levels are standardised and participants must opt out to the same provider for saving and insurance benefits, providers might find ways to cross-subsidise one product through the fees of the other. This has the potential to distort efficient market process, particularly where consumers are more sensitive to one price than to the other.
- **Cherry picking.** Free market pricing introduces underwriting expense and the potential for certain participants to be excluded from cover. The alternative is some form of price standardisation. This in turn introduces the problem of cherry picking. Whatever the basis used for standardised pricing, it divides the market into profitable and unprofitable individuals, opening the door to the very lucrative practice of picking the best customers. A risk equalisation fund is one way around this, but it is not easy to implement, not least because it needs to keep track of all possible risk factors, not only those actually in use for priding risks at the time of its introduction.
- **Conflict of interest potential.** If accredited providers of savings products are not required to bear the risk of the insurance products themselves, a huge interest in the insurance book of these providers is created, in turn establishing the potential for undesirable market practice. This is not an attractive scenario, but neither is the alternative.
- **Different skill sets.** The alternative model is that accredited providers of saving products must make available risk cover rather than contracting it out. This would systematically disadvantage firms with strong administration and investment skills but no insurance experience. Also, if providers are required to take on insurance risks, the range of potential providers is substantially reduced, potentially creating an environment similar to that which has given rise to the concentration of retirement annuity providers.[129]
- **Lower transparency.** Since providers are selling two different types of product, standardisation and comparability become more difficult to establish. Consumers are likely to have a lower understanding of the products that they purchase and may exercise selection less efficiently, in the

[129] National Treasury (2006) quotes the 2004 report of the Registrar of Insurance statement that the five largest South African insurers, excluding reinsurers, look after more than 76% of industry assets.

sense that they do not exercise their choices according to the product features that objectively matter to them.

- **Public-sector provider.** If members can opt out of a default to obtain survivor benefits, it stands to reason that the default should also provide such benefits. A state-owned insurance entity could introduce an additional set of problems to the environment as it could potentially take a different approach to the risks involved and gain unfair competitive advantages over its private sector counterparts.

These two short lists, incomplete surely, demonstrate a little of the complexity of the issues involved. Many of the disadvantages are concerned with issues of transparency, disclosure and the effectiveness of market operation. These should be managed as part of the rule set governing the entire opt out environment. Issues affecting the public-sector provider may be more acute in the area of risk benefits, but should also be managed through the broad approach to ensuring fair competition between the public sector entity and its private sector counterparts.

This suggests that, with sound approaches to mitigating the risks, it is feasible to permit opting out of death and disability benefits to private sector entities. The details need to be considered with care, but perhaps the best way to stratify risk is to provide a basic level of cover through a centrally managed system and allow opting out to private sector providers above this level, with pricing and underwriting on a free-market basis.

APPENDIX 5 ANNUITIES

When designing a pension system, policymakers often err in favour of focusing their attention on the build-up phase, the stage during which savings are accumulated, at the cost of consideration of the decumulation, or consumption, phase. This is usually appropriate, since design changes usually affect the accumulation phase with immediate effect but impacts on the decumulation are delayed.[130] But failure to plan for the payout phase could be detrimental if design features in accumulation lead to undesirable consequences in payout.

Analysis of the South African market

South Africa's annuity market is deep and well-developed. Rusconi (2006a) sets out a systematic analysis of the conventional annuity market, noting that:

- the evidence appears to support the view that the market is broadly competitive and provides, on average, good value to customers; and that
- pricing is generally transparent and inclusive, leaving providers no opportunity to cover costs or add to profits at a later stage in the contract;[131] but that
- with a few exceptions, individuals with a lower expectation of life are systematically disadvantaged by the pricing basis adopted by providers.[132]

He notes that it is the market itself that introduces this perverse disincentive to offer better rates to the poor, rather than the providers. He asks whether the only realistic alternative provider is the state and notes that, to the extent that it pays a guaranteed pension to a meaningful proportion of the population, it already provides a limited intermediation service, taking on longevity risk as it does so.

Rusconi's research covers only the guaranteed annuity market, so-called conventional annuities that pay an income that is guaranteed for life but does not increase. The same conclusions are not necessary valid for other types of annuity, those that increase at a fixed rate or at the rate of inflation, for example, and those that are tied in some way to the rate of return on underlying assets, the with-profit and unit-linked annuities.

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[130] In some countries, notably the Eastern European reformers, citizens above a certain age are forced or encouraged to remain members of the state social security system. Members of the newly-created individual account system are therefore exclusively, or on average, younger, and decisions about the design of the decumulation phase are not required with urgency.

[131] This makes a mockery of the argument from providers that, in the accumulation phase, they must retain the right to increases charges on administration in order to protect themselves against cost uncertainty. The same providers (generally) manage very long-term administration risks very well under annuity contracts.

[132] Pricing by age and sex is generally accurately carried out and a small number of providers offer special rates to smokers and very ill applicants, but there is no systematic allowance for the shorter expectation of life of low-income applicants.

Inflation-linked annuities provide the desirable feature of income that increases with the rising cost of living. However, more complex risk management and a scarcity of appropriate asset classes push down the value for money provided by these products.[133]

With-profit annuities suffer the difficulty of opacity, the open-ended flexibility of declared annual bonuses and absence of disclosure of the annual charge providing considerable flexibility to the insurer to recover losses resulting from mortality losses, which occur if an annuitant lives longer than expected, on average.[134]

Unit-linked annuities are potentially opaque as well. Theoretically, insurers should be paying out more than the annual return on the underlying assets, through rewarding the survivors by sharing out the profits to the insurer from the cessation of payments to deceased annuitants. It is not clear that they do so. It is quite possible for insurers to take advantage of consumer misunderstanding of the dynamics of the market to make a tidy profit and pay out good looking annual returns.

Intermediation: should insurers provide annuities?

> Can the private annuity market deliver? (World Bank 2005:162)

Rusconi takes the view that insurers are well-positioned to service this market, as they have

- the balance sheets to absorb… and
- the technical skill to manage…

… the financial risks associated with their intermediation. This doesn't mean that they do a good job of it. The issue of systematic bias against low-income annuitants has been noted, as has the potential for opacity on with-profit and unit-linked products. What it means is that insurers have the greatest capacity to manage the risks associated with the provision of annuities and that, were they to choose not to, others, at least in the private sector, would be unlikely to step into the breach.

This position is consistent with the view set out in this paper that accredited financial services firms should be responsible for servicing their clients and for managing their payouts.

This does not address the issue of value for money to the poor, where state intervention may be the only feasible option. The author recommends that consideration be given to establishing a public-sector entity responsible for providing annuities to all participants with an accumulation of saving at retirement below a given level, with no option for opt out. Such an entity would not interfere in the appropriate pricing of the more lucrative upper end if the market can be clearly delineated into two segments

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[133] James & Vittas (2000) calculate that index-linked annuities offer money's worth ratios some between seven and nine percentage points lower than the corresponding ratios for flat annuities.

[134] With-profit annuities invest in a mix of assets and pay out declared bonuses that are related to the return actually obtained under those assets but are never less than zero and sometimes provide index-linked returns. Providers seldom disclose the returns gained on the underlying assets or the charge for providing this guarantee, making proper analysis of these products extremely difficult. Unitized annuities provide annual returns in line with the investment returns of the underlying assets, often providing flexibility to the annuitant regarding how the assets are invested.

according to the level of accumulated savings at retirement. The potential for gaming by participants close to the divide between these two markets needs to be considered with care.

Standards for annuity providers

Can every accredited firm provide annuities? What should be required of annuity providers?

The requirements for selling annuities are not the same as the corresponding requirements for managing accumulated assets. Asset accumulation does not involve the same level of financial risk or require the pricing and investment skills needed for providing annuities with reasonable margins for safety.

Firms licensed to provide administration and asset management of mandatory savings should therefore not automatically be permitted to sell annuity products. Accreditation of annuity providers falls under the licensing requirements of the Registrar of Long-term Insurance and should continue to do so, subject to ongoing review of the technical requirements of these firms and prudential regulation of their reserves.

This suggests that some accredited providers of administration and asset management services in the mandatory accumulation phase will also be providers of annuity products and some will not. Those firms providing both sets of products should not be provided a systematic advantage over those who do not. This is because the products require very different skill sets and firms that are able to operate in both markets should be required to compete, on an equal basis, with their peers in each market.

This suggests that retirees should be able to exercise their right to purchase an annuity from any provider – referred to often as an "open market option" – rather than being tied in to purchase an annuity from the company that has managed the accumulation up until that time. In fact, they should be encouraged to do so.

The rationale for this open market option is strengthened by the empirical evidence that annuity prices are volatile, moving considerably from provider to provider, even from one month to the next.[135] Any restrictions on the set of annuity providers could have a significant detrimental impact on the annuity price obtained by the annuitant.

Consideration has been given to the possibility that every provider of annuity products should be required to provide a full range of products. This would not be appropriate because it may force providers to take risks that are imprudent, potentially affecting the firm and its clients. However, a degree of standardisation should be required of providers to make product comparison easier.

[135] This unexpected phenomenon is not limited to South Africa. Prices in the United Kingdom market, the world's deepest are similarly subject to unexpected variations, despite the overall competitiveness of the market (Mackenzie, 2006; Cannon & Tonks, 2006) and research in the United States shows similar price spreads (Mitchell et al, 2001).

The following suggestions should be explored:

- Any provider selling annuities with fixed increases must make available a product with increases of, say, 3% a year.[136]
- Joint life and survivorship annuities, which pay at a reduced rate to the surviving spouse of the original annuitant, must be available at a rate of 50% of the original annuity, and separately at a rate of 75% of the original annuity.
- With-profit annuities, which typically offer a range of implied discount rates, giving purchasers the choice of taking more up-front in return for lower annual increases, if they are sold at all, must be available at an implied discount rate of, say, 3%.

Index-linked annuities

Finally, suppliers should be strongly encouraged to make available index-linked annuities. No other annuity provides complete protection against the two most important risks after retirement:

- the risk of outliving one's assets, and
- the risk of financial loss as a result of income failing to keep up with prices.

Concerns have been raised that index-linked bonds are available in insufficient quantity to make the purchase of such assets cost-effective to providers, and their clients. Government should be encouraged to continuing issuing more index-linked bonds to support its policy objective that individuals be protected in retirement against the effects of inflation. Ways should be found to encourage the private sector to follow suit. Few countries seek to protect its citizens against inflation more effectively than Chile, where guaranteed annuities are not available without inflation protection and the primary monetary unit in the pension system is index-linked.[137]

Difficulties in selling the products at value-for-money ratios as high as for conventional flat annuities have been noted. These problems would be reduced by keener demand, itself stimulated by better supply, and by addressing the issue of the thin market in index-linked bonds.

Compulsory annuity purchase

It is extremely difficult for an individual to assess correctly their options at retirement, trading off the benefits of longevity insurance (through annuity purchase) against the potential for higher investment returns and the bequest available on early death (if an annuity is not purchased). Even experts find it hard to agree on the correct decision under a specified set of circumstances. Changing investment conditions do not make the trade-offs easier to assess. In the case of a postponed annuitization, the slowly shifting dynamics brought about by an individual's increasing age only complicate the matter further.

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[136] *The rate could be modifiable by instruction of the Registrar of Long-term Insurance to reflect changes to current conditions and could be extended to more than one rate.*

[137] *The UF, or unidad de fomento, is the monetary unit for all pension payments and is indexed to the consumer price index.*

It is thus not surprising that determining whether the authorities should force participants to purchase an annuity at retirement is fraught with complexity. Policymakers should take care to consider the full range of issues impacted by this decision – forcing every participant to purchase an annuity can have a profound impact on the pricing of those annuities – to avoid exposing annuitants to unforeseen harmful consequences (Rusconi, 2006b).

Living annuities: the income drawdown alternative

Living annuities serve to complicate the issue yet further. They ought not to be defined as annuities at all because they provide no longevity insurance; they simply provide a vehicle for accessing accumulated retirement capital in a controlled manner. Customers facing the choice are often subject to the perverse incentives of intermediaries who recommend them in preference to conventional annuities because they receive some asset-based income. Intermediaries are also unlikely fully to comprehend the risks involved in income drawdown products.

Whether and how to offer living annuities must come under the careful consideration of the policymaker. One option is to allow some flexibility to cater for individual circumstances and the growing incidence of phased retirement but to mandate the purchase of longevity insurance for a specified minimum proportion of retirement saving at or before a given maximum age, say ten years after the normal retirement age.

APPENDIX 6 AUSTRALIAN CASE STUDY

This paper does not have room for detailed descriptions of a number of national systems, but recent information emerging from the Australian environment provides interesting lessons for South Africa.

Among OECD countries, Australia is unusual in a number of respects:

- prior to the reform citizens did not enjoy high levels of coverage either in occupational plans, defined benefit or defined contribution, or under state social security (Gordon, 2003), and now,
- Australians depend very heavily on mandatory advance-funded individual accounts, as by far the most significant vehicle for retirement saving.

This makes the Australian Superannuation system – simply 'super', as it is sometimes known – one of the cleanest examples of a mandatory account system introduced into an environment with limited pre-existing infrastructure, and for that reason, a very important research environment.

In a very short time, the country has established a large retirement industry. Five broad types of retirement entity exist.

- **Master trusts** are multi-employer arrangements that provide both retirement and risk benefits. Profit-motivated and distributing mainly through commissioned sales channels, master trusts also welcome individual members. The largest master trusts have hundreds of thousands of members.[138]
- **Industry funds**, so-called because they grew out of the industry-wide and union-based arrangements of the past, have been until recently closed to the general public, but now offer a not-for-profit inexpensive alternative to master trust arrangements, usually with limited flexibility. Large industry funds also have huge membership, many of them outdoing the master trusts.[139]
- **Occupational** arrangements continue, most of them defined benefit, but are on the decline.
- **Public sector workers** are covered under separate schemes.
- **Self-managed Super Funds** and arrangements for small groups of employees that are attractive to members proliferate because of the freedom to members to direct retirement savings as they choose.

The table below sets out the significance of each of these arrangements.

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[138] Chant West (2004) reports AMP membership of 680 000 and MLC membership of 340 000.

Table A1. Australian industry segments

	Funds	Member accounts ('000)	Total (A$ bn)	Assets Per fund (A$m)	Per account (A$'000)
Corporate (standalone)	555	606	52.4	94.4	86.5
Industry	91	9 793	150.5	1 653.8	15.4
Public sector	44	2 899	152.0	3 454.5	52.4
Small funds	326 641	627	214.8	0.7	342.6
Retail (master trust)	192	14 974	298.4	1 554.2	19.9
Other	n/a	n/a	43.9	n/a	n/a

Source: Rice Warner (2007:12), data from the Australian Prudential Regulatory Authority as at 30 June 2006. "Other" refers to superannuation amounts included in life office statutory funds that APRA has not attributed to fund type.

The Australian environment is puzzling because of the wide range of fee ratios across different types of providers. Whitehouse (2000b) calculates the difference in annual reduction in yield[140] between master trusts, 1.91%, and industry funds, 0.51%. Chant West (2004) provides figures for each of the largest providers that demonstrate a similar quantum of difference between master trusts and industry funds as those calculated by Whitehouse.[141]

Mitchell & Bateman (2003) echo these figures and demonstrate the impact on cost of, on the one hand, retail against employer-sponsored funds, and on the other, small and large groups of customers. Chant West (2003) echoes this sentiment. These figures suggest that average group size goes some way to explaining differences in charges. Table A1, however, shows that these relationships could not explain the empirical differences in the charges of master trusts and industry funds.[142]

Then again, not all researchers agree. Rice Warner figures suggest that wholesale master trust plans – it defines plans as large if they have more than A$5million in assets – actually charge less than their industry fund counterparts. The report goes on to suggest that, while small funds charge considerably more than industry funds, the differences are not as great as those quoted by Whitehouse and have not been for some time (see Table A2).

The differences are not easily resolved, but they need to be examined if their sources are to be understood. A clue may lie in a note to the calculations set out by Chant West (2004) to the effect that advisors are assumed to receive a fee of 2% up front and what it refers to as standard trail fees. The analysis of Rice Warner, which considers all actual expenses, suggests that advisors are not receiving fees as high as this. Furthermore, these fees appear to be falling. The cost of advice, as a percentage of

[139] Membership of 700 000 for Sunsuper, 550 000 for ARF and 450 000 for STA is reported by Chant West (2004).

[140] The reduction in yield is the percentage point reduction in annual return over the period of saving that is equivalent in overall impact to the erosion of value due to all charges.

[141] Chant West (2004) calculates reductions in yield for four large master trusts that lie between 2.07% and 2.43% and corresponding figures for the largest industry funds of between 0.67% and 0.71%.

[142] The master trust community achieves higher average account balances and almost as high a level of assets per provider as its industry fund counterpart.

assets, to large corporate master trusts has fallen from 0.10% in 2004 to 0.02% in 2006. The corresponding fall for smaller master trusts is 0.50% to 0.46% and larger falls have been noted for personal superannuation products and retirement savings accounts.

Table A2. Trends in Australian charges for selected segments

			Expense rate (% of assets)		
			2006	**2004**	**2002**
Wholesale	**Corporate**		0.78	0.75	0.86
	Corporate Super Master Trust	> A$5m	0.81	1.14	1.24
	Industry		1.13	1.18	1.23
	Public sector		0.70	0.66	0.63
Retail	**Corporate Super Master Trust**	< A$5m	2.01	2.11	2.36
	Personal Superannuation		2.12	2.30	2.41
	Retirement Savings Accounts		2.30	2.30	2.30

Source: Rice Warner (2007:5).

Longitudinal studies in Australia are important because regulatory changes have recently been introduced. In the middle of 2005, members were permitted to select their provider – previously only the employer could make that choice. Furthermore, licensing requirements have been tightened. Mandatory licensing of trustees was introduced in mid-2004 with a two-year transition period. The requirements are fairly substantial and expected to lead to some industry consolidation.[143]

A detailed assessment of these licensing requirements must form a key part of the next stage of the assessment of accreditation standards in South Africa.

Asher's (2004) examination of the substantial cost differences concludes that distribution costs are the main cause of the differences between master trusts and industry funds, but not the only one:

> The higher costs of retail funds can be explained largely by the costs of distribution. While the distribution system also offers advice to members, much of it appears unnecessary. There appear also to be a number of conflicts of interest and instances of excessive charging. Some of the distribution costs, and what looks like a greater amount spent on the administration of self-managed funds, arise from the complexity of the tax and social security codes and the many opportunities for avoidance. Investment management charges also appear to be high relative to the underlying costs. This is difficult to explain as the costs are clearly disclosed, and there is significant choice and competition in this area. (Asher, 2004:27, paragraph breaks removed)

His paper is worth examination by readers interested in the dynamics of the Australian system and the lessons that might be applied to South Africa, particularly as the non-profit industry funds sector presents a number of characteristics that would make it effective in our environment.

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[143] *These comments were provided by Merrie Hennessy of the Australian Prudential Regulatory Authority in e-mail correspondence with the author.*

Table A3. Trends in market mix in Australia

	Number of entities			Assets under management (A$ bn)		
	2006	2005	2004	2006	2005	2004
Corporate	555	963	1 394	52.4	52.5	50.5
Industry	91	92	115	150.5	119.8	94.0
Public sector	44	43	41	152.0	128.6	112.1
Master trust	192	226	235	298.4	242.6	207.5
Small	326 641	309 546	289 132	214.8	175.2	138.8

Sources: APRA (2006a:11, 2006b:16) and Rice Warner (2007:12) quoting APRA data.

What can we tell from the available evidence?

- **Charges do not appear to have fallen significantly.** While charges appear to have come down sharply in certain industry segments, like the provision of advice, the same is not necessarily true of the industry as a whole. Rice Warner points out an overall fall in industry average fees over the last two years from 1.30% of assets annually to 1.26%,[144] but this does not seem particularly impressive in the face of an increase in total assets from A$625 billion to A$913 billion. Some sectors seem to be more competitive than others and the intermediary community appears to be taking a sizeable share of the reduced fee income, but the overall figures have fallen only marginally, on much higher assets under management.[145] It is suggested in Australia that one-off expenses associated with regulatory compliance may have damped the fall in charges that would otherwise have taken place.
- **Consolidation is indeed taking place.** Except for small funds, the number of providers is falling, particularly industry and master trust entities (refer to table A3). There is also just a hint of growing pressure on master trusts to be the benefit of industry funds. Even though master trusts experienced a slightly greater increase in membership between 2005 and 2006 than industry funds (4.7% against 2.6%) the master trust sector consolidated in numbers while industry funds did not.[146]

Charges are probably not as low as the authorities would like them to be and focus continues to be laid on implementing the multiple objectives of improving the security of retirement saving and motivating consumers to obtain the information and act in a way that maximizes their benefit. The market dynamics in Australia, as in any country, are complex.

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[144] The press release put out by the Investment and Financial Services Association, which commissioned the research, is up-beat about the results: "This year's report assesses the industry just one year after the introduction of Superannuation Choice and clearly shows that, competition and increasing FUM [funds under management] is putting downward pressure on the average fees across the Super industry." Examination of the evidence suggests that euphoria would be a little premature.

[145] This illustrates the potential for confusion in the area of charges. If the analysis had focused on charges as a proportion of contributions paid, it may well have come to completely different conclusions that charges are in fact rising.

[146] The growth in assets under management in the year to 30 June 2006 was 23.0% while the corresponding growth for industry funds was 25.6%. This results from a combination of shifts in membership profile and the asset returns emerging from different asset mixes, so reading too much into this trend is cautioned against.